

The background of the slide features a close-up of several Euro coins, with a semi-transparent financial chart overlaid. The chart includes a candlestick pattern and a blue line graph with data points. Numerical values such as 0.1750, 0.1500, 0.1350, and 0.1200 are visible on the chart's vertical axis.

# **EUROPE'S UNTAPPED CAPITAL MARKET**

## **MARKET-BASED FINANCE AFTER THE GREAT FINANCIAL CRISIS**

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# Highlights

2

- Roughly 300 pages with over 120 charts and tables
- 36 Cross-border barriers to capital market integration
- 33 Policy Recommendations
- It cuts across the whole financial sector
- Focus on financial integration policies
  - ▣ Barrier removal plan
- Differences with Banking Union
  - ▣ Whole European Union
  - ▣ Strengthening current institutional framework
  - ▣ No public risk sharing
  - ▣ No 'trigger event'

# Financial integration

# Financial integration

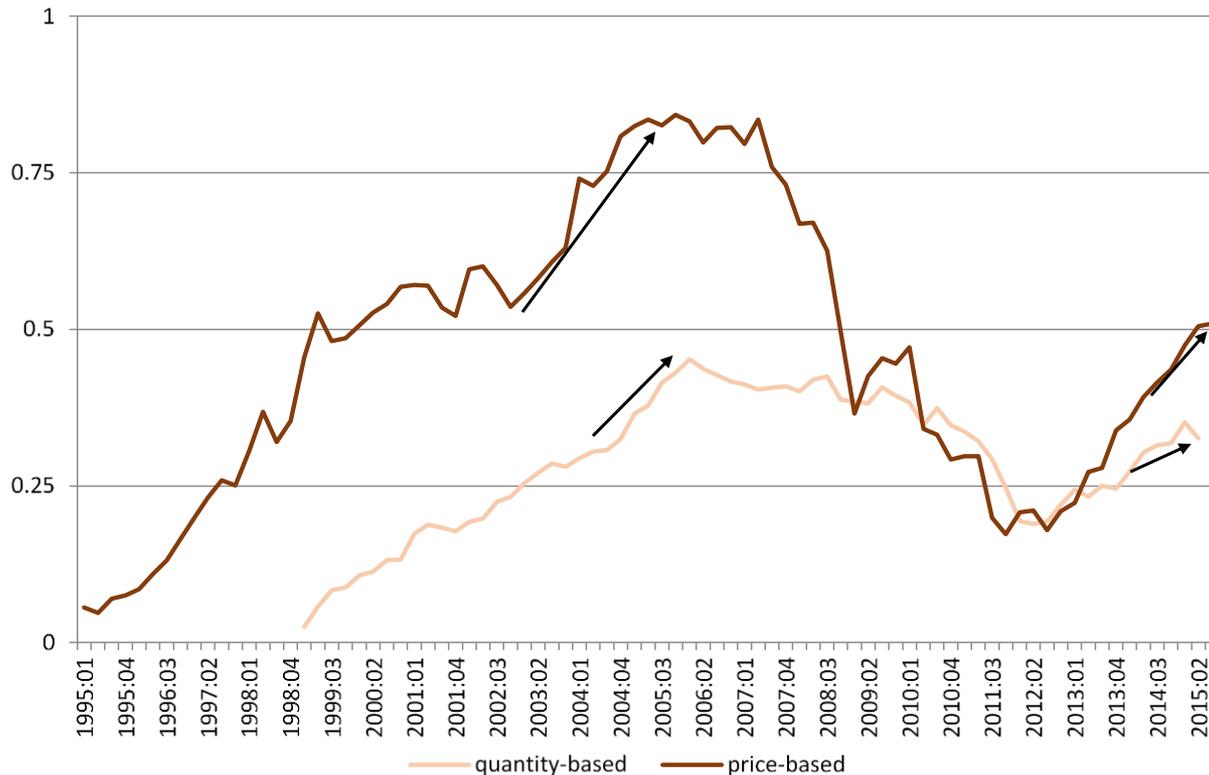
- **Financial integration** is the process through which different regions or countries become more financially interconnected. This process involves the free circulation of capital and financial services among those areas. It usually determines an increase in capital flows across regions (private risk sharing) and a convergence of prices and returns for financial assets and services. (section 2.1)
- **Financial integration in Europe builds upon three principles:**
  1. Right of establishment (a financial institution can set up permanently in any EU country).
  2. Free movement of services (cross-border provision by a firm located in another country through the use of a passport).
  3. Free movement of capital (a transfer of assets from one country to an individual or legal entity in another country).

# Integration after the financial crisis

5

## □ Price with no quantity (holdings) convergence?

*Price-based and quantity-based FINTEC (1995-2015)*

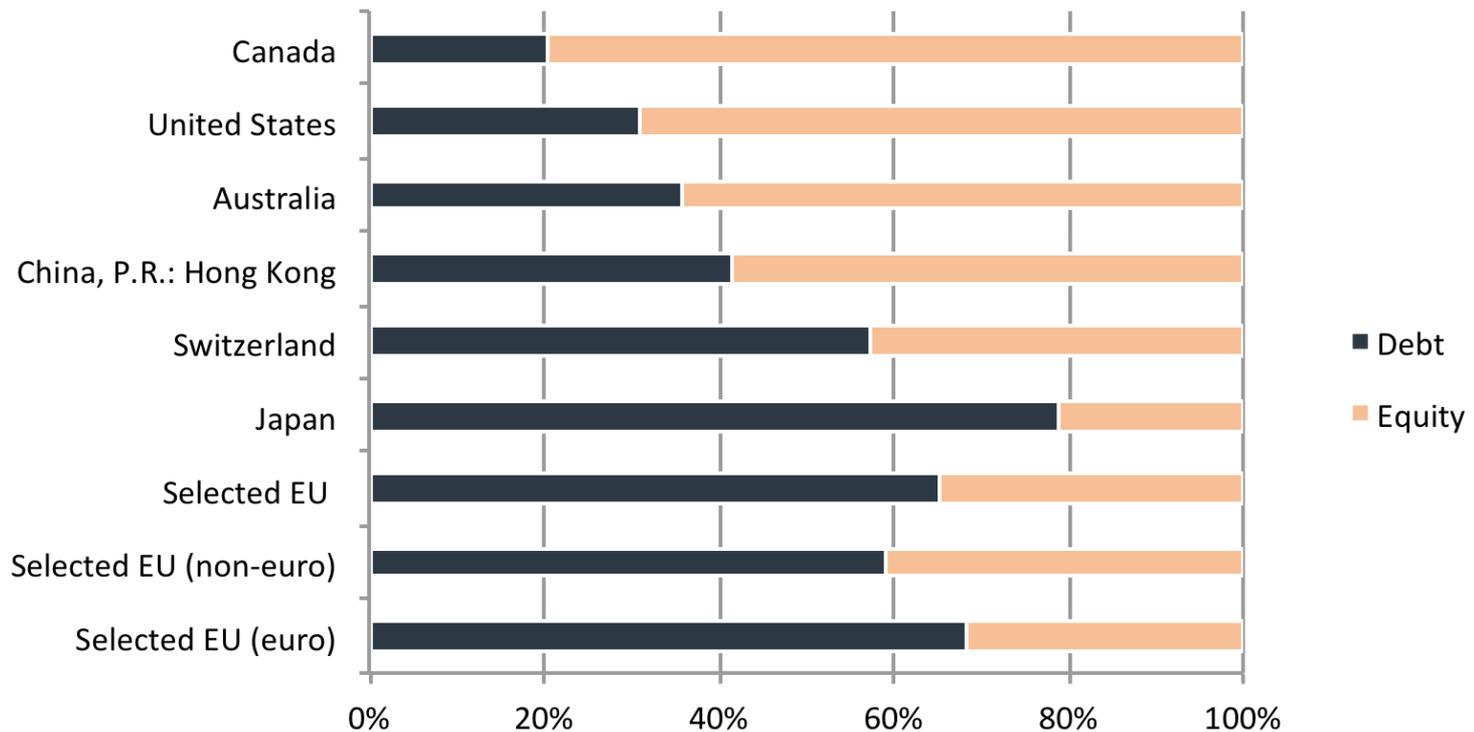


Data Source: ECB.

# Investment flows

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Total debt & equity portfolio investment (average 2001-2014; % total)

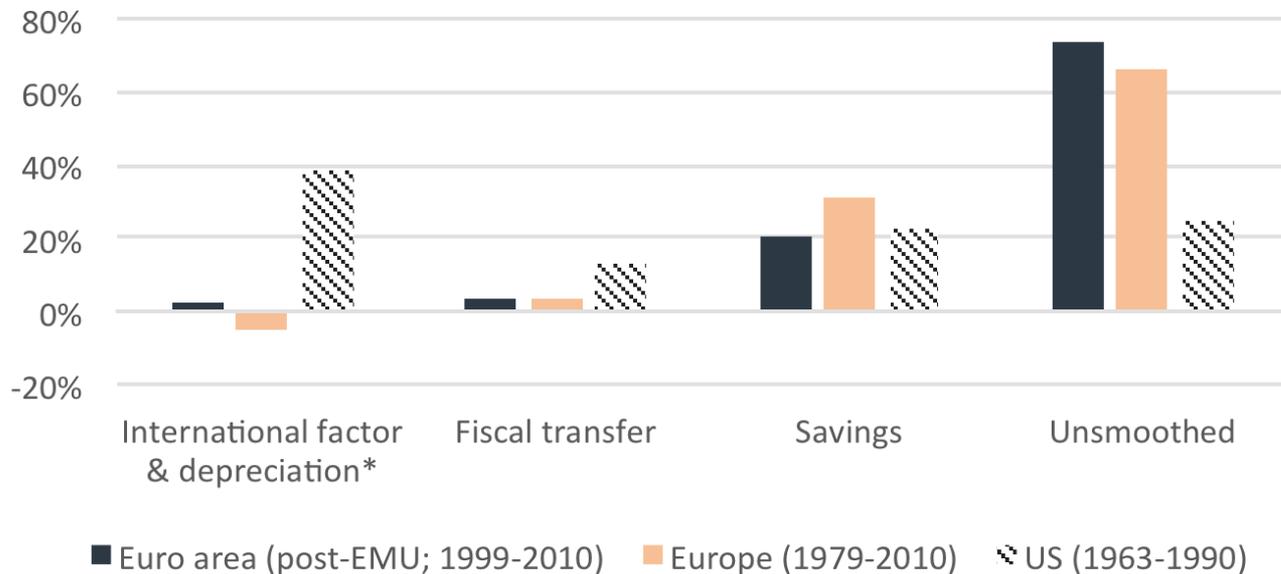


Source: Author's elaboration from CPIS-IMF. Note: 'Selected EU' countries include Germany, France, Italy, Spain, The Netherlands, United Kingdom, Sweden, Poland. No 2014 data for Sweden and Australia. 'Euro' means cross-border flows towards Euro area countries. 'Non-euro' means cross-border flows towards non-Euro area countries (including flows from the rest of the world).

# Risk sharing

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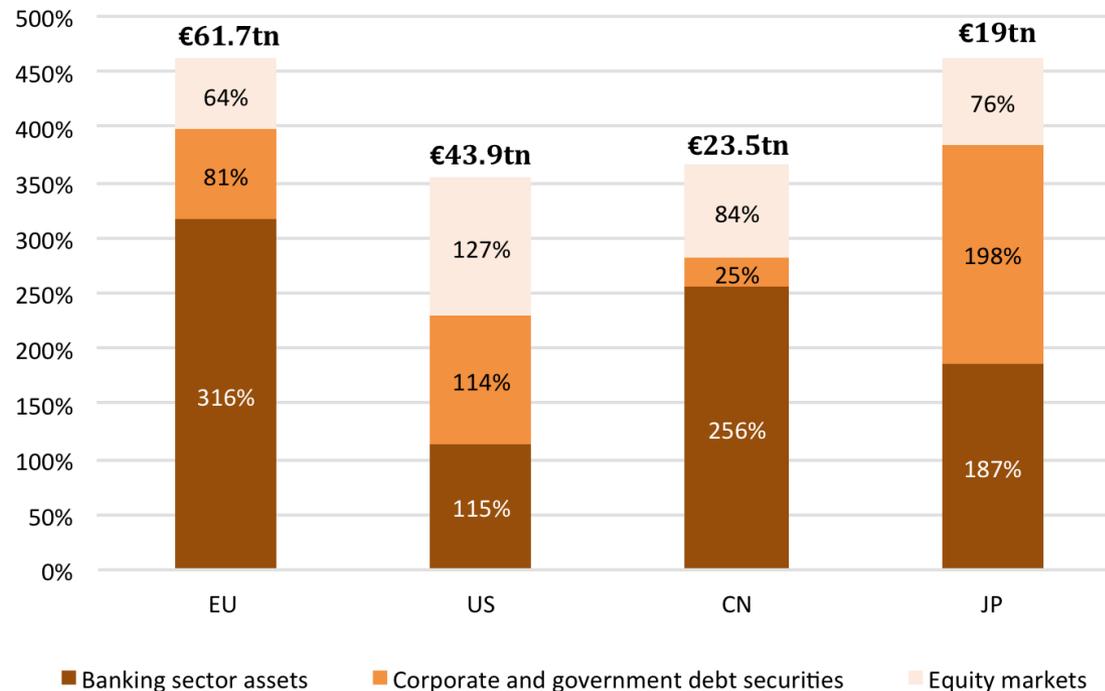
## Channels of output smoothing in Europe and US



Source: Based on Furceri & Zdzienicka (2013) and Asdrubali et al. (1996). Note: \*This includes factor income flows and capital depreciation output produced in part by international financial flows (including capital markets, credit markets and FDI). It is the difference between gross domestic product (GDP) and gross national product (GNP), minus the difference between GNP and Net Income (NI). This number may, however, underestimate the contribution of capital markets (including secondary trading activities), which also contribute to the GNP.

# Financial sector

*Simplified structure of the financial sector in the EU (% GDP, average 2010-14)*



*Note:* For debt securities, we use outstanding amounts and exclude financial institution debt securities (which are implicitly included in the banking sector assets statistics). For equity, we use domestic market capitalisation. For US bank assets data, we include gross notional value of derivative positions and credit union assets.

*Data sources:* IMF (GDP), BIS, ECB, US Fed, BoJ, PBoC, WFE, FESE, individual stock exchanges. Eurostat for exchange rates

# Why an integration plan?

9

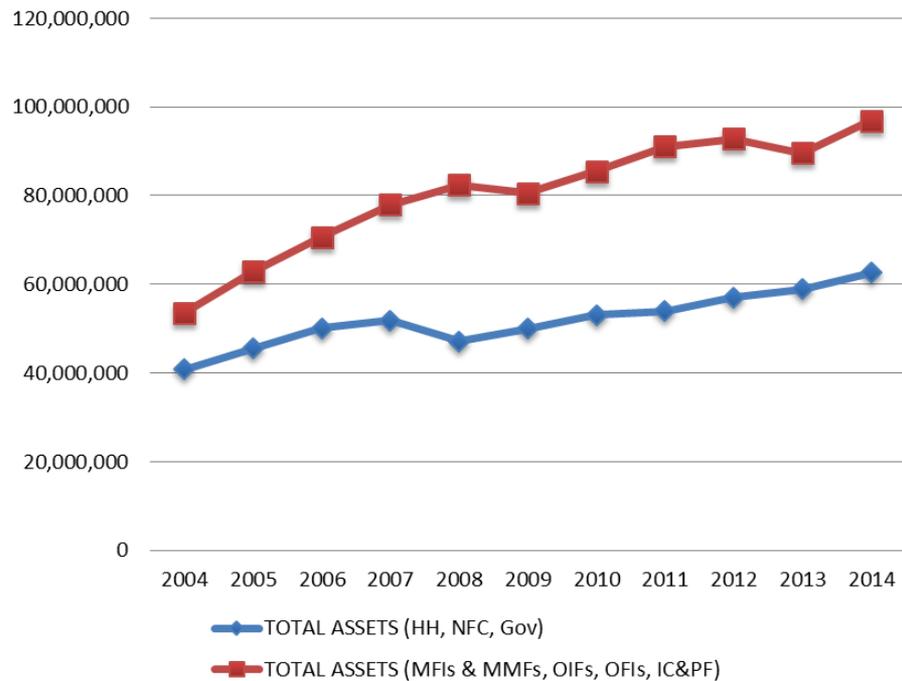
- I. Private risk sharing via capital markets
  - ▣ To stabilise capital flows in case of shocks from aggregate risk (cross-sectional risk sharing)
    - More market-based funding
    - More equity-based funding
- II. Monetary policy transmission
  - ▣ Concentration in interbank market funding
  - ▣ Market-based reference rate
- III. Access to finance
  - ▣ Competition among funding channels (greater choice)
  - ▣ Risk dispersion and standardisation (mid-caps)
- IV. Finance for innovation
  - ▣ Equity more suitable for innovation
  - ▣ Risk dispersion and customisation (start-ups)
- V. Bank restructuring
  - ▣ Market solution to NPL?
  - ▣ Contestability of ownership and consolidation

# Europe's financial structure

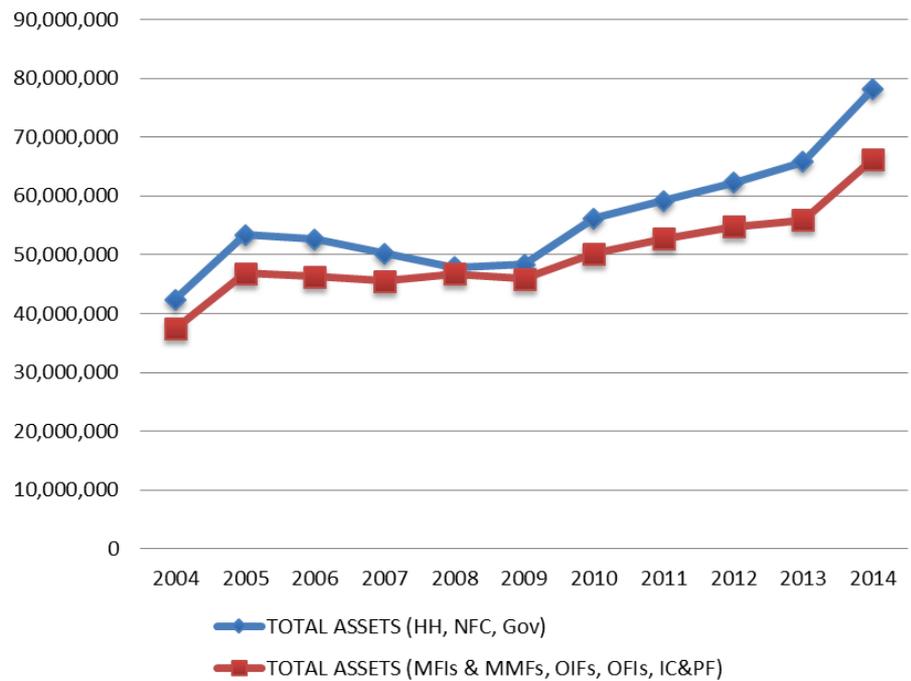
# Financial sector (1)

11

## Europe



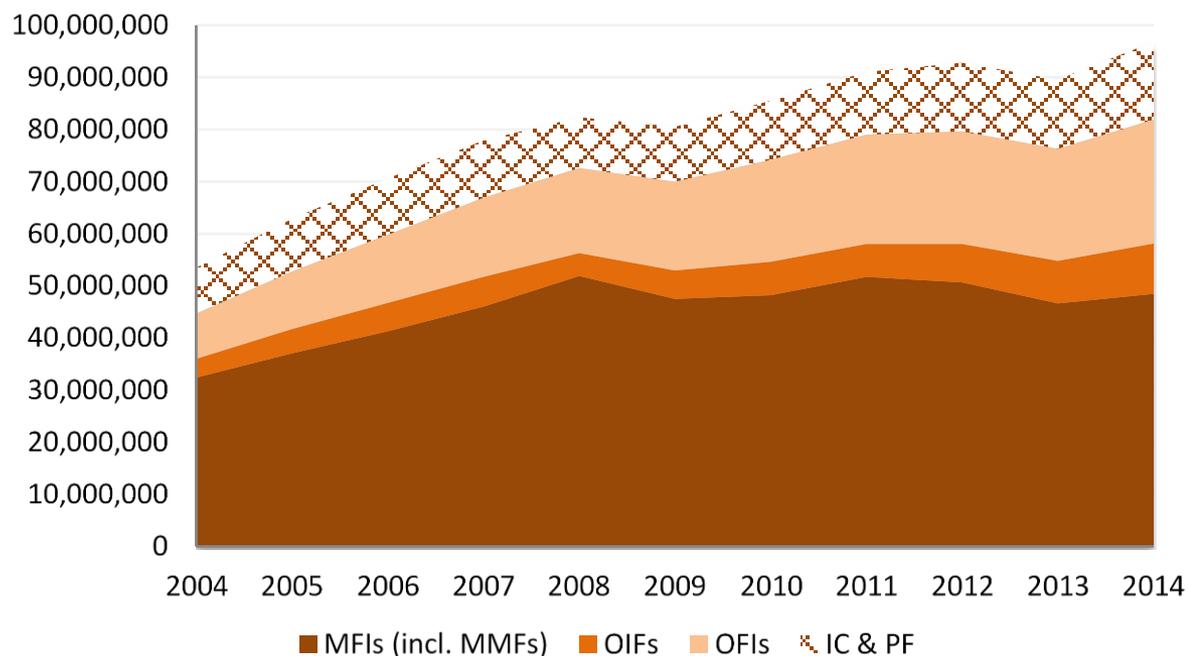
## US



# Financial sector (2)

12

*Total financial assets by type of entity in Europe (€mn)*



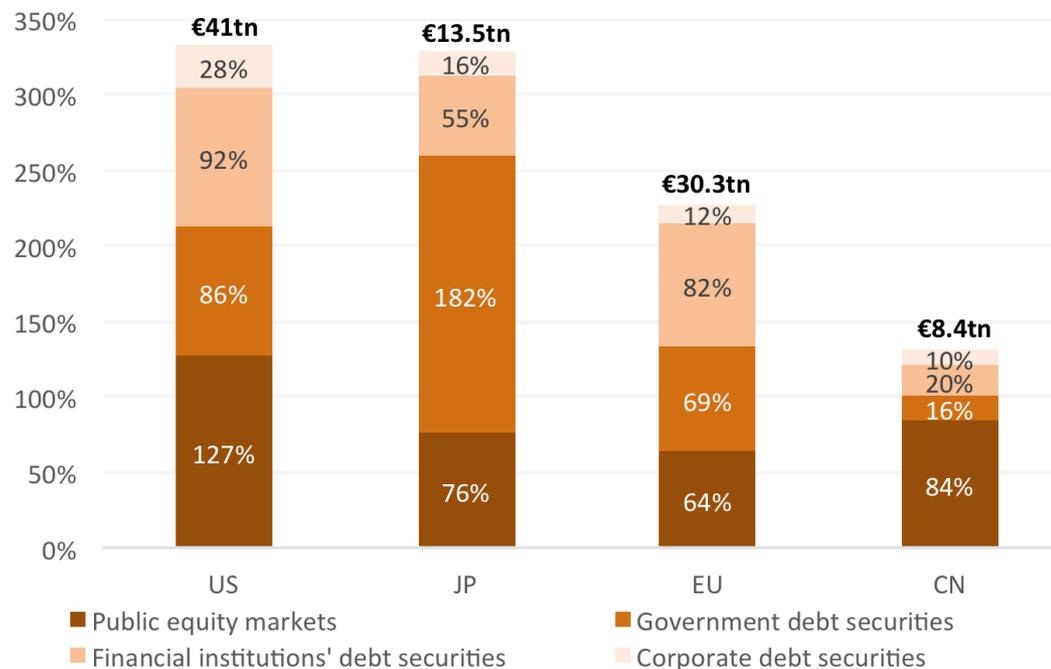
*Notes:* 'MFIs (incl. MMF)', Monetary Financial Institutions (including Money Market Funds); 'OIFs', Other Investment Funds; 'OFIs', Other Financial Institutions (incl. financial vehicle corporations engaged in securitisation transactions [FVC], security and derivative dealers, financial corporations engaged in lending, and specialised financial corporations); 'IC & PF', Insurance Companies & Pension Funds.

Data Source: Eurostat.

# Capital markets

13

*Capital market structure (value of outstanding securities, excl. derivatives; average 2010-14; % GDP)*



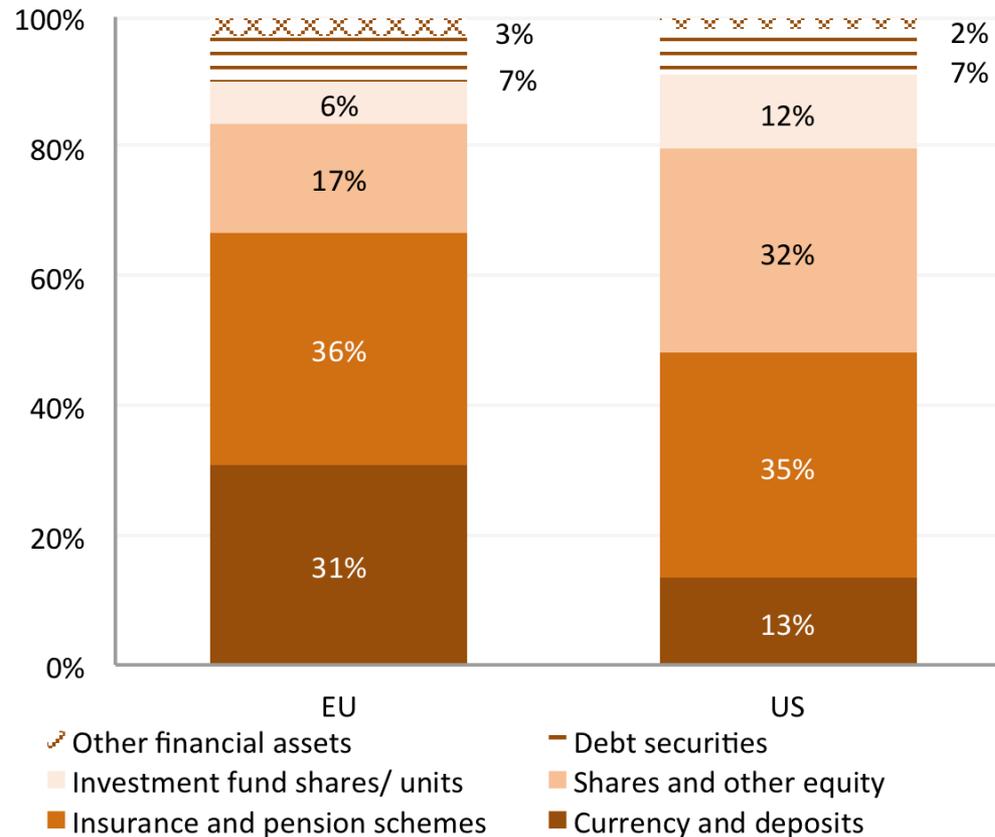
*Notes:* Derivative markets, excluded from this chart, include securitisation, derivative contracts, and indexes (exchange-traded products; see following sections). 'Public equity markets' are equal to domestic market capitalisation.

*Data Sources:* BIS, ECB, WFE, FESE, individual stock exchanges. Eurostat for exchange rates.

# Household liquidity

14

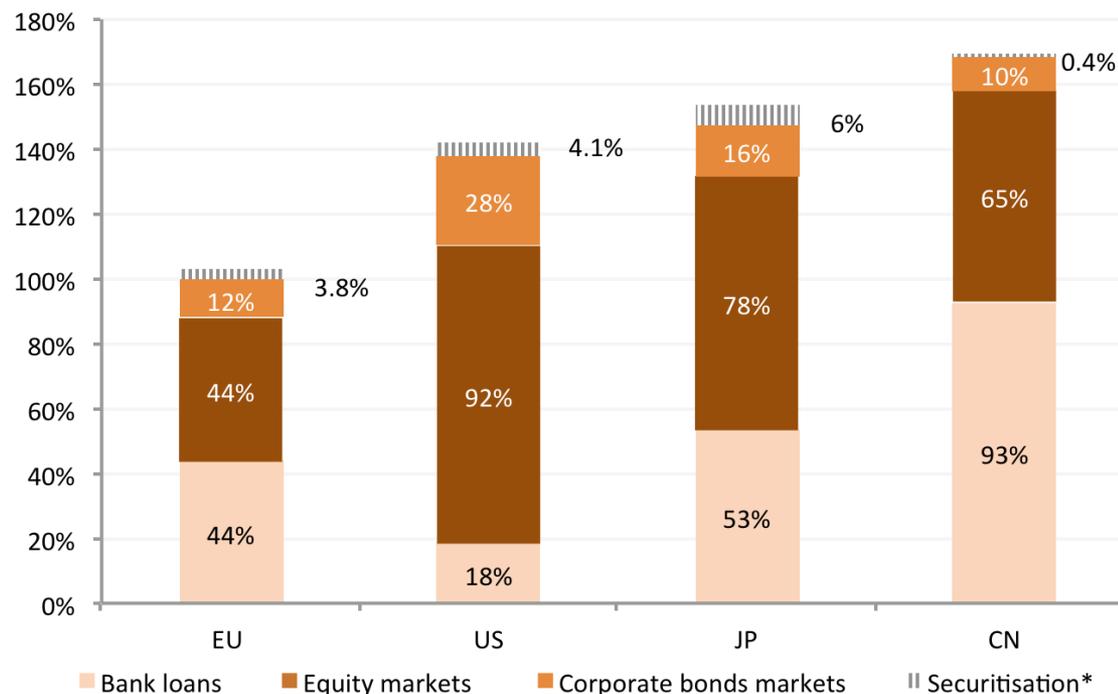
*Households' financial assets in Europe and the US (% total assets; average 2007-14)*



Source: ECB, Eurostat, US Fed. Eurostat (exchange rates).

# NFC funding

NFC bank and market intermediation % GDP [on bars], average 2010-14)

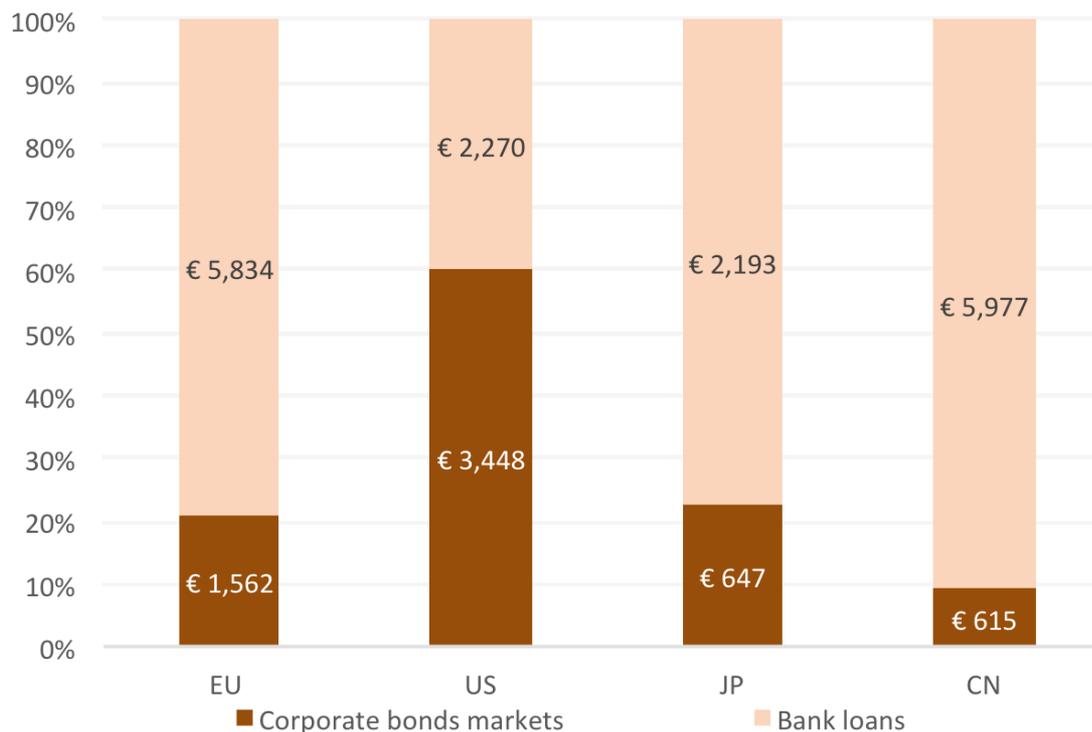


Source: IMF, Eurostat, BIS, ECB, US Fed, BoJ, PBoC, WFE, FESE, individual stock exchanges, AFME, SIFMA, CICC Research. Eurostat (exchange rates). Note: Securitisation refers to the non-financial corporate sector both in the US (CMBS) and the EU (CDO/CLO, CMBS, SME, WBS/PFI), while it includes total outstanding securitised products in JP and CN.

# NFC debt funding

16

Market vs bank-based NFC debt funding (€bn; average 2010-14)

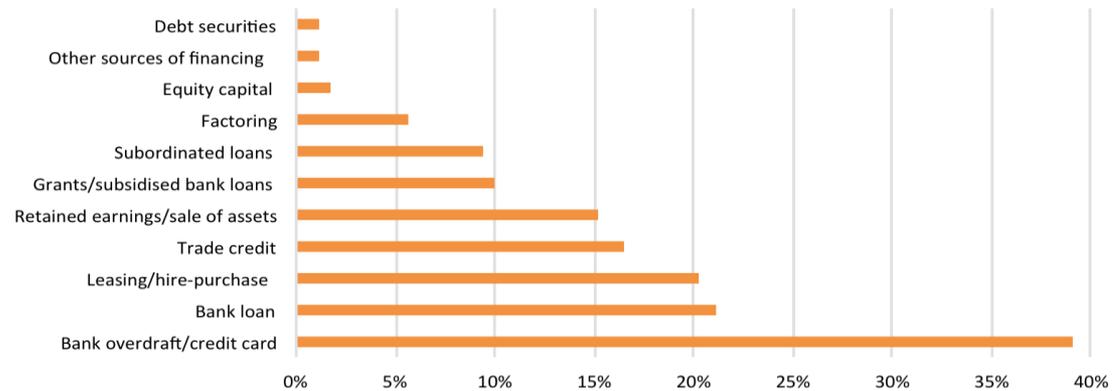
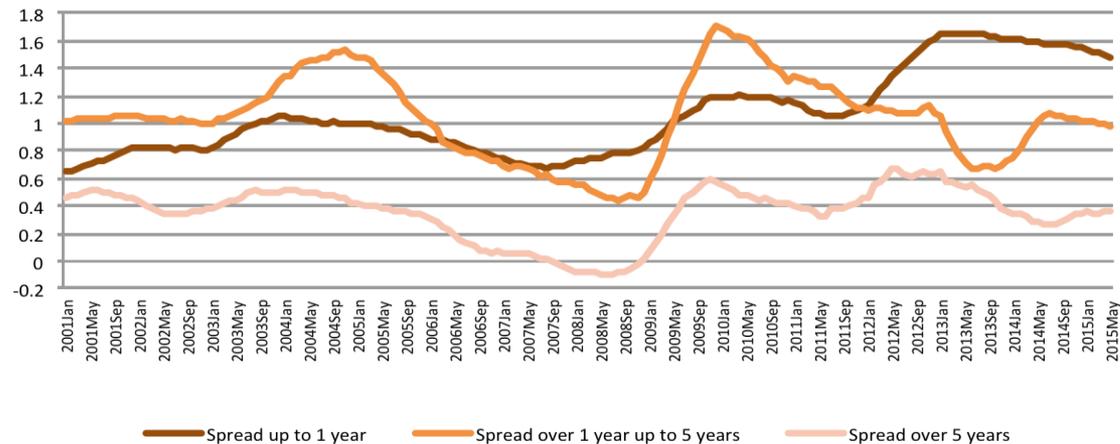


Source: Source: IMF, BIS, ECB, US Fed, BoJ, PBoC, WFE, FESE, individual stock exchanges. Eurostat (exchange rates). Note: for the US we use the dataset of commercial banks released by the FED, instead of the broader category of depository institutions.

# SMEs funding

17

Spread between loans below and above €1mn by maturity (% points) and SME liabilities



Note: Data coverage (second chart): euro area SMEs, October 2014–March 2015.

Data Sources: ECB Data Warehouse & SAFE, 2015, survey published by the ECB in June

# The state of EU capital markets

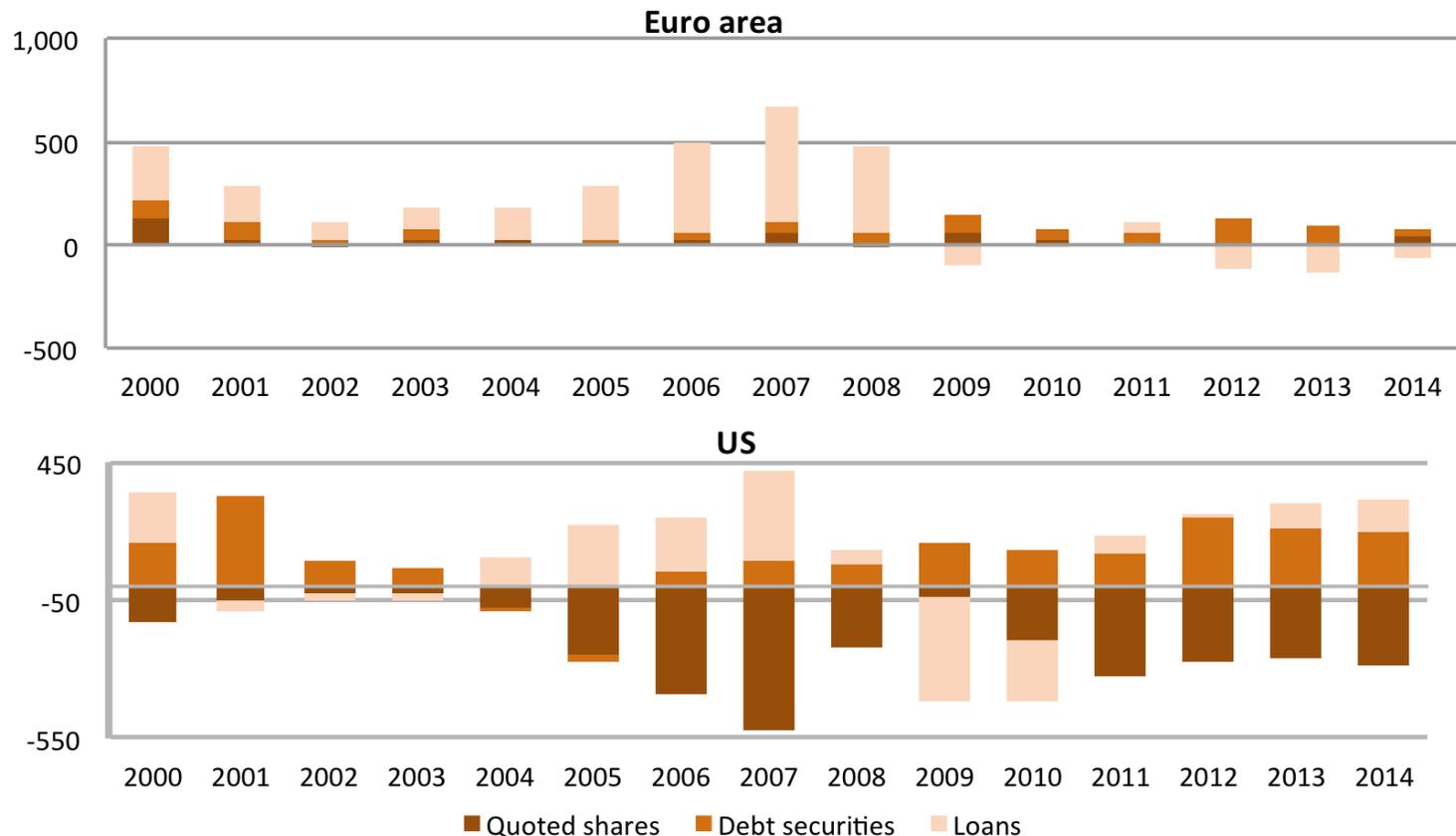
# Quality of EU financial markets

19

- **Integration & efficiency of individual markets** is poor
  - Single currency played a limited role
  - Equity markets are fairly geographically fragmented, lack depth & quality (secondary markets)
  - Bond markets are OTC, but as active as equity markets
  - Private equity and venture capital are systemically irrelevant
  - Private placement and securitisation are & will remain *niche* (the former also national and limited to banks and insurance)
- **Asset management industry** is fragmented and costly compared to the US
  - Weight of domestic industry and limited cross-border retail
- **Dealer banks** continue to scale down trading activities but struggle to find a successful business model
- **Short-term funding** costs up (SMEs struggle)

# Equity markets (1)

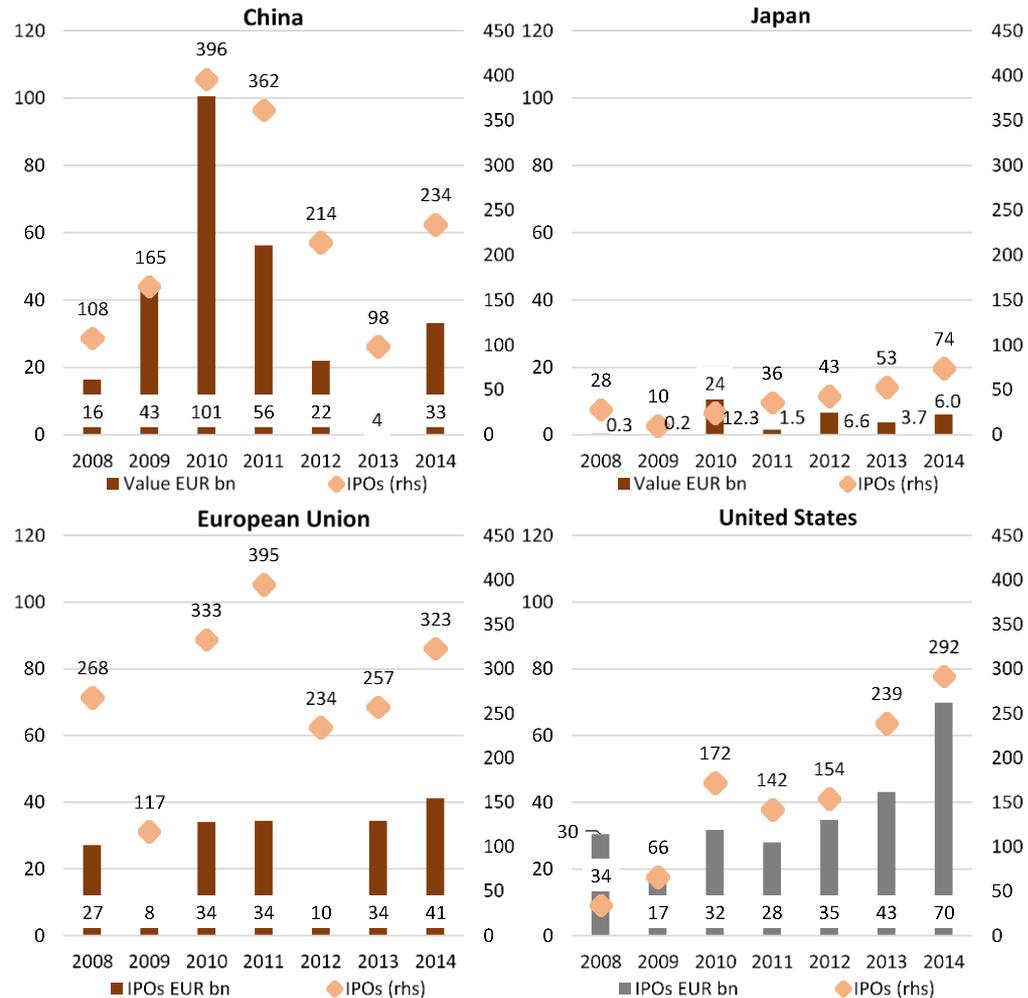
Net issuance of loans, debt securities and equity (2000-14; €bn)



Data Sources: ECB and US Federal Reserve. Eurostat for exchange rates.

# Equity markets (2)

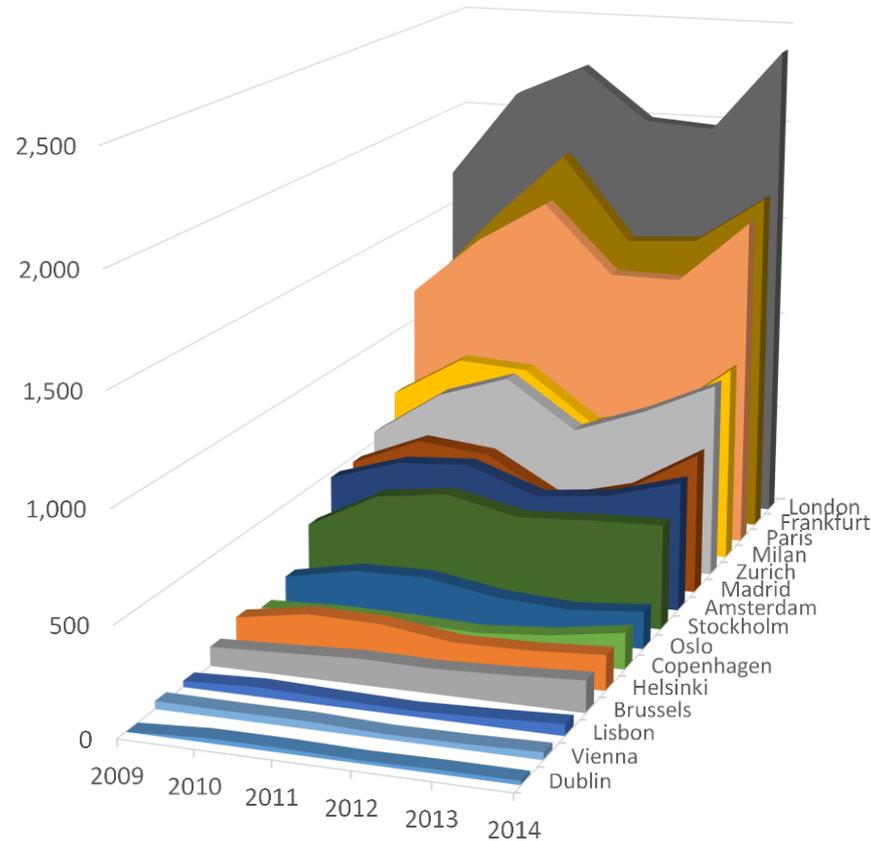
IPO activity by regions (value and number of trades; 2008-14)



# Equity markets (3)

22

Electronic order book turnover by local national markets (lit, dark, auction; €bn, 2009-14)



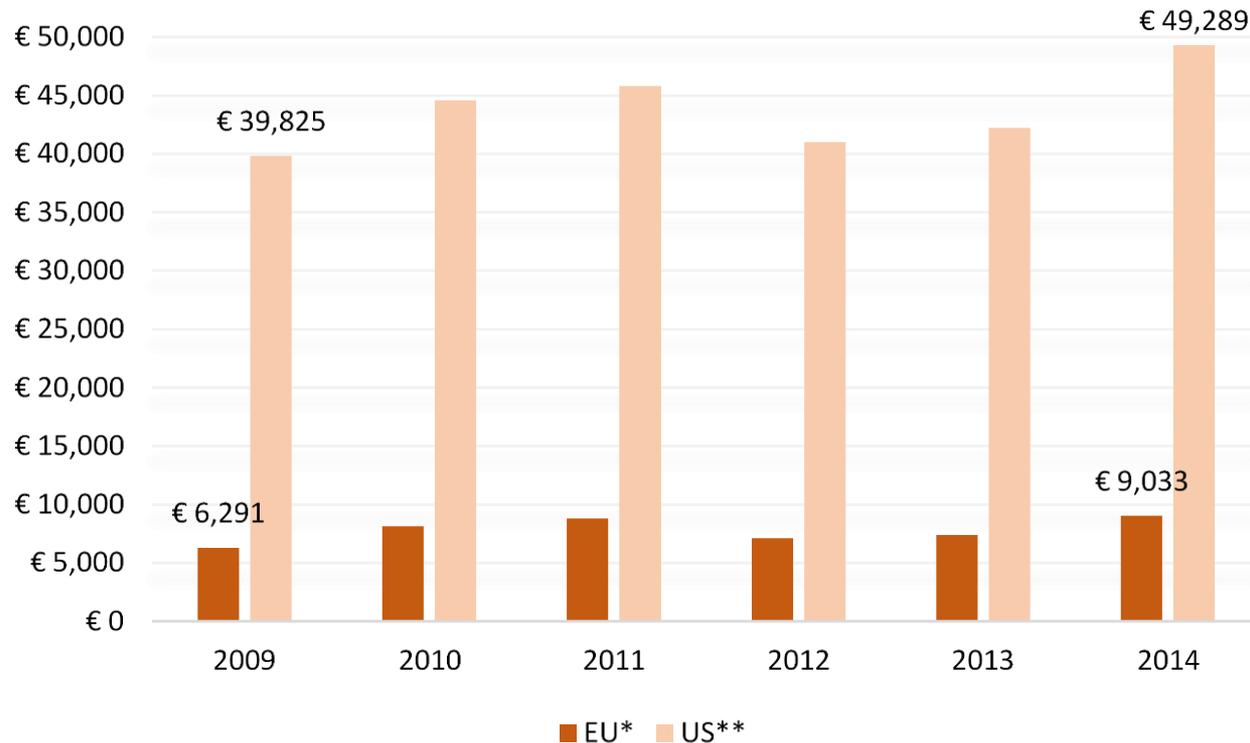
Note: Sum of daily data points.

Data Source: *BATS Europe*.

# Equity markets (4)

23

*Total turnover of European and US exchanges (€bn; 2009-14)*

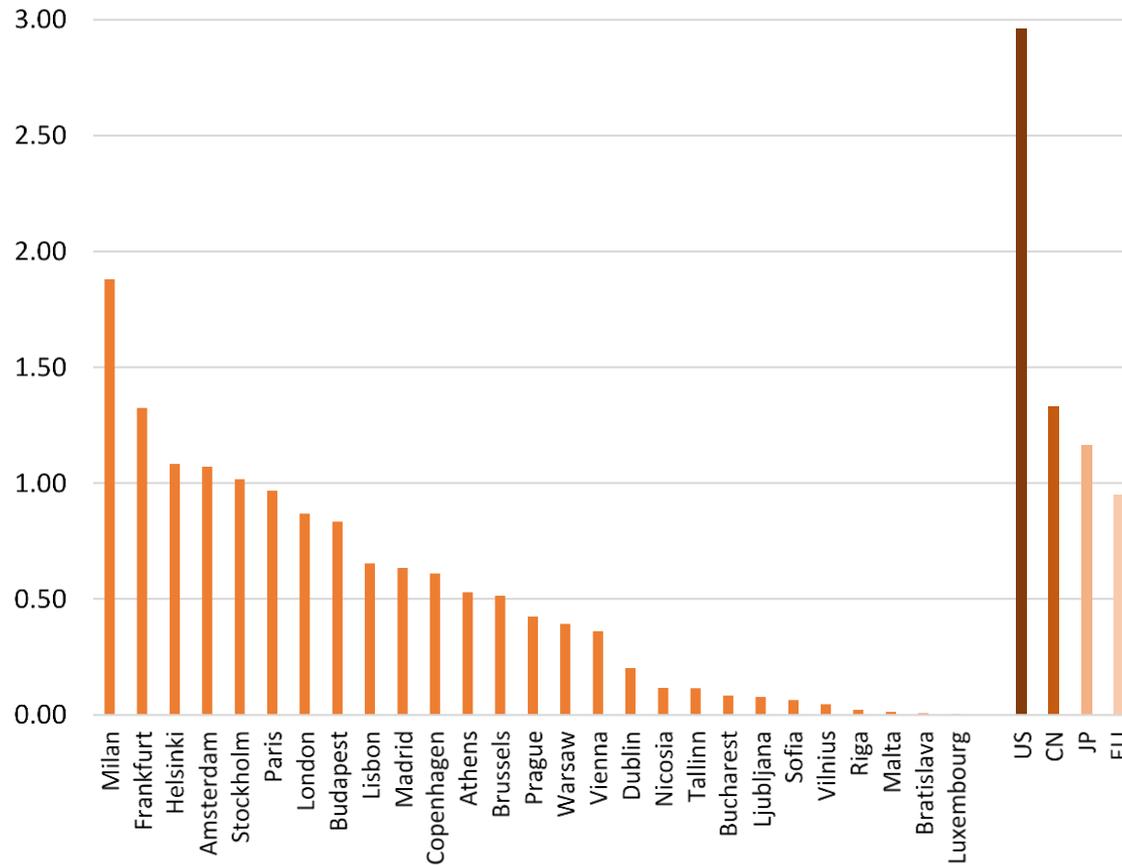


*Note:* \*Includes London, Frankfurt, Paris, Milan, Amsterdam, Madrid, Stockholm, Copenhagen, Brussels, Helsinki, Lisbon, Vienna, Dublin (98% of the market); \*\*includes US NYSE, Nasdaq, BATS (sum of daily data).

*Source: BATS Europe, BATS US.*

# Equity markets (5)

Market efficiency indicator (average 2009-14)

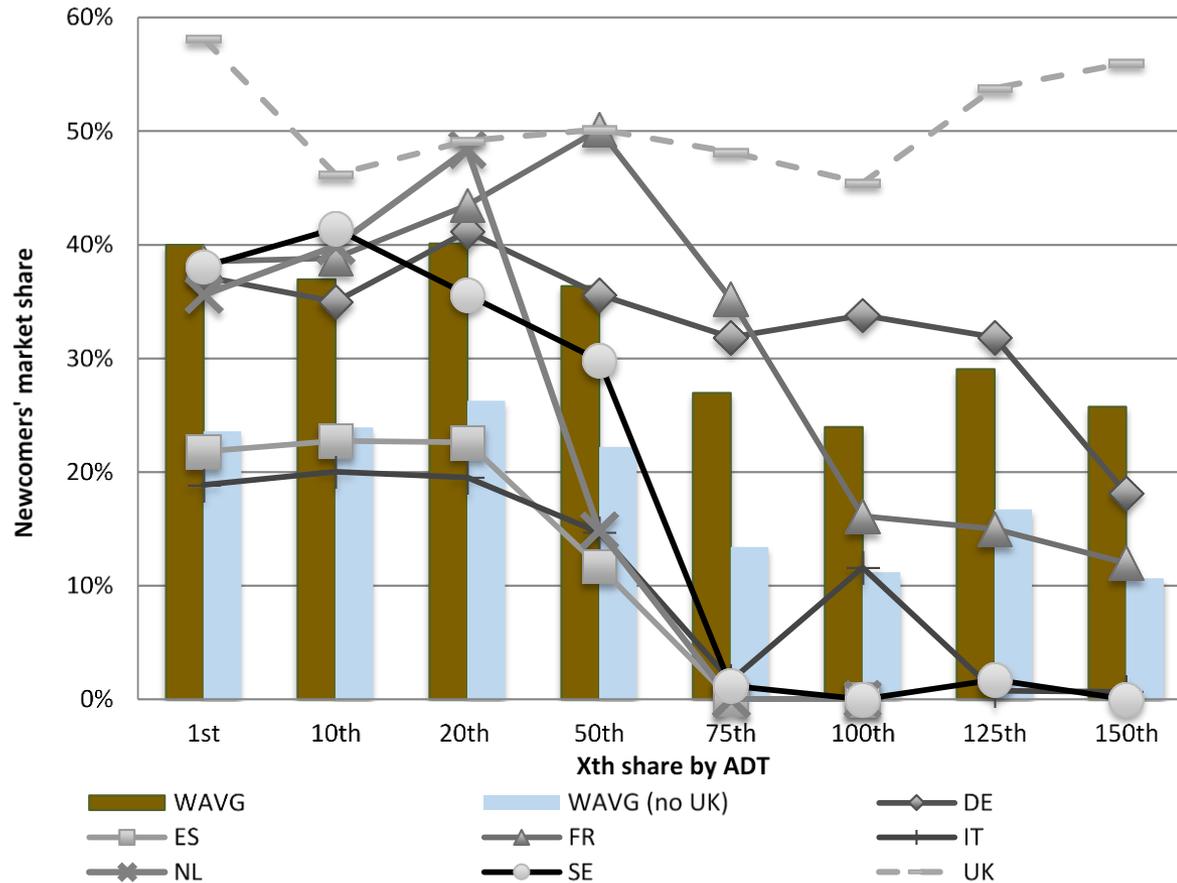


Note: This ratio is equal to value of turnover over market capitalisation.

Source: Author's elaboration from FESE, WFE, individual stock exchanges.

# Equity markets (6)

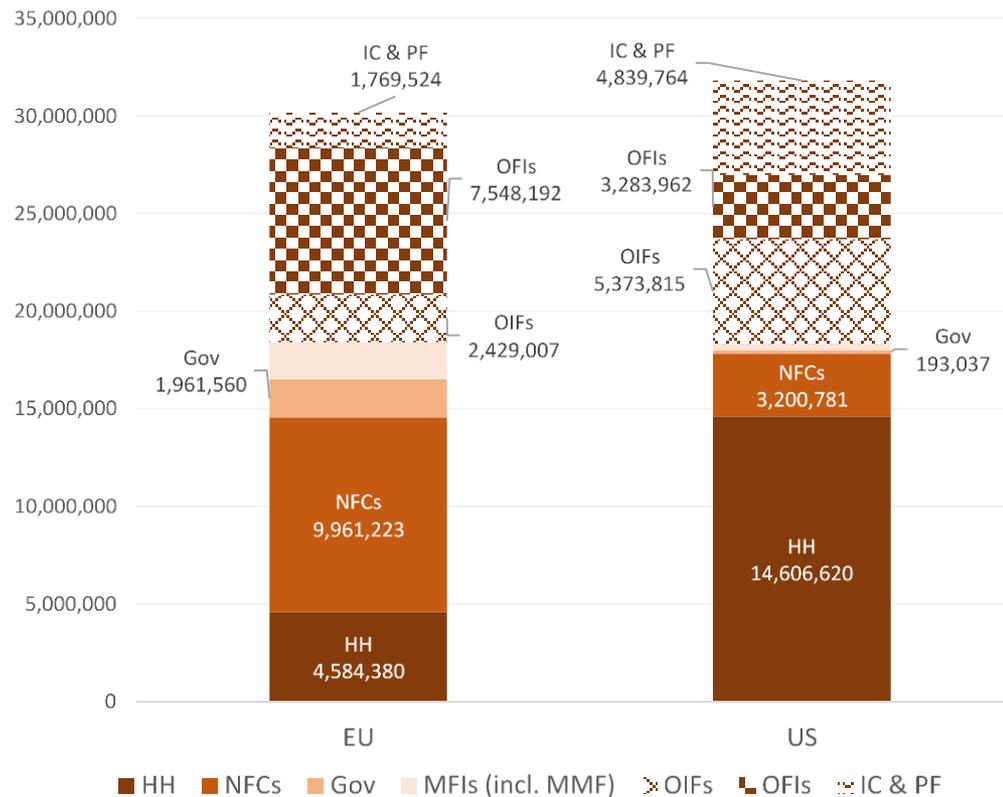
Newcomers' market share in top 150 most liquid shares by selected national markets (%)



Source: Author's elaboration from ESMA and Fidessa Fragulator. Note: 'WAVG' stands for 'Weighted Average'.

# Equity markets (7)

Equity holdings by type of holder (€mn; average 2010-14)



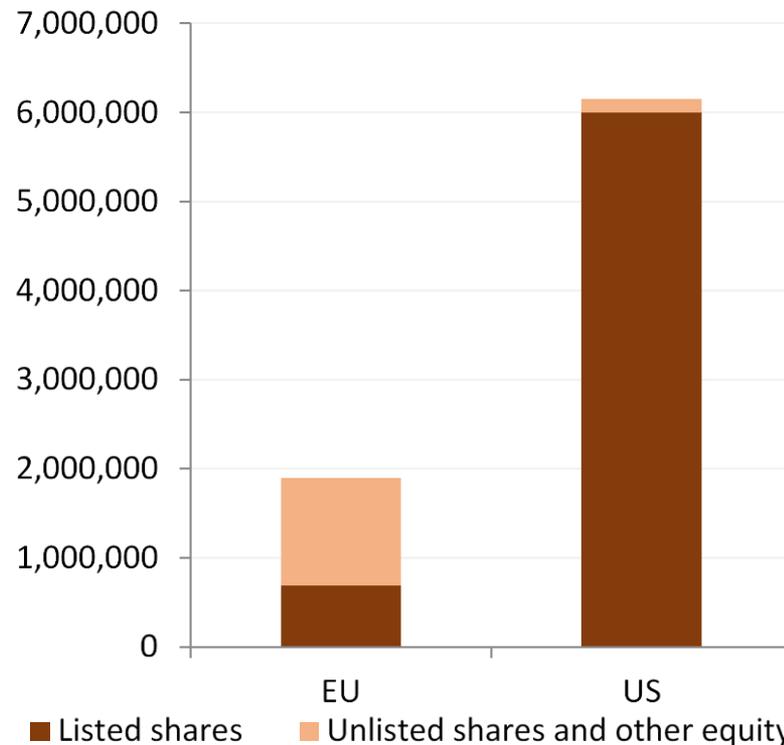
Note: 'HH', Households; 'NFCs', Non-Financial Corporations; 'Gov', General Government; 'MFIs (incl. MMF)', Monetary Financial Institutions (including Money Market Funds); 'OIFs', Other Investment Funds; 'OFIs', Other Financial Institutions; 'IC & PF', Insurance Companies and Pension Funds.

Data Sources: Eurostat and US Fed. Eurostat (exchange rate).

# Insurance and pension funds

27

*Investments in equity of insurance and pension funds (end 2014; €mn)*



Data Sources: Eurostat and US Federal Reserve. Eurostat for exchange rates.

# Cross-border integration

# Methodology

29

- 'Financial contracting' approach
  - ▣ Contracting and renegotiation
- Three key areas:
  - ▣ **Price discovery**
    - Information about underlying assets and financial instruments
  - ▣ **Execution**
    - Entry and exit requirements
  - ▣ **Enforcement**
    - Public and private enforcement
- Artificial & structural barriers
- Cost predictability for discounting purposes

*Cost predictability in cross-border market-based financial contracting*

Functions	Output	Cost predictability
Price discovery	Data	Comparability
Execution	Entry/exit requirements	Fairness
Enforcement	Rules & procedures	Certainty

# Cross-border barriers - Execution

30

- Execution could be much better...
  - ▣ Distribution channels are closed (marketing rules)
  - ▣ Static execution policies and limited ongoing disclosure
  - ▣ Cases of discrimination in tax treatment and authorisation procedures
  - ▣ 8 barriers (1 requires immediate action) & 6 policy recommendations

# Barriers - Execution

<b>A. ENTRY PROCEDURES</b>			
<b>1. Execution policies</b>	Artificial	No	Immediate action
<b>2. Tax discrimination</b>	Artificial	Yes	Action needed
<b>3. Local facilities, paying agents &amp; other marketing rules</b>	Artificial	Yes	Action needed
<b>4. Corporate action standards</b>	Artificial	Yes	Action needed
<b>5. UCITS filing process</b>	Artificial	Yes	Action needed
<b>6. Passport processing fees</b>	Artificial	Yes	Action needed
<b>B. EXIT PROCEDURES</b>			
<b>7. Withholding tax refund and collection procedure</b>	Artificial	Yes	Action needed
<b>8. Full disclosure of exit charges and conditions</b>	Structural	n/a	Action needed

# Cross-border barriers – Price discovery

32

- ...data comparability is poor...
  - ▣ Opaque internal evaluation models
  - ▣ Conflicts of interest data (e.g. RPT, cross-ownership)
  - ▣ Access and quality of company data
  - ▣ 16 barriers (4 require immediate action) & 13 policy recommendations

# Barriers – Price Discovery

33

Cross-border barrier	Nature	Cost predictability	Policy outcome
<b>PRICE DISCOVERY</b>			
<b>A. INFORMATION ON THE UNDERLYING ASSET</b>			
1. IFRS optionality for discretionary evaluation models, e.g. asset retirement obligations, loan provisions, etc.	Artificial	No	Immediate action
2. Domestic accounting standards for non-listed companies	Artificial	No	Immediate action
3. Reporting formats, e.g. half-yearly reports, etc.	Artificial	Yes	Action needed
4. IFRS optionality for alternative calculation methodologies or definitions, e.g. classification problems, such as pension interest in income statement as interest or operating expense or calculation of debt at amortised cost or fair value	Artificial	Yes	Action needed
5. Alternative performance measures	Artificial	Yes	Action needed
6. Voting share disclosure threshold	Artificial	Yes	Action needed
7. Domestic business registries	Artificial	Yes	Action needed
8. Credit risk scoring and national credit bureaux	Artificial	Yes	Action needed
9. Rules on related-party transactions (definitions)	Artificial	Yes	Action needed
10. Compensation disclosure (methodology)	Artificial	Yes	Action needed
11. Off-balance sheet items	Structural	No	Action needed
<b>B. FINANCIAL INSTRUMENT INFORMATION</b>			
12. Ongoing performance disclosure (domestic market practices)	Artificial	No	Immediate action
13. Exit conditions disclosure (domestic market practices)	Artificial	No	Immediate action
14. Prospectus disclosure requirements	Artificial	Yes	Action needed
15. Calculation methodologies for PRIIPs costs (in KID)	Artificial	Yes	Action needed
16. Market data formats/costs & national bias in securities listing	Artificial	Yes	Action needed

# Cross-border barriers - Enforcement

34

- ...but enforcement is even worse.
  - ▣ Quality of implementation
  - ▣ Judicial review (quality of courts and ADR)
  - ▣ Weak sanctioning powers & due process
  - ▣ 11 barriers (7 require immediate action) & 13 policy recommendations

# Barriers - Enforcement

35

<b>A. PUBLIC ENFORCEMENT</b>			
1. 'Good faith' acquisitions	Artificial	No	Immediate action
2. Acquisition and disposition of securities	Artificial	No	Immediate action
3. Conflict-of-laws regime	Artificial	No	Immediate action
4. Art. 17 Breach of EU law proceedings (ESMA)	Structural	n/a	Action needed
5. Art. 9 consumer protection powers (ESMA)	Structural	n/a	Action needed
6. Sanctioning regimes (illicit profits restitution)	Artificial	Yes	Action needed
<b>B. PRIVATE ENFORCEMENT</b>			
7. Automatic stays	Artificial	No	Immediate action
8. Company's valuation in insolvency (principles)	Artificial	No	Immediate action
9. Secondary proceedings (conditions & deciding court)	Artificial	No	Immediate action
10. COMI for legal persons (uncertain presumption) & decentralised appeal	Artificial	No	Immediate Action
11. Gatekeepers' supervision	Structural	n/a	Action needed
12. Cross-border Alternative Dispute Resolution (ADR) mechanism (EU-wide)	Structural	n/a	Action needed

# Policy recommendations - Highlights

36

## 1. Price discovery

- ▣ Reducing discretion in internal evaluation models with ‘comply-or-explain’ regime (e.g. IFRS 9 ‘significant increase in risk’ or IAS 24, ‘control’ definition in RPT) Company filings and business registries
- ▣ Accounting standards for unlisted companies
- ▣ Accounting standards and tax reporting
- ▣ Listing authority and national requirements (regulatory license)

## 2. Execution

- ▣ Uniform application of KID beyond PRIIPs
- ▣ Review of marketing rules and authorisation procedures
- ▣ Uniform tax reclaim procedures

# Policy recommendations - Highlights

37

## 3. Enforcement

- ▣ ESMA's review (internal)
  - Independence (e.g. appointment)
  - Representation of 'EU-wide interest' (e.g. art. 17 procedure)
- ▣ ESMA's review (external)
  - More binding powers
  - More direct supervision (through colleges and binding decisions)
    - Accounting rules, listing of UCITS, EU passport and so on
  - More exclusive competences (e.g. CCPs, ICSDs, etc)
- ▣ Network of national ombudsmen
  - Facilitate access at national level
  - Mediation powers
- ▣ Consumer agency (in ESMA)
  - To lead convergence of national laws
  - Retail market is key for diversification
- ▣ Insolvency proceedings (COMI, secondary proceedings and stays)
- ▣ Legal architecture (securities law, etc)

# Conclusions (micro)

38

- Barriers are not insurmountable
  - ▣ Plan can be spread over the years but with a firm and detailed roadmap
- Enforcement should be the priority
  - ▣ Strengthening the role of ESMA in the network is inevitable
    - Start with internal governance issues and plan ahead
  - ▣ Private enforcement (ADR and insolvency) has been neglected for too long...
    - ...but plan needed to improve quality of courts.
- Data comparability is still insufficient (not just new data)
- Execution needs a shift towards more ongoing disclosure and a pan-European architecture (e.g. retail brokers)

# Conclusions (macro)

39

- Financial fragmentation is a destructive process
  - ▣ Macro (flows retrenchment) & micro (quality of markets)
- Focus on how to repair this process (huge upside)
- Complementary (if not alternative) to greater fiscal policy coordination
- A capital market integration plan can link the Eurozone (and its banking union) with the rest of the European Union
  - ▣ Only real perspective to re-launch the EU political project (single market)

# Thank you!

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ECMEG final report available at

<http://bit.ly/CMU-EU>

[www.ceps.eu](http://www.ceps.eu)