Enhancing the competitiveness of EU capital markets

1. The concept of competitiveness for EU capital markets

The Chair stated that the topic of competitiveness has been at the forefront of many recent discussions and declarations in Europe. In September 2023 the German and French finance ministers published a paper emphasising the importance of considering competitiveness in the capital markets framework in order to ensure that European businesses can find adequate financing in the EU and strengthen the EU's position in the global financial market. What competitiveness means for services markets and for financial markets in particular can be challenging to define however.

A regulator stated that competitive markets are markets that operate effectively, which makes them attractive to firms and investors. Effective competition is also important as it may foster the growth of players that can compete on a global basis, but competitiveness and competition are different notions.

Answering a question from the Chair about the importance of competition for the competitiveness of EU capital markets, an industry representative stated that there is a cause and effect relationship between the two. Effective competition delivers competitiveness by making the market ecosystem more competitive, and the competition within that market also means that globally competitive players can develop. Competition also contributes to bringing down costs, raising service levels, and increasing choice for people using the market, which makes the market more attractive, both internally and externally. Trading is a good example of an area where competition has flourished in the EU. There is also quite an effective competition at the clearing level in the EU despite the number of central counterparties clearing houses (CCPs) operating in the EU.

A second industry representative argued that competitiveness and competition are different notions. Competitiveness is a focus on the EU's own attractiveness towards investors and issuers, whereas competition is a focus on the outside i.e. competition with financial players from other jurisdictions. The two are however related because attractiveness is relative. For example, T+2 settlement currently works well for the EU, but the fact that the US is moving to T+1 challenges the EU's competitiveness and leads the EU to reconsider its standards, because it is effectively competing with other jurisdictions. Competition creates an edge in terms of competitiveness that the EU can compare itself to and benchmark against, and acts as a stimulus because issuers and investors compare different regions. Competition is a trigger to the EU's own competitiveness.

It is also important to have a holistic approach to the competitiveness of capital markets, considering the different trading, clearing and settlement layers and interactions with market participants.

Answering a question from the Chair about the compatibility of the objective of attracting more capital to the EU and the open strategic autonomy ambition of the EU, the industry speaker noted that it is important to identify where autonomy is needed and where openness is needed. Autonomy is needed in areas such as the energy market, payments and vaccines, but for funding growth and innovation it is necessary to attract sufficient money from outside the EU, which requires the EU to be open in order to facilitate the circulation of capital. An 'open' strategic autonomy is therefore needed for ensuring competitiveness.

A third industry representative agreed that clarity is needed on what competitiveness means in practical terms. For a market to be competitive it needs to be deep, liquid, and to facilitate efficient risk transfer. A healthy and diverse ecosystem of market participants is also important. In terms of market structure, a balance is needed between allowing sufficient competition and consolidation in order to achieve a critical mass of activity in the market that is able to draw in capital flows from the outside. This remains a challenge in Europe.

A fourth industry representative emphasized that competitive capital markets are essential for financing growth and innovation. Solely relying on bank financing and family savings, as is often the case in the EU for SMEs, could inhibit that. If the EU lacks a strong capital market at the regional or local level then companies requiring that type of flexible and long term financing will look elsewhere.

2. Current level of competitiveness of EU capital markets

An industry representative noted that capital markets remain under-developed in Europe, with companies typically borrowing 75% of their debt from banks and 25% through the debt capital markets. In the US it is the reverse. One issue with the general reliance of EU firms on banks is that it absorbs funding capacity that could be going into SMEs.

One area where Europe has a clear strength, the industry speaker stressed, is its leading position regarding ESG products. The European ESG capital market represents roughly 41% of global issuance, which is much higher than the overall EU share of global capital markets. The main weakness of the European capital market is its fragmentation, as seen in the number of listing exchanges, CCPs and central securities depositories (CSDs) that the EU has compared to the US: 31 listing exchanges compared to 3 in the US, 17 CCPs compared to 1 and 22 CSDs compared to 1. This structural fragmentation compounded by legal and fiscal fragmentation and the lack of a common supervision, is a barrier to the development of EU capital markets.

A second industry representative highlighted that what must be avoided is redundant fragmentation. Effective competition can lead to more complexity and more players operating in the market, but it delivers benefits, as seen in the trading space and the central clearing area where new pan-European offers have developed. In some cases however there is fragmentation without benefits from competition, which leads to additional costs. This is the case for CSDs. Trading across Europe requires accessing a large number of CSDs, creating extra costs and no competitive benefit. Liquidity is also fragmented in the exchange traded fund (ETF) market because of local practices and the settlement of trades in different local CSDs which makes these products non-fungible across Europe, although they are effectively the same instrument.

A third industry representative noted that the comparison between the EU and the US can be misleading. It is true that the US has only one CSD, but the US is one country and has a market that is structured to serve one country, whereas the EU is comprised of 27 countries. The EU can improve its competitiveness and integration but will never be one country. That is acceptable, because investors and issuers are not looking for the same opportunities as the US. The EU needs to build its differentiation in the market and sell it better to outside investors and issuers.

A fourth industry representative observed that there has been some improvement in the EU market since 2010, but liquidity volumes have effectively stagnated, particularly in the equity and index options markets. In the same time period other jurisdictions have grown twofold, fourfold or even sixfold in these markets. There is a real cost to fragmentation in Europe, which results in shallower liquidity and fragmented liquidity pools leading to less efficient risk transfer for end users. It is necessary to overcome that fragmentation and reduce the cost of fragmentation baked into the pricing that a liquidity provider is able to offer to the market, which impacts end users and investors and reduces the attractiveness of the EU market.

This fragmentation also increases complexity for institutional investors, with effectively the same ETFs being listed on 25 different venues with different post trade setups. Fragmentation also impacts issuer choice, because they are looking for a vibrant secondary market that supports a primary listing market. For retail investors the issue is more a lack of equity culture and awareness about the need to save for retirement using capital market instruments.

The Chair noted that further consolidation and critical mass would be beneficial in certain areas of the financial system, but not necessarily in all parts. For example competition in the trading area is healthy and has benefitted investors.

3. Expected impact of the CMU reforms underway

Several panellists emphasised the expected impacts of the Capital Markets Union (CMU) actions underway.

A regulator noted that MiFID has fostered greater competition across Europe in the provision of services to investors and in the interaction between trading venues. In the fund management area the UCITS and AIFMD directives have become globally recognised brands and have made Europe competitive in that area. The measures proposed in the latest CMU action plan and MiFIR review will likely contribute to enhancing the competitiveness of EU capital markets further. Consolidated Tapes (CT) and the European Single Access Point (ESAP) will provide information about EU companies and securities transactions in a central location, which will facilitate access and the comparison between instruments and issuers. The Listing Act that has been agreed may also help to enhance competitiveness, making European markets more attractive for innovative and growing SMEs.

An official agreed that the MiFIR review should allow significant progress. CTs will increase transparency and make EU bond and equity markets more competitive and transparent. ESMA has the responsibility of getting the calibration right and selecting the right candidates to set up the service. ESAP is also important, and a balanced result has been achieved on the EMIR 3 proposal. There is also a strong political momentum behind the CMU initiative more generally. Support has been expressed for the CMU by the German and French Ministers and a statement of the Eurogroup on the future of CMU will be published in March 2024 outlining priority areas for action.

An industry representative agreed that significant work has been done on the CMU, which should contribute to enhancing the competitiveness of EU capital markets. In the last 10 years there has been reform of trading, clearing, settlement and market conduct, and a harmonisation of capital market rules. The CT should also help mitigate and tackle the fragmentation of European markets. Much has been done to make progress on the CMU, and this accomplishment must now be sold to foreign issuers and investors.

Another industry representative concurred that CT, ESAP and the EU Listing Act are great developments that should be celebrated. ESAP has the potential to become a proper single access point for information, improving transparency to potential investors and enhancing the attractiveness of EU capital markets. However, more needs to be done in terms of market integration to achieve the CMU because the market infrastructure will remain significantly fragmented despite these actions, which ultimately has a cost and impact on the attractiveness of EU capital markets.

4. Further measures needed to enhance the competitiveness of EU capital markets

4.1 Reducing fragmentation in the EU capital market

A regulator stated that more needs to be done in a number of areas of the regulatory framework to enhance the competitiveness of EU capital markets. A strong regulatory framework and well-designed rules are essential for the competitiveness of the market, including having clear unified rules that are applied in a consistent way. There is still too much fragmentation in the rules and too much national discretion in terms of implementing those rules in national law, despite the efforts made to achieve a single rulebook.

The regulator also emphasised the importance of having more regulations rather than directives in the European framework in order to move towards a single rulebook. However, a single rulebook will be difficult to achieve so long as supervisory implementation and application differ across member states. Financial regulation is also influenced by aspects that are outside the field of financial regulation and EU competencies such as taxation and pensions. The Chair agreed that moving all directives into regulations would be a good start to reduce fragmentation.

An industry representative concurred that the lack of a common regulatory platform and common supervision in Europe is an obstacle to CMU. While the ECB has become the single supervisor for the largest European banks, this is not the case for ESMA. An evolution of the mandate would be needed.

A second industry representative agreed that while the EU currently has a single rulebook in name in many areas, it is not applying it as such. The single rulebook must be enforced by a single supervisor or a single system of supervision under the auspices of ESMA. Reacting to a remark from the Chair that harmonisation has progressed in certain areas of the rulebook such as pre-trade waivers or IFRS supervision, the industry speaker acknowledged that consistency in the application of the single rulebook differs across measures and sectors. Product intervention is the area with the biggest divergence between member states, with differences in the way suitability for retail investors is assessed. This is detrimental for retail participation. For example, there is no common view on the suitability of listed products compared to bilateral ones, which has led to transparent listed products being banned alongside non-centrally cleared and opaque bilateral products in some cases.

Another area of divergence is the application of MiFID, the industry speaker emphasized. The conduct of business rules are the same, but the national competent authorities (NCAs) apply the rules in slightly different ways and with slightly different requirements, which raises the costs and complexity of cross border activity. A single application of these common rules is needed. A further issue is that the EU does not need 27 separate ecosystems that all provide the full value chain of capital markets. Domestic markets are needed but not all member states need to have a fully developed financial centre.

An official added that it is also important to give market participants the possibility to consolidate and increase their competitiveness. That should be driven by market forces and not regulation.

4.2 Competitiveness checks and mandates

The Chair noted that proposals have been made to introduce competitiveness checks of new regulations before they are implemented or a competitiveness mandate for EU supervisors and regulators. How that may be structured and made operational considering the peculiarities of the different sectors and the different mandates of supervisors and regulators needs further considering. The Chair asked the panellists if there is sufficient emphasis on competitiveness in the rule-making and implementation process in Europe, and what further measures may be needed.

A regulator agreed that taking care of competitiveness in the rule-making and implementation process is extremely important. Regulators need to examine what the impacts of regulations are on the competitiveness of Europe in the wider global market. There is already a recital in the ESMA regulation that says it has to consider the impact of its activities on the EU's global competitiveness. However, the primary focus at the supervisory level should be on the core objectives of financial stability, orderly markets and investor protection. If competitiveness is added at the same level alongside those objectives, that may create potential conflicts and confusion. Where competitiveness is most important to consider is at Level 1, because there is less flexibility to adapt rules at Levels 2 and 3.

An official concurred that financial stability is the cornerstone of the financial supervisors' mandate, which is also true for financial regulators. However it is also important to ensure that the ecosystem remains competitive, while guaranteeing financial stability. Both objectives are important.

An industry representative observed that legislators and regulators always struggle with how to enshrine competitiveness in the legislative process and the resulting regulation. ESMA and the NCAs can be given a competitiveness mandate, but the question then becomes how to measure it. Outcomes need to be periodically examined. What needs evaluating is whether the CMU is able to deliver capital to EU firms for growth and innovation, and whether it can provide savers with adequate returns, rather than evaluating impacts on the market microstructure. This evaluation should take place every 6 months and have an EU-level perspective to avoid 27 different perceptions. Another aspect is whether regulation is able to enhance the EU capital market ecosystem, increase bridges between member state markets and reduce market fragmentation. Retail is the area where it is hardest to have an impact from top-down EU level measures, because so many aspects of the retail market are enshrined in national legislation and taxation.

Another industry representative noted that regular reviews of existing regulations are performed, where time is taken to reassess whether they are still fit for purpose, which is an opportunity to reassess the impacts of regulations in terms of competitiveness.

4.3 Improving regulatory and supervisory agility

A regulator stated that a more agile rulemaking process is needed to support market competitiveness. Changing Level 1 requirements currently takes four or five years, which can be detrimental for the EU's competitiveness, if rules need to be adjusted to new market developments. An ability to deal with unexpected market circumstances through the use of no action letters for example could contribute to improving the agility of the rulebook. An industry representative agreed that the ability to issue no action letters is important.

An official concurred that improving the agility of rule-making is important. Currently, changing rules and evaluating the feasibility of doing so takes too long. It is necessary to find ways to provide supervisors with more flexibility in this regard, particularly the European authorities.

4.4 Increasing incentives for market participants

An industry representative emphasized the importance of proper incentives to encourage market participants to engage in the capital markets, rather than mandating their participation. That will drive volume and innovation in the market, supporting the growth of domestic and non-domestic businesses and allowing them to compete globally.

Another industry representative observed that policies should create the proper incentives for market participants to join the market and support an effective ecosystem aligned with these incentives and policy choices. The Chair remarked that the success of the development of the Swedish market was driven more by actions to improve investor awareness and equity culture, develop pension funds and strengthen the ecosystem, than by financial regulation.

The industry representative agreed that different aspects are important for ensuring the competitiveness of the EU capital market, beyond a strong capital market regulation, which is a necessary but not a sufficient condition. Besides incentives to attract market participants, pension regimes and a strong ecosystem, non-financial tax and corporate rules including withholding taxes for dividends, insolvency law harmonisation and takeover law are also important.

An official noted that incentivising investors to buy sustainable ESG products and exporting that asset class to other jurisdictions is essential and requires reducing the complexity in the EU sustainability framework. It is difficult for retail investors or institutional investors to understand what Article 8 and Article 9 funds represent, so the Sustainable Finance Disclosure Regulation (SFDR) review in the next legislative cycle should be used to reduce the complexity of the sustainable finance framework.

4.5 Developing private pensions

An industry representative stated that reforming Europe's pension systems is a priority for developing EU capital markets. There is a dearth of long-term capital, and most pension savings in Europe are in pay-as-you-go systems that do not accumulate capital. 34% of household assets sit in cash deposits with banks, which could be channelled into the capital markets though private pension contributions or pension funds. 62% of funded European pension assets are concentrated in Sweden, the Netherlands and Denmark. There should also be a greater role for private pensions with auto-enrolment mechanisms in the EU.

The Chair agreed that the role of pensions must not be overlooked. The difference in the amount of investable assets is one of the main differences between the US and EU capital markets.

An official highlighted the importance of establishing and incentivising larger pools of long-term capital, as it is one of the key triggers to enhance the CMU. That requires strengthening pension schemes that work on an asset accumulation basis. Germany is going to establish an equity based pool for its pension system, as well as strengthen its second pension pillar and attempt to reform its third pillar for private pensions.

An industry representative noted that it is important to also be honest with European citizens about pension gaps. Greater awareness about this should create incentives to participate earlier in the capital markets than is the case at present.