Attractiveness of EU capital markets for issuers and investors

1. Challenges that hinder Europe's capital markets attractiveness

1.1 Inadequate funding of growing companies in the EU

An industry representative stated that Europe has a relatively high number of successful and innovative private companies in different sectors, which are very important for addressing the key challenges ahead, such as the energy transition and healthcare challenges. To support their growth, they need to be adequately capitalised at key stages of their lifecycle, possibly leading to an initial public offering (IPO).

Currently, many home-grown European companies look outside the EU, and in particular to the US, for this capital and for a listing. There is a perception that higher IPO valuations can be achieved in the US than in Europe. Companies also look for a broad and deep investor base, combining institutional and retail investors, which is more readily available in US markets, where retail participation is higher than in the EU. High-growth companies also seek financing at various stages before going public, which requires a well-developed and vibrant ecosystem of venture capital, private equity firms and institutional investors. Further action is needed to strengthen Europe's financing ecosystem to retain growing companies.

1.2 Fragmentation issues along the capital markets value chain

An industry representative suggested that inefficiencies, particularly in terms of fragmentation, prevent capital markets in Europe from fully playing their role of optimising the allocation of capital to the real economy and delivering the best possible returns to investors. Further integration would add value for investors and issuers by improving the flow of capital across the EU and increasing choice and competition.

It is important to identify, across capital market activities and asset classes, where inefficiencies due to fragmentation exist and where more choice and competition would be beneficial. This does not require full integration and centralisation of markets, but specific fragmentation issues and inefficiencies need to be addressed. At the trading level, there is generally a benefit to having venue competition. At present, however, there is probably too much dispersion of trading venues in Europe. In equity markets, while pan-European multilateral trading facilities (MTFs) compete with regulated markets, the latter do not really compete with each other for listings or secondary trading in a given listing. Unlocking more competition in this area would likely lead to more consolidation, which would be beneficial.

Market data provision also needs to be further unified at the European level. Historically, it has been highly fragmented, but steps have been taken in the MiFID II review to introduce a consolidated tape and to improve the transparency framework, notably in terms of deferrals and consistency. For clearing and settlement, at least on the equities side, there are opportunities to reduce fragmentation and redundancy in the infrastructure, as identified in the Draghi report and other reports on CMU. There is merit in exploring further consolidation of equity clearing and settlement infrastructures. Margin and haircut regimes will be further harmonised. For cleared instruments, they are set by clearing houses in a fairly standardised way, and efforts have been made in OTC derivatives markets to create more standardised margin models.

Another industry representative added that fragmentation in European markets has a real cost for end-investors and market participants. There is fragmentation in terms of the range of products available. For example, different Exchange Traded Funds (ETFs) are offered in different Member States, which are largely identical products with identical underlyings. This limits corresponding liquidity pools and reduces the attractiveness of these ETFs, as investors are looking for very liquid and highly traded products with high turnover.

A second area where fragmentation increases costs is in trading venues and post-trading. Providing liquidity across many venues in the European equity landscape is costly for market makers because they need to connect their systems to all the venues to provide adequate price information. This affects the price and bid-ask spread displayed to investors. Post-trade fragmentation also affects this bid-ask spread. The fragmentation of liquidity across venues, which leads to thinner trading volumes and higher costs, also drives down the valuations that companies can achieve.

The fragmentation of secondary markets affects primary markets as well. When companies are in the pre-IPO phase and deciding where to list, they consider factors such as secondary market trading volumes, potential valuations, and the investor base they can tap into. Due to Europe's fragmented landscape, many companies opt to list in regions with more liquid markets. This is a missed opportunity for Europe, as higher liquidity drives better valuations and attracts more listings, creating a self-reinforcing cycle.

1.3 Insufficient retail participation

A regulator noted that ESMA statistics show that EU equity markets are in decline, with a market capitalisation to GDP ratio of 11%, down from 16% 10 years ago and compared to 45% in the US. One of the main reasons for the underdevelopment of EU capital markets is low household participation due to tax issues, cultural

aspects such as risk aversion and domestic policies that support the acquisition of real estate. This hampers liquidity and reduces the attractiveness of the market for issuers, with knock-on effects for the whole ecosystem. A more integrated and deeper capital market would also support liquidity and contribute to more efficient European capital markets.

An industry representative stressed the need for the EU to channel savings into productive risk capital. According to the Draghi report, the EU has a savings rate four times higher than the US, but lower overall household wealth in financial assets. Over the last 14 years, the net increase in household wealth in the US has been 151% compared to only 50% in the euro area, largely due to lower investment returns. Savings that are not properly invested also deprive the real economy of productive risk capital that could fuel more innovation and growth. Expanding pension provision and encouraging more self-directed retail investment is essential for the further development of capital markets in Europe.

1.4 Levels of remuneration in the EU

An industry representative highlighted the lower remunerations in the European financial sector compared to other regions, which make it more difficult for European firms to compete with other jurisdictions or other sectors in terms of attracting and retaining talent. This balance needs to be adjusted to encourage innovation in the capital markets.

2. Expected impact of adopted CMU actions

The Chair noted that increasing the attractiveness of European capital markets has long been a goal in the EU. Some progress has been made, but more needs to be done to meet Europe's significant financing needs. There are reasons to be optimistic about the change in political tone on CMU. The need to further develop capital markets is now widely shared across Europe. There is also a shared sense of urgency, as evidenced by the Letta report, the Eurogroup conclusions and the recommendations of the Draghi report.

An industry representative concurred that much has already been done by the European Commission, regulators and market stakeholders to create integrated capital markets, notably in the context of the CMU initiative, but more is needed.

Another industry representative agreed that, on the regulatory side, there have been many positive changes in recent years, but different parts of the ecosystem, such as post trade, trading and listing, have been looked at in isolation rather than together. The impacts that changes in one part of the ecosystem can have on other parts have not been sufficiently considered. One example is the application of bank-centric regulation to investment firms that provide liquidity. The prudential regime for investment firms has led liquidity providers to either reduce their activities in Europe or relocate to other jurisdictions, thereby reducing market liquidity.

An official highlighted that several initiatives at the EU level have contributed to strengthening European capital markets, but more needs to be done to further integrate European capital markets and increase firms' access to productive capital and funding for innovation. Measures to improve access to finance have mainly been taken by individual member states and capital markets have evolved very differently across the EU. Further regulatory efforts should aim at ensuring a well-functioning interplay between national and European measures, where market integration does not come at the expense of well-functioning local markets.

The Swedish example illustrates that structural national measures beyond regulatory and supervisory adjustments are needed to achieve well-functioning and deep capital markets. Sweden has well-developed capital markets. There is a great deal of IPO activity, and Swedish households have a high degree of exposure to equity and risk capital. This has been encouraged for decades by national measures. The introduction of tax-incentivised mutual funds took place in the late 70s, and major pension reforms were undertaken in the 90s with a development of occupational pensions and a diversification of investment options in the state pensions. The Investeringssparkonto (ISK) investment account was moreover introduced in 2012, with the aim of making it easier for retail investors to invest in capital market instruments, with simple taxation and limited reporting requirements, and it has proven to be very attractive. 4 out of 10 Swedes hold an ISK account. The official summarised that providing retail investors with a choice of investments is important, as is nudging them to take well-informed decisions. Low fees and building trust in capital markets are also key.

3. Approach for enhancing the attractiveness of EU capital markets

A regulator suggested that the development of capital markets is less about financial regulation or supervision than about incentives to ensure that sufficient capital is invested in European markets. Sweden, which has the most vibrant capital market in Europe, with the same supervisory structure and European regulation as other Member States, is proof of this. Financial regulation and supervision can have an impact on improving the functioning of the existing market, but are less effective in attracting larger volumes of investment and savings and increasing liquidity.

The next Commission and Parliament should address the underlying issues that explain why investment and capital market financing, particularly for the more innovative companies, are insufficient in Europe, leading to weak balance sheet structures. One challenge is that many of the issues to be addressed relate to tax incentives for investors and issuers, financial literacy and investment culture, and are either outside direct European competence or politically challenging. For example, the proposal for a debt-equity bias reduction allowance (DEBRA) to address the current asymmetry between debt and equity financing for companies has unfortunately been shelved for the time being.

Another regulator emphasised that developing European capital markets should not be viewed as an end in itself; instead, efforts should be directed toward specific improvements within the EU market that serve Europe's needs. The aim is not to mirror the US financial system, nor to simply reduce reliance on bank financing or expand capital markets. Instead, the focus should be on more specific objectives such as enhancing the appeal of public capital markets and expanding equity financing, especially for late-stage and pre-IPO companies that are critical to fostering growth and innovation. Additionally, increasing retail investment in capital markets should primarily aim to offer investors better long-term returns on their savings, rather than improving the financing structure or lowering costs for European companies.

An industry representative stressed the need for capital markets to grow in Europe to complement bank financing and provide additional sources of risk capital to fuel business growth and innovation. However, banks must continue to play their current role. It is also important to improve the efficiency of bond markets as an important source of financing for companies, alongside equity markets. In the US, the amount of capital raised so far in 2024 is 10 times higher in bonds than in equity: $1.3 trillion in bond issuance compared to $130 billion in primary and secondary equity issuance.

4. Key areas of focus for enhancing the attractiveness of EU capital markets

4.1 Further harmonising capital markets regulation

An industry representative suggested that the strong political momentum around CMU should be taken advantage of to address the divergence in the application of regulation across member states. This divergence has a tangible impact on competitiveness as it translates into barriers for both issuers and investors and is the starting point for any further discussion on greater integration or consolidation. Divergence in the application of regulation affects issuers' listing and reporting processes by adding cost and complexity. As a result, they either decide not to list because it becomes too complicated, or they continue to seek financing from other sources, or they list elsewhere. On the investor side, barriers such as different tax regimes in different Member States discourage cross-border investment and create a competitive disadvantage for European markets.

4.2 Increasing supervisory convergence and coordination

An official emphasised the importance of creating conditions for more efficient supervision within the EU. In some areas, EU-level supervision could bring efficiency gains, cost savings and a more comprehensive view of risks. However, moving supervisory responsibility to the EU level should not be an objective in itself, and should be done in areas where this is likely to strengthen EU markets.

An industry representative noted that more unified supervision is often presented as a solution to problems of regulatory divergence, but unified supervision in itself is not sufficient. In addition, it will not make supervision easier, and could even make it more difficult, as it will not necessarily have all the capacities that local national competent authorities (NCAs) have in terms of expertise and knowledge of local markets.

A regulator noted that some recent reports including the Draghi report, propose moving towards a single supervisor, but the implications of this must be further assessed. More supervisory convergence is necessary, but it is not a sufficient condition for further integrating markets. There has been single supervision for large banks for a decade, but the level of cross-border lending is lower than when the Single Supervisory Mechanism (SSM) was implemented. Central supervision however makes sense in certain areas. For large, systemic cross-border infrastructures, there is a case for moving towards supervision at the EU level. That should probably come with a change in governance at ESMA and more legal powers in certain respects.

One aspect that needs improving is to allow ESMA to make changes to regulation in a more agile way. Currently, many changes require a Level 1 discussion, which is a very cumbersome process that only takes place every 5 to 10 years. In other jurisdictions, regulators have more leeway to make agile changes, for example by using no-action letter powers to temporarily suspend the application of regulation if necessary. In the UK, the Financial Conduct Authority (FCA) controls the level of dark trading. Another aspect to consider is that the roles of the three European Supervisory Authorities (ESAs) do not need to be fully aligned, as securities market supervision and regulation at EU level is at a different stage than banking or insurance.

Another regulator stated that more unified supervision would help to improve the European rulebook. As supervision is fragmented, Level 1 rules are excessively detailed to avoid differing interpretations and loopholes, making the rulebook very complex. The industry also complains that the European rulebook is not flexible enough and suggests that Level 1 texts should be more principle-based, leaving the possibility for Level 2 requirements to be more continuously adapted to market developments. However, this will only be possible with a more unified supervisory structure in the EU. Improving the supervisory architecture is a long-term project that needs to be implemented step by step. In addition, unified supervision may not be necessary for all areas of the market and all aspects of regulation. For example, retail markets are very local and require strong national supervisors.

The Banking Union serves as a warning, but it is not a counter-example. The institutions of the Banking Union were created primarily to improve financial stability. No progress has been made in further integrating the European banking sector, but that was not the main objective of the Banking Union. This shows the need to clarify the objectives of a possible further integration of capital market supervision.

An industry representative emphasised that targeted changes are needed to the supervisory structure, rather than a move to centralised supervision. The aim is to

remove significant friction points in areas where this can bring tangible benefits. National gold-plating of rules makes it difficult to operate cross border. This happens more often with directives but is also seen with national interpretations of regulations. More coordinated supervision would help to alleviate these issues. That does not mean suppressing the NCAs, but ensuring that firms that operate across multiple countries are asked to comply with exactly the same rules.

The industry speaker agreed that Level 1 legislation is too detailed. The details hardwired into Level 1 legislation make the rulebook less dynamic. Waiting 5 to 10 years for a regulatory review to make changes hinders innovation and growth.

4.3 Improving investor and issuer financial literacy

An official emphasised the importance of educating and nudging retail investors to encourage them to participate more in the capital markets. Policies need to create incentives, so that retail investors move part of their capital from their deposits into simple capital market products likely to provide a higher yield over the long term. Developing pension capital is also essential to foster a deeper capital market. At present three member states (Sweden, Denmark and the Netherlands) represent more than 60% of funded pension capital in Europe.

An industry representative added that financial literacy is the cornerstone of investor protection, because investors who understand the functioning of capital markets and the related risks are much better equipped to make appropriate decisions. Investor protection must, however, be embedded in regulation to ensure an improvement of the overall investment landscape. Financial literacy efforts should also be extended to issuers. Many SMEs struggle to understand the implications of listing from a regulatory, governance and economic standpoint. The lack of investment culture of issuers can also lead to conflicts of interest from financial players. For example, for a bank, it is easier to lend money via a loan than to support an issuer's IPO. There is a widespread belief that the US market is more attractive, but that is not true for all issuers. European issuers need to be educated about how the EU can provide a more tailored and nuanced framework that can allow them to grow in their own region.

4.4 Further integration and consolidation in the European capital market ecosystem

An industry representative highlighted that although further integration is needed, that does not mean full consolidation. On the secondary market side, reducing the number of venues and infrastructures makes sense. On the primary listing side, different aspects need to be considered. Smaller companies need a first port of call in their country, such as an SME growth market. However, more concentrated mid and large-cap venues offering greater liquidity are needed to meet the funding needs of larger companies, so that they can reach higher valuations.

A regulator noted that while some reports on CMU and the Draghi report recommend further consolidation of European infrastructure, it is up to the private sector to achieve this. However, European competition policy has been an obstacle to consolidation in the past and may need to be reviewed in some respects.

A second industry representative stated that progress has been made in developing a vibrant ecosystem for growth companies in Europe, consisting of venture capitalists, private equity firms and pension funds, but this ecosystem is mainly organised at national level. For European markets to compete with other regions, larger pools of capital need to be available, which requires the ecosystem to operate at a European level, otherwise the match between supply and demand of capital for growth companies will not be efficient enough.

Conclusion

The Chair summarised that there are many challenges to improving the attractiveness of EU capital markets. Action is required from all parties: European institutions, Member States and the financial industry. EU markets need to be more competitive, as companies looking to raise funds to finance their growth are turning to global markets. This requires fostering a virtuous circle that attracts both investors and issuers, with a strong focus on equity financing and innovation. Among the challenging issues that need to be addressed are better incentives for retail participation, pension reforms to create the necessary liquidity pools, and improved supervision. In addition, tackling regulatory fragmentation and aligning interpretations of EU rules are essential steps to reduce market friction and support greater integration where it adds value.