



EUROPE'S UNTAPPED CAPITAL MARKET

MARKET-BASED FINANCE AFTER THE GREAT FINANCIAL CRISIS

BME, Madrid
11 May 2016

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Highlights

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- Yearlong discussion with experts, academics & policy-makers
- Roughly 300 pages with over 120 charts and tables
- 36 Cross-border barriers to capital market integration
- 33 Policy Recommendations
- Focus on financial integration policies
 - ▣ Barrier removal plan

Financial integration

Financial integration

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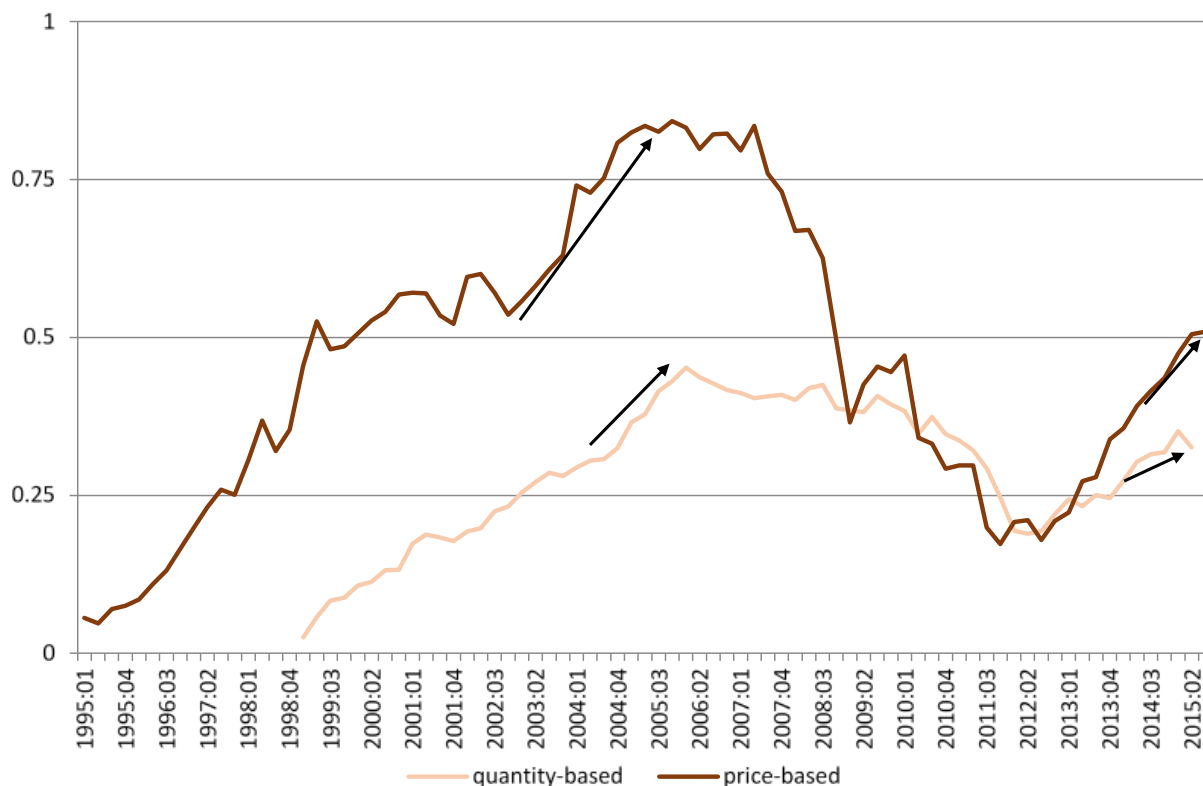
- ***Financial integration*** is the process through which different regions or countries become more financially interconnected. This process involves the free circulation of capital and financial services among those areas. It usually determines an increase in capital flows across regions (***private risk sharing***) and a ***convergence of prices and returns*** for financial assets and services. (section 2.1)

Integration after the financial crisis

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□ Price with no quantity (holdings) convergence?

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

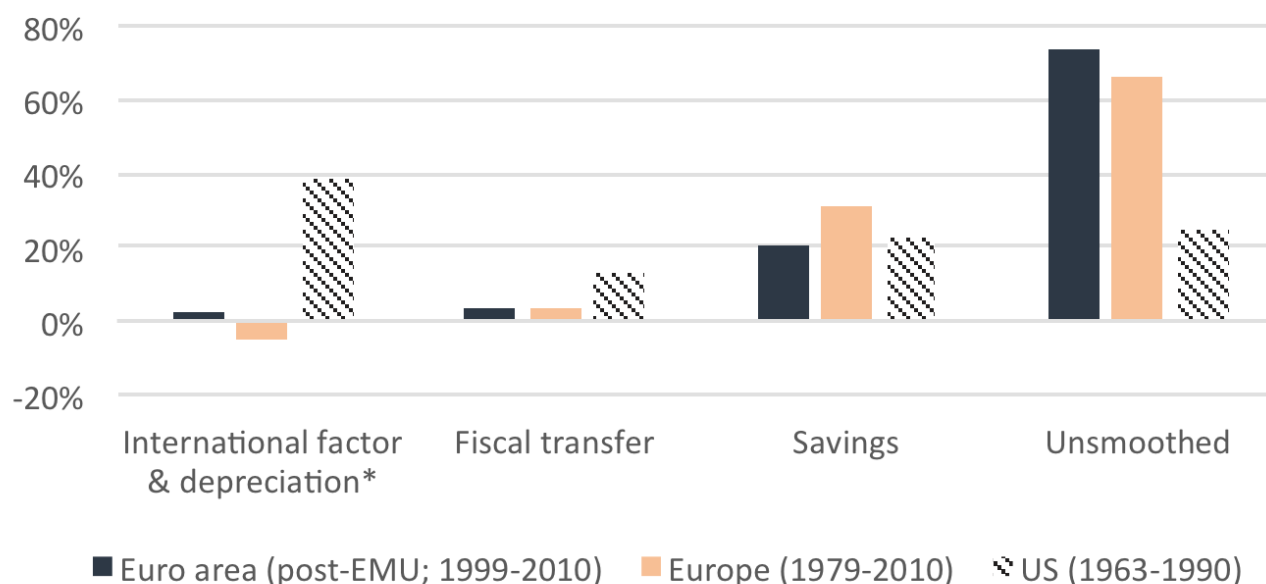


Data Source: ECB.

Risk sharing

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Channels of output smoothing in Europe and US

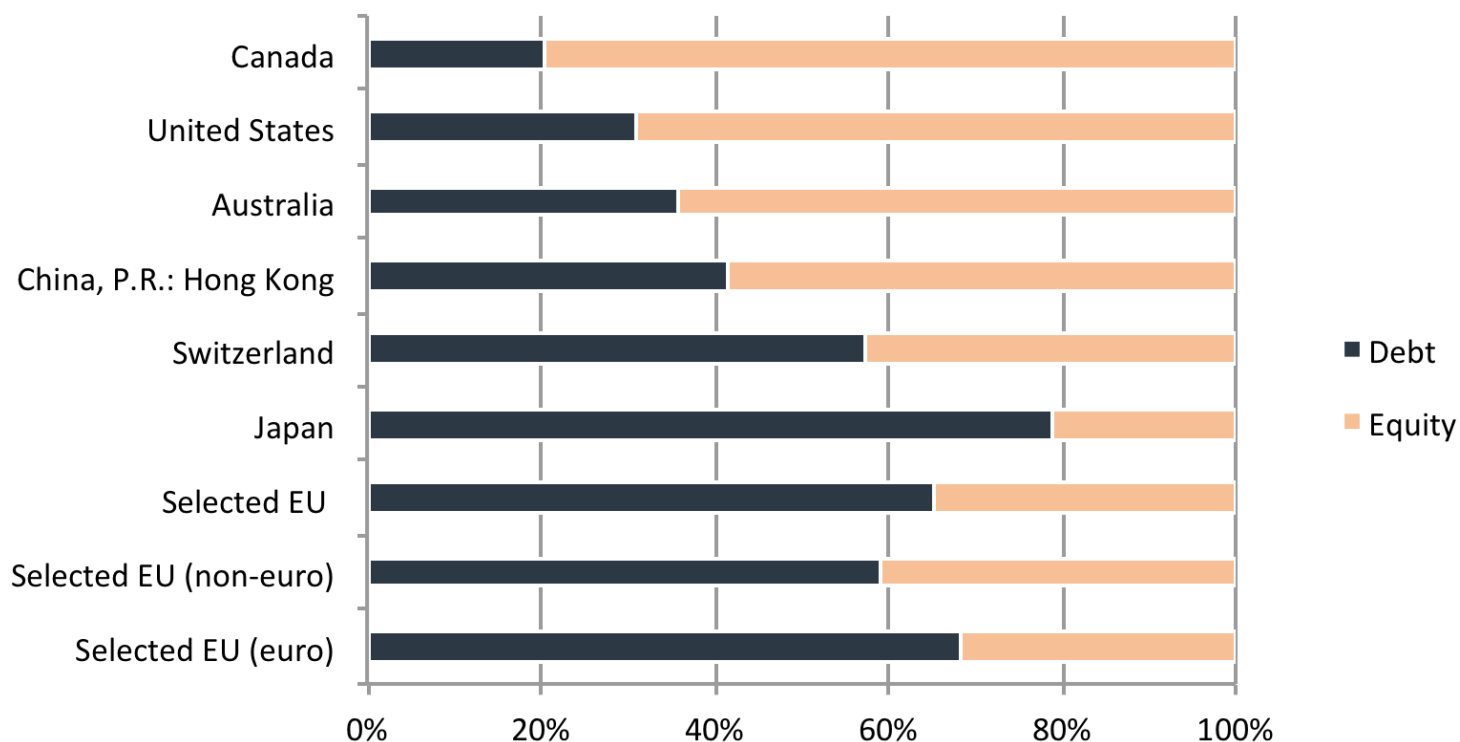


*Source: Based on Furceri & Zdzienicka (2013) and Asdrubali et al. (1996). Note: *This includes factor income flows and capital depreciation output produced in part by international financial flows (including capital markets, credit markets and FDI). It is the difference between gross domestic product (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.*

Investment flows

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

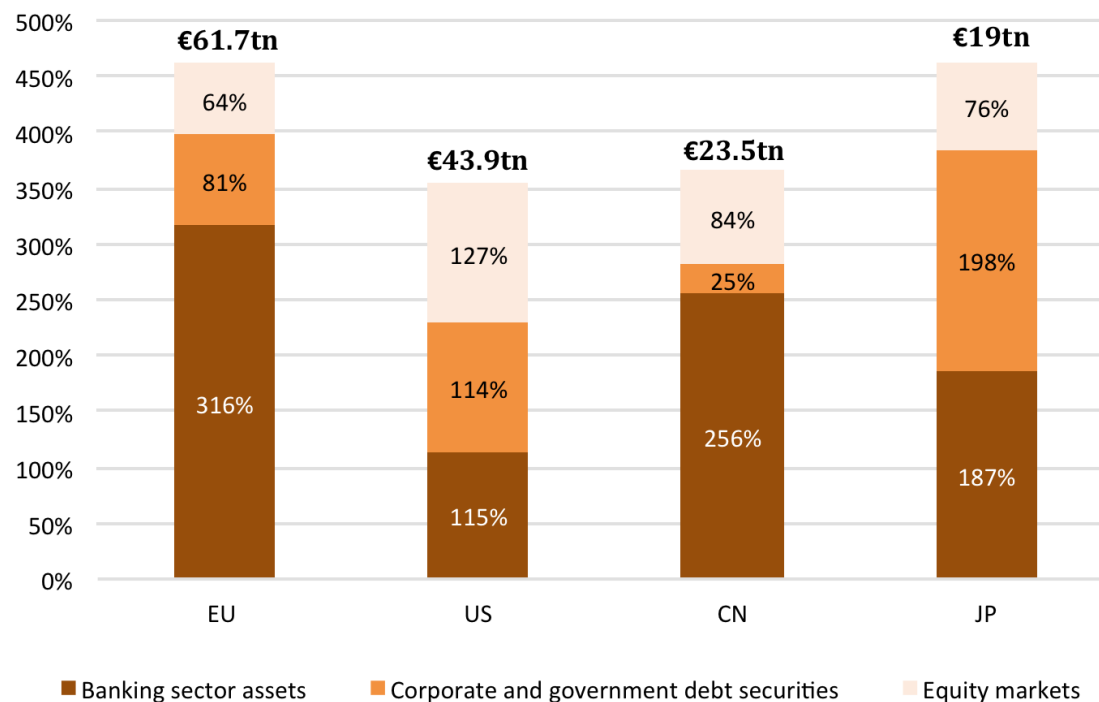


Source: Author's elaboration from CPIS-IMF. Note: 'Selected EU' countries include Germany, France, Italy, Spain, The Netherlands, United Kingdom, Sweden, Poland. No 2014 data for Sweden and Australia. 'Euro' means cross-border flows towards Euro area countries. 'Non-euro' means cross-border flows towards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

Financial sector

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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?

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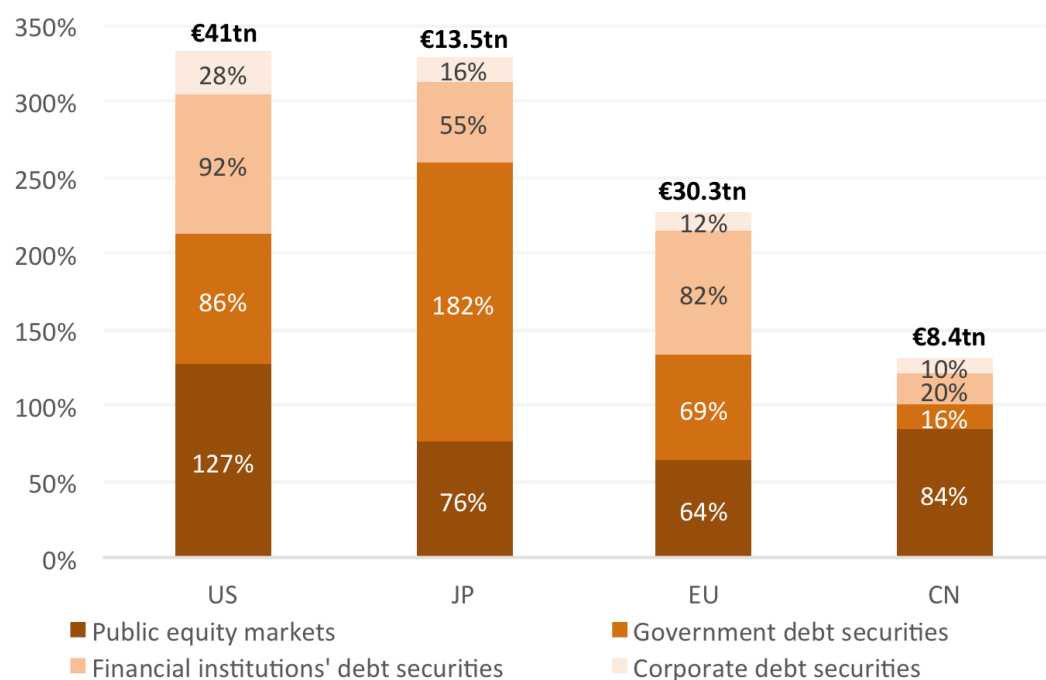
- I. Private risk sharing via capital markets
 - ▣ To stabilise capital flows in case of shocks from aggregate risk (cross-sectional risk sharing)
 - More market-based funding
 - More equity-based funding
- II. Monetary policy transmission
 - ▣ Concentration in interbank market funding
 - ▣ Market-based 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

Capital markets

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



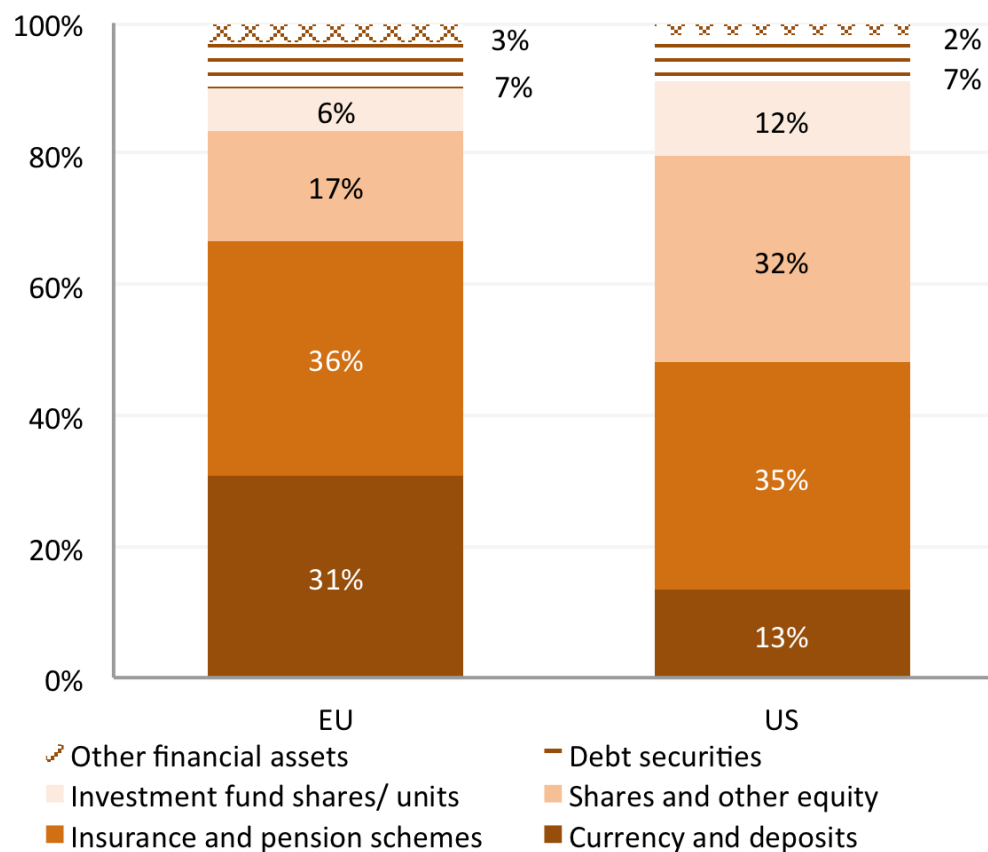
Notes: Derivative markets, excluded from this chart, include securitisation, derivative contracts, and indexes (exchange-traded products; see following sections). 'Public equity markets' are equal to domestic market capitalisation.

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

Household liquidity

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

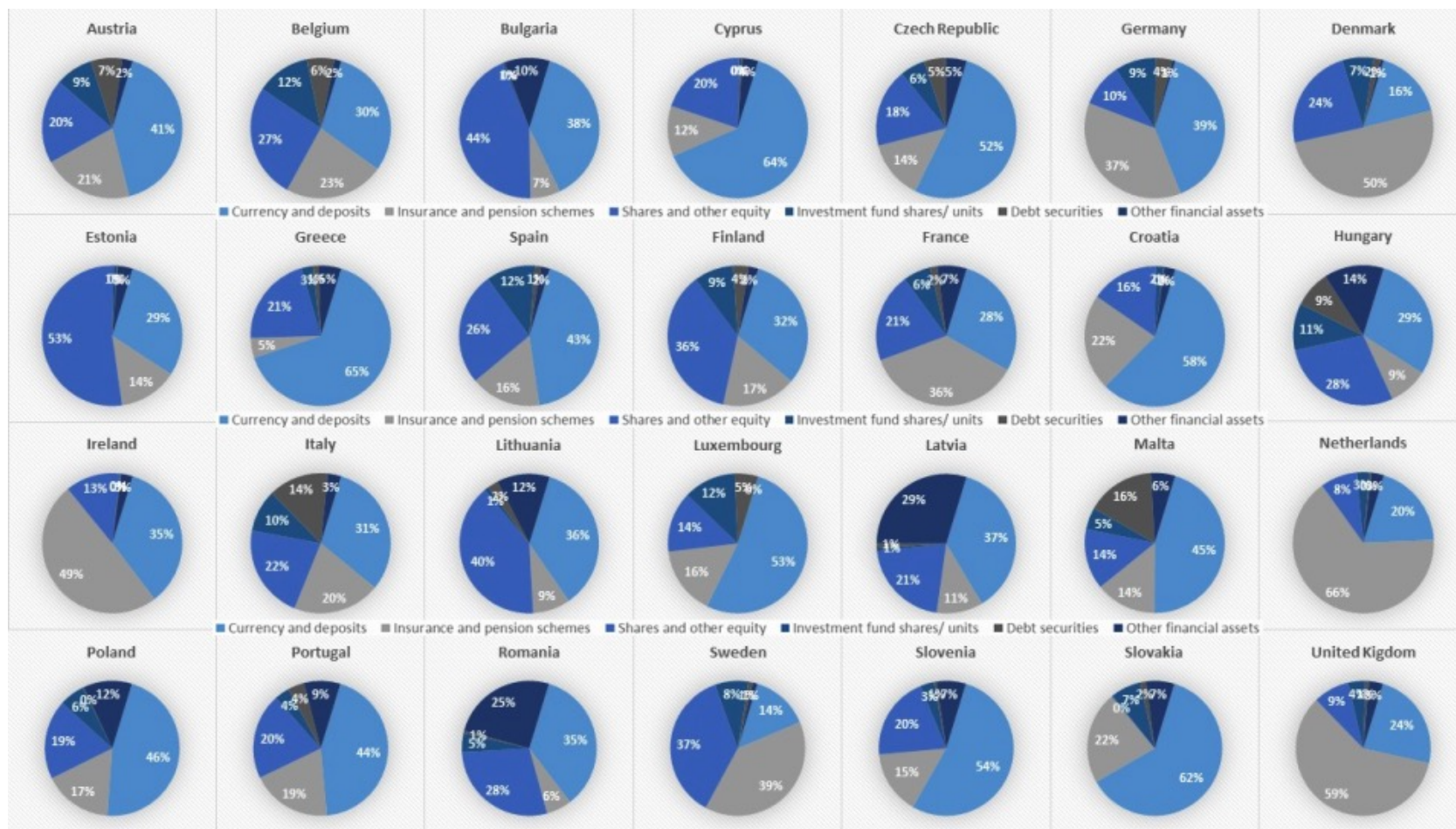


Source: ECB, Eurostat, US Fed. Eurostat (exchange rates).

Financial market integration in Europe

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EU households' financial assets composition by country (% of total assets)

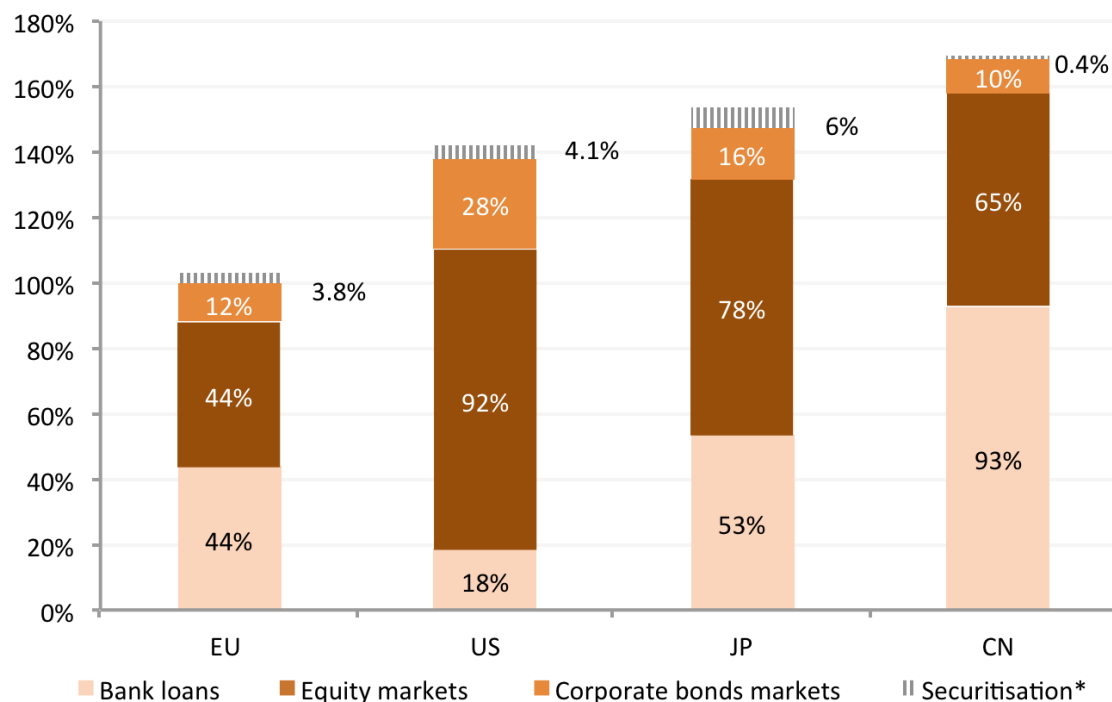


Source: Eurostat.

NFC funding

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

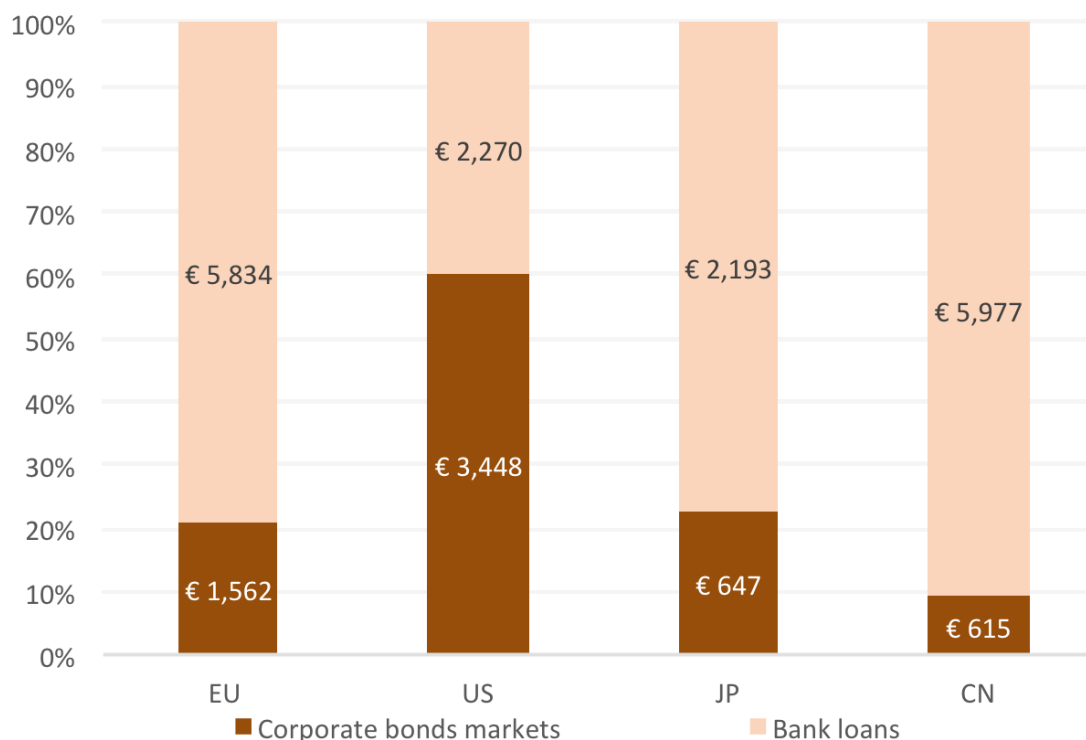


Source: IMF, Eurostat, BIS, ECB, US Fed, BoJ, PBoC, WFE, FESE, individual stock exchanges, AFME, SIFMA, CICC Research. Eurostat (exchange rates). Note: Securitisation refers to the non-financial corporate sector both in the US (CMBS) and the EU (CDO/CLO, CMBS, SME, WBS/PFI), while it includes total outstanding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

NFC debt funding

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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.

The state of EU capital markets

Quality of EU financial markets

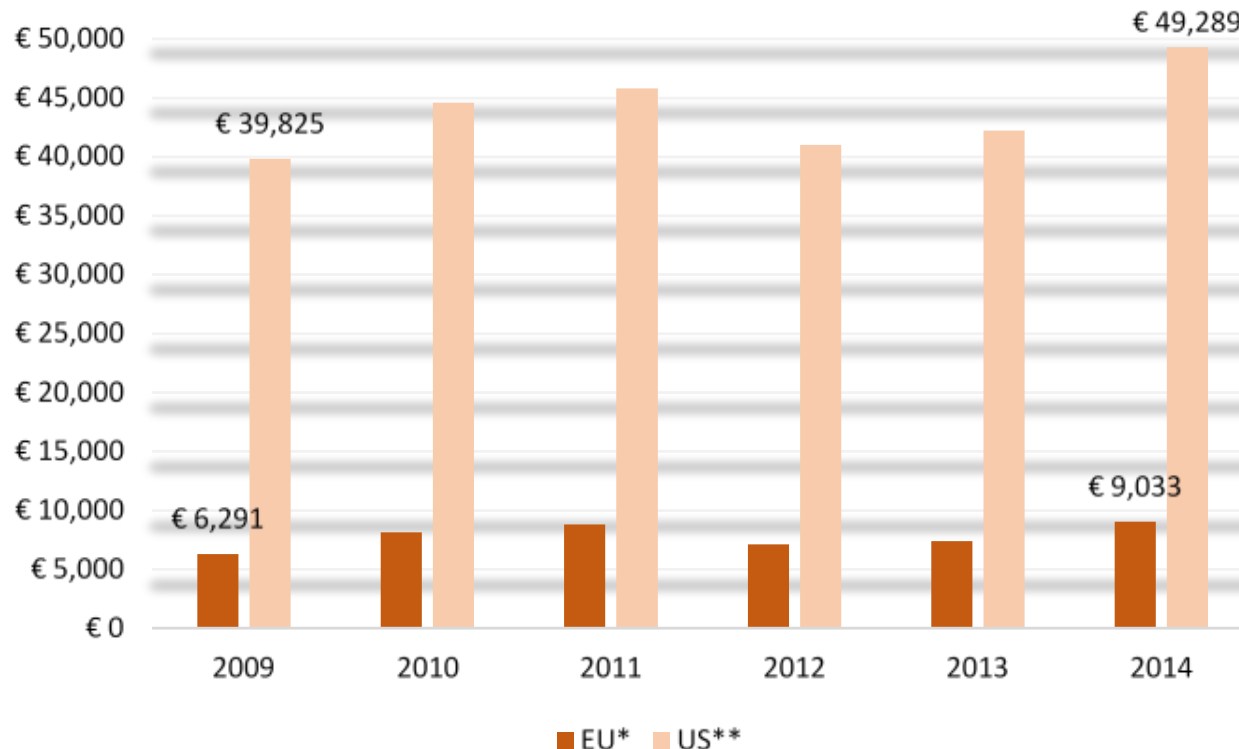
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- **Integration & efficiency of individual markets** is poor
 - ▣ Single currency played a limited role
 - ▣ Equity markets are fairly geographically fragmented, lack depth & quality (secondary markets)
 - ▣ Bond markets are OTC, but as active as equity 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 (4)

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



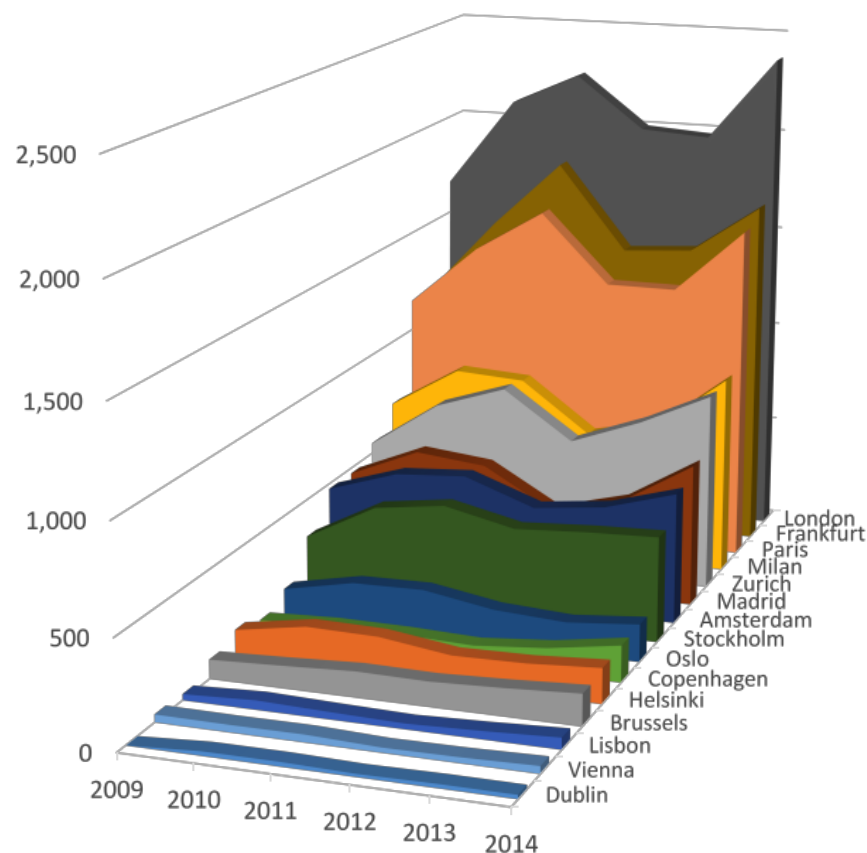
Note: *Includes London, Frankfurt, Paris, Milan, Amsterdam, Madrid, Stockholm, Copenhagen, Brussels, Helsinki, Lisbon, Vienna, Dublin (98% of the market); **includes US NYSE, Nasdaq, BATS (sum of daily data).

Source: BATS Europe, BATS US.

Equity markets (3)

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



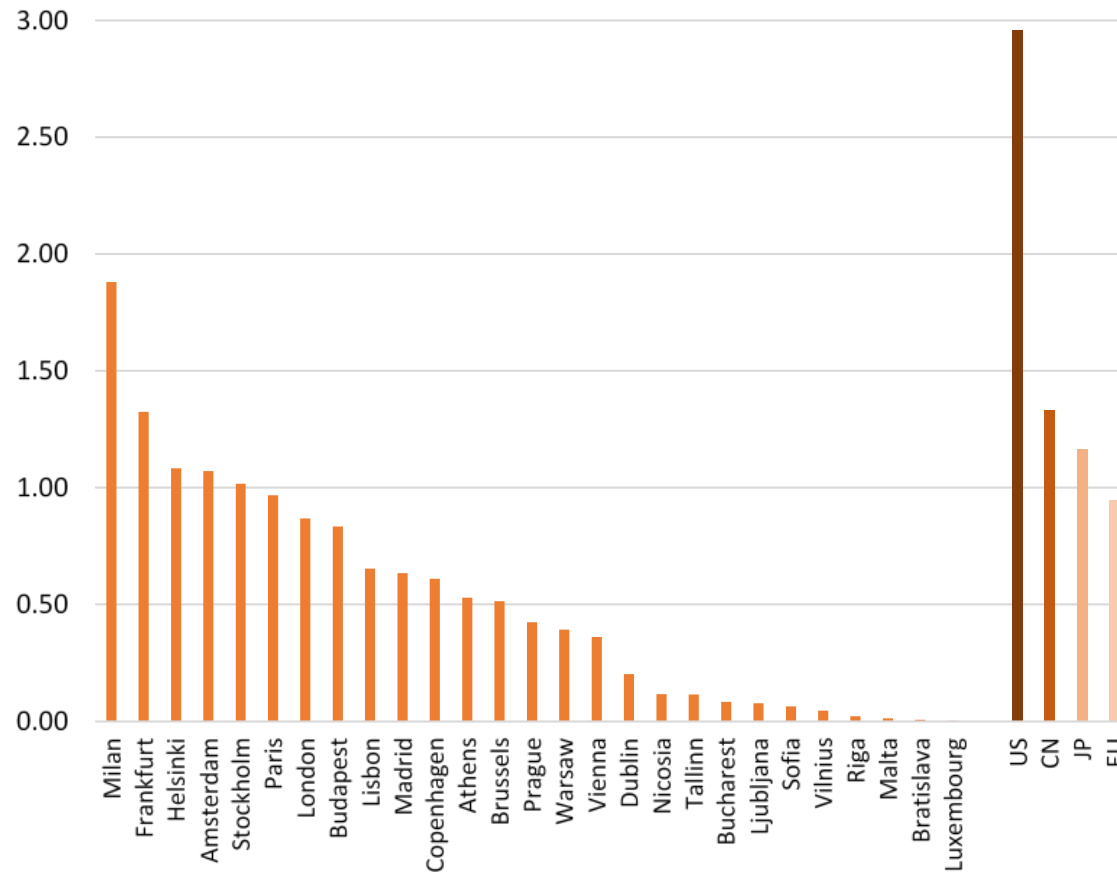
Note: Sum of daily data points.

Data Source: BATS Europe.

Equity markets (5)

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Market efficiency indicator (average 2009-14)



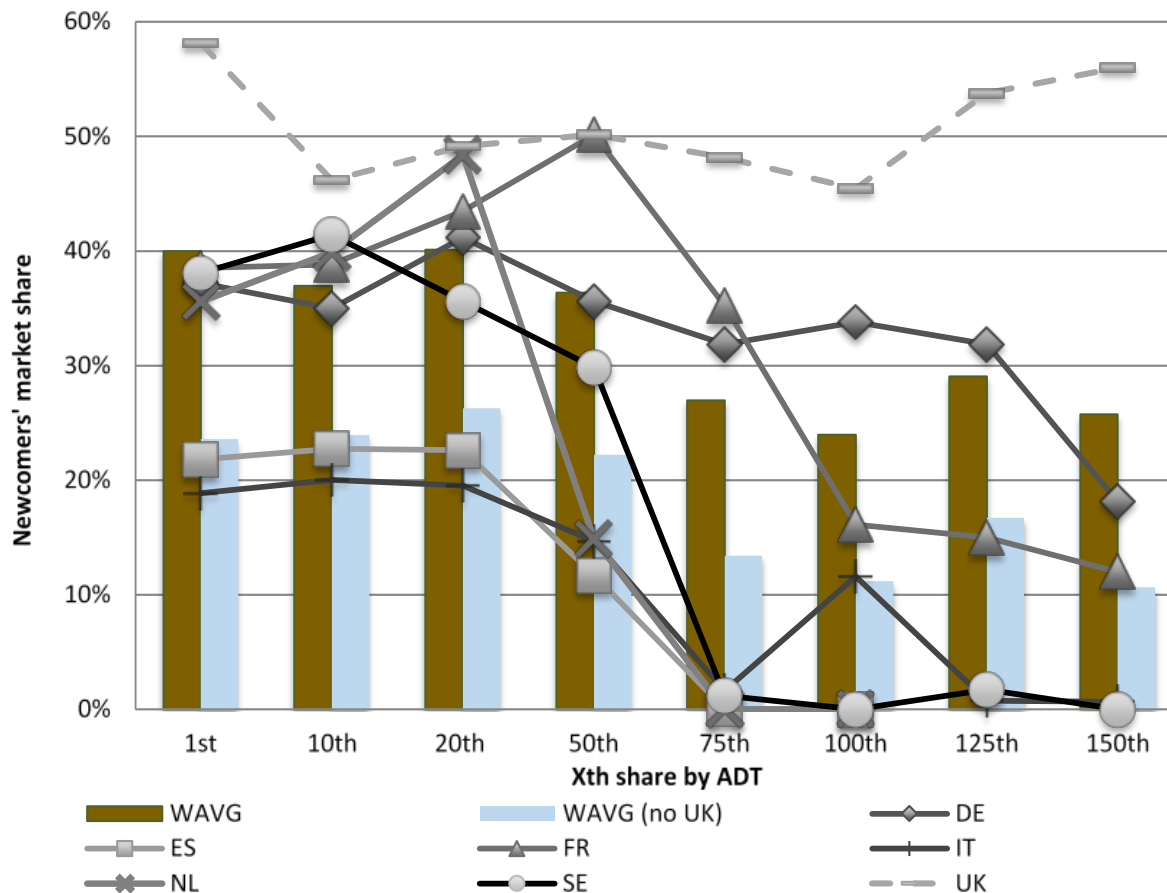
Note: This ratio is equal to value of turnover over market capitalisation.

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

Equity markets (6)

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

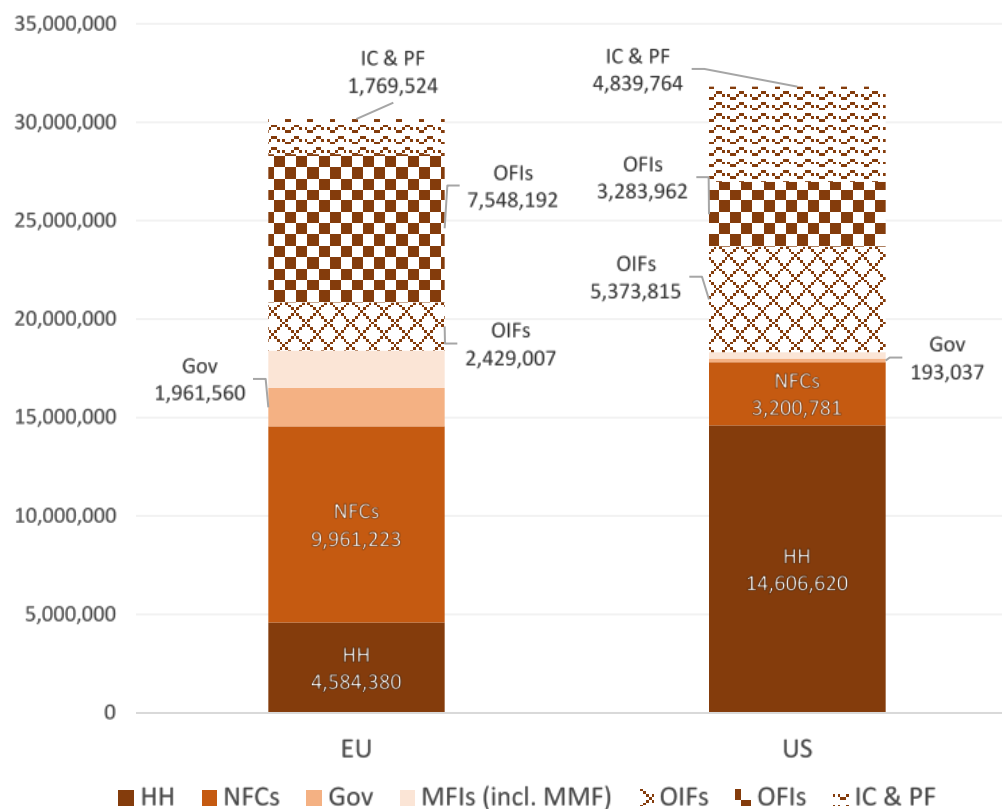


Source: Author's elaboration from ESMA and Fidessa Fragulator. Note: 'WAVG' stands for 'Weighted Average'.

Equity markets (7)

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



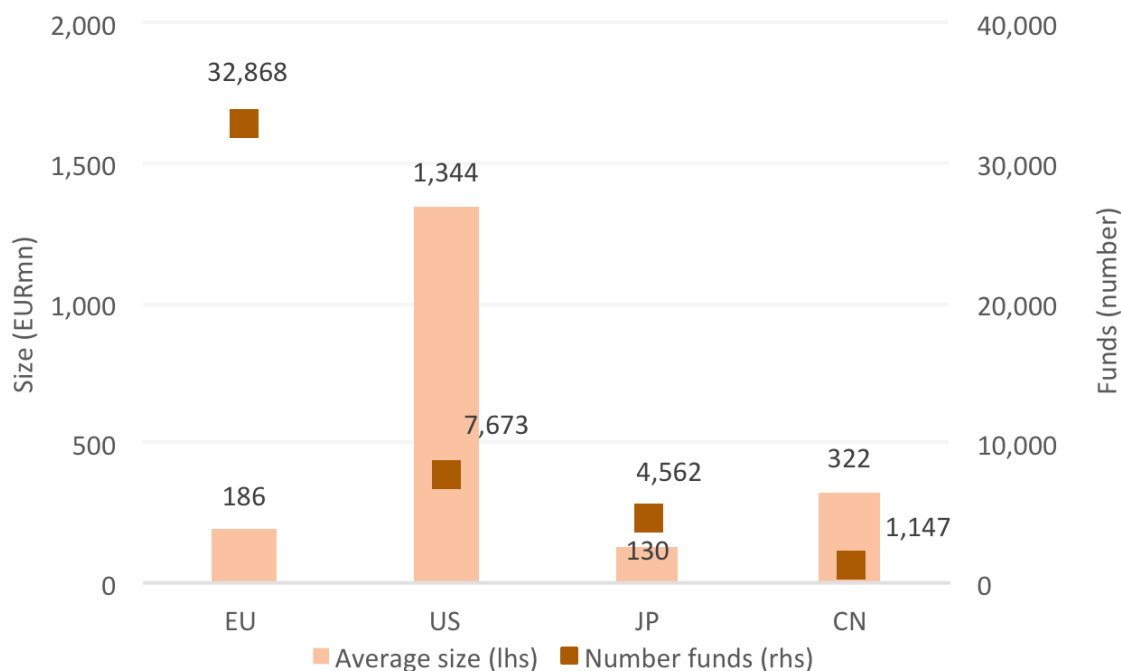
Note: 'HH', Households; 'NFCs', Non-Financial Corporations; 'Gov', General Government; 'MFIs (incl. MMF)', Monetary Financial Institutions (including Money Market Funds); 'OIFs', Other Investment Funds; 'OFIs', Other Financial Institutions; 'IC & PF', Insurance Companies and Pension Funds.

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

Investment fund market

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Average size (€mn) and number of open-end (mutual) funds (average 2010-14)



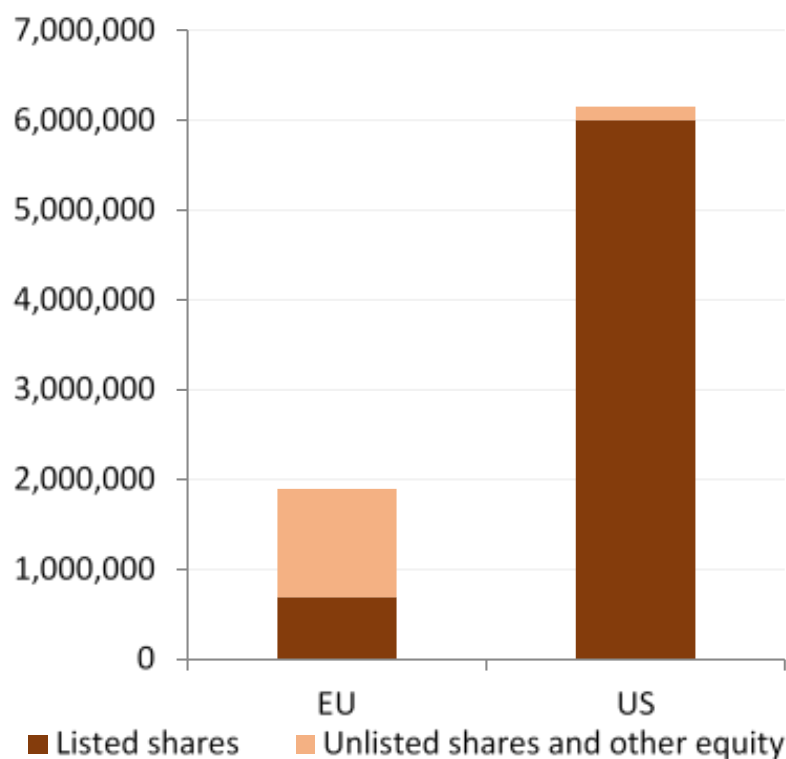
Notes: China includes Hong Kong. Mutual funds include equity, bond, balanced/mixed, money market, and other funds. Funds of funds are not included, except for FR, DE, IT, LU. No data available for Cyprus, Estonia, Lithuania and Latvia.

Source: EFAMA International Quarterly Statistical Releases, 2015 ICI Investment Company Institute Fact Book.

Insurance and pension funds

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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

Capital Markets Union (CMU)

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- Focus on financial integration policies
 - ▣ Barrier removal plan
- Differences between Capital Markets Union and Banking Union
 - ▣ Whole European Union
 - ▣ Strengthening current institutional framework
 - ▣ No public risk sharing
 - ▣ No 'trigger event'

Methodology

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- ‘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

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- **Execution could be better...**
- 8 barriers (1 requires immediate action, 13%), including:
 - ▣ Distribution channels are closed (marketing rules)
 - ▣ Static execution policies and limited ongoing disclosure
 - ▣ Cases of discrimination in tax treatment and authorisation procedures
 - ▣ Withholding tax procedures
- 6 policy recommendations, including:
 - ▣ Uniform application of KID beyond PRIIPs
 - ▣ Review of marketing rules and authorisation procedures
 - ▣ Uniform tax reclaim procedures

Barriers - Execution

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

Cross-border barriers – Price discovery

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- **...data comparability is poor...**
- 16 barriers (4 require immediate action, 25%), including:
 - ▣ Opaque internal evaluation models & classifications of assets
 - ▣ Conflicts of interest data (e.g. RPT, cross-ownership)
 - ▣ Access and quality of company data

Cross-border barriers – Price discovery

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- 13 policy recommendations, including:
 - ▣ Reducing discretion in internal evaluation decisions 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 and path dependence
 - ▣ Accounting standards and tax reporting
 - ▣ Listing authority and national requirements (regulatory license)
 - ▣ Standardised ongoing performance template

Barriers – Price Discovery

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Cross-border barrier	Nature	Cost predictability	Policy outcome
PRICE DISCOVERY			
A. INFORMATION ON THE UNDERLYING ASSET			
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. FINANCIAL INSTRUMENT INFORMATION			
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

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- **...but enforcement is even worse.**
- 11 barriers (7 require immediate action, 64%), including:
 - ▣ Quality of implementation
 - ▣ Judicial review (quality of courts and ADR)
 - ▣ Weak sanctioning powers & due process

Cross-border barriers – Enforcement (2)

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- 13 policy recommendations, including:
 - ▣ 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 in mediation
 - More direct supervision (through colleges and binding decisions)
 - Accounting rules (empirical evidence), 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)

Barriers - Enforcement

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A. PUBLIC ENFORCEMENT			
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. PRIVATE ENFORCEMENT			
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

Conclusions (macro)

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- **Stability.** Financial fragmentation is a destructive process
 - ▣ Macro (flows retrenchment) & micro (quality of markets)
 - ▣ Focus on how to repair this process (huge upside)
- **Cohesion.** A capital market integration plan can link the Eurozone (and its banking union) with the rest of the European Union...
 - ▣ ...and it is complementary (if not alternative) to greater fiscal policy coordination
- **Efficiency.** It is the only real perspective to re-launch the EU political project, i.e. competition and well-functioning of the single market for capital, goods and services.

Conclusions (micro)

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- Data comparability is still insufficient (not just new data)
- Execution needs a shift towards more ongoing disclosure and a pan-European market architecture (e.g. retail brokers)
- 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.
- Barriers are not insurmountable
 - ▣ Plan can be spread over the years but with a firm and detailed roadmap (measurable objectives)

Thank you!

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ECMEG final report available at

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