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A NEW SENSE OF URGENCY: THE FUTURE OF CAPITAL MARKETS UNION

ANALYSIS OF THE PROGRESS SO FAR, THE CHALLENGES AHEAD - AND THE WAY FORWARD

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> This report underlines why Europe needs more capital markets and why it needs more integrated capital markets. It outlines a more ambitious and more focused roadmap for CMU over the next few decades that combines 'top down' initiatives at an EU level and 'bottom up' initiatives at a national level to build bigger and better capital markets.

The future of capital markets union

Capital markets union is five years old. Depending on your view, CMU is either an ambitious initiative to reduce the EU economy's reliance on its struggling banking system, map the challenges facing capital markets in the EU, and lay the foundations for further growth in the decades ahead - or a missed opportunity for fundamental reform that avoids the difficult questions and that will do little more than tinker at the edges of the problem.

This report argues that while the concrete output from CMU over the past five years has been relatively modest, a lot of the criticism levelled at the CMU project is unfair. Not least, CMU has put capital markets on the political agenda and - for the first time - has framed capital markets as part of the solution to Europe's economic and social challenges, instead of being part of the problem.

However, the EU and individual member states need to inject more urgency and ambition into CMU if it is to deliver on anything like its promise. This report outlines what we think is an ambitious but achievable roadmap.

Crucially, we draw a clear distinction between 'top down' initiatives at an EU level ('more union') to drive more integrated capital markets, and 'bottom up' initiatives in individual member states ('more capital markets') to build capacity. Too much of the focus of CMU 1.0 over the past five years has been on 'top down' initiatives. While it is vital that CMU continues to focus on these areas, transformational change in EU capital markets can *only* be achieved if individual countries commit to building deeper capital markets from the 'bottom up'.

The report addresses the following questions:

- What has CMU achieved so far and is it on track?
- How have European capital markets developed over the past five years?
- Why does Europe need bigger capital markets? And why does it need more integrated capital markets?
- What are the key levers that the EU and individual member states can pull to drive growth in capital markets?
- What should be the guiding principles for the next phase of CMU?
- And - perhaps most importantly - what policies can the EU and individual member states implement?

Note: this report focuses less on sustainable finance than many papers and reports on CMU. While we think the work on ESG and sustainability within CMU is hugely valuable in its own right (particularly the development of an EU-wide taxonomy for sustainable finance) we believe it is vital that it does not distract the EU or member states from the underlying challenges facing capital markets in Europe.

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SUMMARY

Here is a short summary of this report:

1. **A strong backdrop:** capital markets in Europe are heading in the right direction. The value of capital markets activity has increased by almost 50% across 28 different sectors in the five years since the launch of the capital markets union, and activity has increased in all but one sector. While this growth cannot be attributed to the CMU project it has provided a strong backdrop for it.

2. **On the agenda**: while the concrete output of the CMU project has been relatively modest in its first five years, we believe that much of the criticism of CMU has been unfair. Most importantly, CMU has put capital markets on the political agenda and - for the first time - has framed capital markets as part of the solution to Europe's economic and social challenges, instead of being a big part of the problem.

3. **The main barriers:** in the coming decade the EU will have to work hard to ensure that CMU overcomes the main barriers that have limited its progress so far. Most obviously, it will need closer political alignment between the European Commission, European Parliament and member states - and a concerted effort by the financial services industry to regain the trust of European policymakers and citizens.

4. **More capital markets:** the arguments that made a compelling case for CMU back in 2014 are even more compelling after Brexit. The EU27 needs bigger and deeper capital markets to reduce its reliance on bank lending, to diversify funding for companies, to help address the pensions time bomb, and to help fund the investment needed to address climate change. Much of this work needs to be done at a national level.

5. **More integrated capital markets:** the EU also needs more integrated capital markets. Despite significant progress over the past few decades, EU capital markets are largely a patchwork of 28 national markets. EU-wide initiatives to help integrate capital markets can help drive growth and reduce costs, but will not be enough on their own.

6. **Some principles for the next phase:** five core principles can help guide the next phase of CMU: i) a clearer distinction between 'more union' (EU-wide initiatives to drive integration) and 'more capital markets' (at a member state level); ii) making a better case for capital markets; iii) a more focused and prioritised action plan; iv) a focus on competition and transparency; and v) an 'open CMU' that retains a global perspective.

7. **Regulation and supervision:** redesigning the supervisory and regulatory framework in the EU will not on its own create a CMU, but it will be impossible to have a fully-integrated capital market without significant change. Moving towards centralised markets supervision and redefining the mandate for regulators will be an important step.

8. **Deeper pools of capital:** you cannot have deep capital markets without deep pools of capital. This should be the top priority for the next phase of CMU. While pensions reform is beyond the remit of the EU, it can work closely with member states to incentivise and encourage best practice, such as the phased introduction of auto-enrolment workplace pensions.

9. **Laying the foundations:** there are few better examples of the barriers ahead to CMU than the complex patchwork of stock exchanges and market infrastructure. The EU should encourage more consolidation, more competition, and more transparency to accelerate closer integration. At the same time, it can work with member states to develop a more appropriate and consistent tax regime to incentivise more investment and a longer-term focus.

10. **A national prerogative:** ultimately most of the big levers to encourage the growth of bigger and better capital markets can only be pulled by individual member states. If national governments want to ensure that companies in their country have access to a diverse range of short- and long-term funding to invest in jobs and growth, that savers have access to low cost and sustainable investment and retirement products, and that cross-border investors want to invest in their country, it is up to them - and not the EU - to act *(there is a list of questions for national governments at the back of this report).*

AT A GLANCE - EU CAPITAL MARKETS OVER FIVE YEARS

Fig. 1 The change in the size and depth of capital markets in the EU since 2013

This table summarises the change in absolute size and depth relative to GDP in different sectors of the capital markets since 2013 in the EU28 and EU27 (by comparing the three years to 2018 with the three years to 2013). It also looks at whether capital markets in the EU28 have narrowed the gap in depth with the US, and whether markets in the EU27 have narrowed the gap with the UK.

	EU28			EU27		
Sector	Increase in value?	Increase in depth?	Narrowed gap vs US?	Increase in value?	Increase in depth?	Narrowed gap vs UK?
Pools of capital						
- Pensions assets	🟢 33%	🟢	🟢	🟢 35%	🟢	🟢
- Insurance assets	🟢 18%	🟢	🟢 *	🟢 19%	🟢	🟢
- Household assets	🟢 23%	🟢	🔴	🟢 23%	🟢	🟢 *
- Pensions + insurance	🟢 23%	🟢	🟢	🟢 24%	🟢	🟢
Market / asset values						
- Stockmarket	🟢 31%	🟢	🔴	🟢 40%	🟢	🟢
- Corporate bond market	🟢 17%	🟢	🔴	🟢 34%	🟢	🟢
- Bank lending to companies	🔴 -4%	🔴	🔴 *	🔴 -3%	🔴	🟢 *
Asset management						
- Assets under management	🟢 45%	🟢	🟢	🟢 46%	🟢	🟢
- Investment funds (by domicile)	🟢 65%	🟢	🟢	🟢 65%	🟢	🟢 *
Debt markets						
- Corporate bond issues	🟢 38%	🟢	🟢	🟢 39%	🟢	🟢
- High-yield bond issues	🟢 27%	🟢	🟢	🟢 31%	🟢	🟢
Equity markets						
- All equity issues	🟢 34%	🟢	🟢	🟢 27%	🟢	🔴
- IPOs	🟢 109%	🟢	🟢 *	🟢 158%	🟢	🟢
- Small IPOs (<$100m)	🟢 138%	🟢	🟢	🟢 174%	🟢	🟢
- Equity trading	🟢 19%	🔴	🟢	🟢 23%	🔴	🔴
Merger & acquisitions						
- All M&A activity	🟢 61%	🟢	🟢	🟢 46%	🟢	🔴
- Domestic M&A	🟢 47%	🟢	🟢	🟢 34%	🟢	🔴
Private equity & venture capital						
- Private equity funds raised	🟢 115%	🟢	🟢	🟢 114%	🟢	🟢
- Private equity activity	🟢 63%	🟢	🟢	🟢 71%	🟢	🟢
- Venture capital activity	🟢 95%	🟢	🔴	🟢 86%	🟢	🔴

*Note: sectors marked with a * are more developed relative to GDP than in the US or UK and the traffic lights denote whether they have increased or decreased their lead. Sources: New Financial analysis of data from Dealogic, EFAMA, Eurostat, AFME, ECB, BIS, Insurance Europe, EIOPA, US Treasury, WFE, local exchanges, Invest Europe, NVCA, AIC, Preqin, Willis Towers Watson, Fidessa*

THE GROWTH IN EU CAPITAL MARKETS

Heading in the right direction

A first step in analysing the progress of EU capital markets since the European Commission announced the capital markets union initiative in 2014 is to look at the change in the size of capital markets activity since then. Over the past five years, the size of capital markets activity in the EU has grown significantly. Fig.1 on the previous page shows the change in the absolute value of activity in different sectors of the capital markets in the EU28 and EU27 in the three years to 2018 compared with the three years to 2013. Of course, the CMU project on its own has not driven this growth in activity, but the increase in capital markets activity provides valuable context for assessing the progress and future of CMU.

1. **Across the board:** over the past five years the value of activity in all but one of the 28 sectors of the capital markets that we analysed has increased in nominal terms in both the EU28 and EU27. The average increase across 28 sectors is just under 50% between the three years to 2013 (the year before the launch of CMU) and the three years to 2018. The only sector that shrunk was the value of bank lending to companies, which fell by 3% in the EU27, but this was more than offset by the increase in the value of outstanding corporate bonds. This reflects a shift in the reliance on bank lending by companies in the EU27: in the three years to 2018, 23% of corporate borrowing in the EU27 was from corporate bonds, a significant increase from 18% in 2013.
2. **Growing risk appetite:** it is encouraging that the areas of capital markets that can have the biggest impact on growth have increased considerably in size. IPO activity has more than doubled (+158%) over the last five years in the EU27 while the value of smaller IPOs (which raise less than $100m) has nearly tripled (+174%). Venture capital activity has nearly doubled (+86%) while private equity deals have increased by more than two thirds (+71%). The combined value of stock markets in the EU27 has grown by 40% since 2013.
3. **A strong foundation:** steady but less spectacular growth has been achieved in building deeper pools of capital. The value of pensions assets in the EU27 has increased by 35% over the five-year period, which translates into an additional €900bn in long-term capital, and the combined value of pensions and insurance assets has increased by a quarter. In a sign of the growing demand for investing in the EU27, the amount of money held in cash deposits has fallen by around 8%, while the value of investment funds domiciled in the EU27 has increased by two thirds (+65%) and the combined value of assets under management has grown by nearly half (+46%).
4. **Closing the gap:** it is encouraging to see that every sector of capital markets in the EU27 except equity trading has increased in depth (that is, the value of activity relative to GDP). And in most sectors, capital markets in the EU27 have grown faster over the past five years than across the EU as a whole (see page 6 for more analysis on the depth of capital markets). The only sectors where the gap between capital markets in the EU27 and the UK has widened over the past five years are the overall value of equity issues, equity trading, M&A activity and venture capital.
5. **Playing catch up:** while the growth in capital markets across the board over the past five years provides a strong backdrop for CMU, it is important to put that growth in context. First, the inherently long timeframe of the CMU project means that little if any of the increase in activity since it was launched can be directly attributed to CMU itself. Second, while the overall depth of capital markets has increased significantly over the past five years (see Fig.2), much of that growth has been the natural process of recovery from the financial crisis and subsequent euro crisis.

For all of the recent growth, capital markets across the EU28 are still significantly smaller relative to GDP than they were before the financial crisis.

Fig.2 The changing depth of EU capital markets

Average size of EU capital markets relative to GDP 2006-2018
Three year rolling average, rebased to EU = 100 in 2014

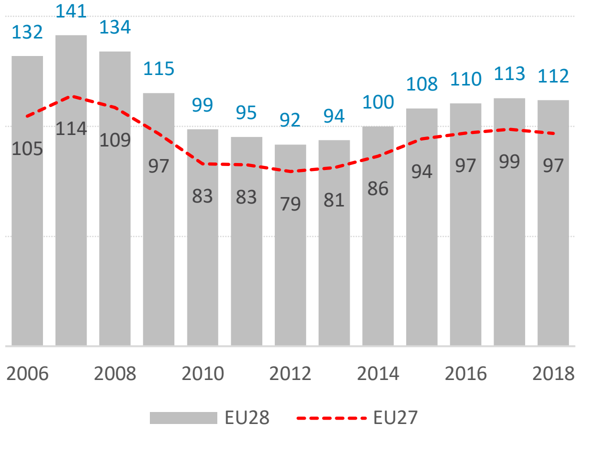
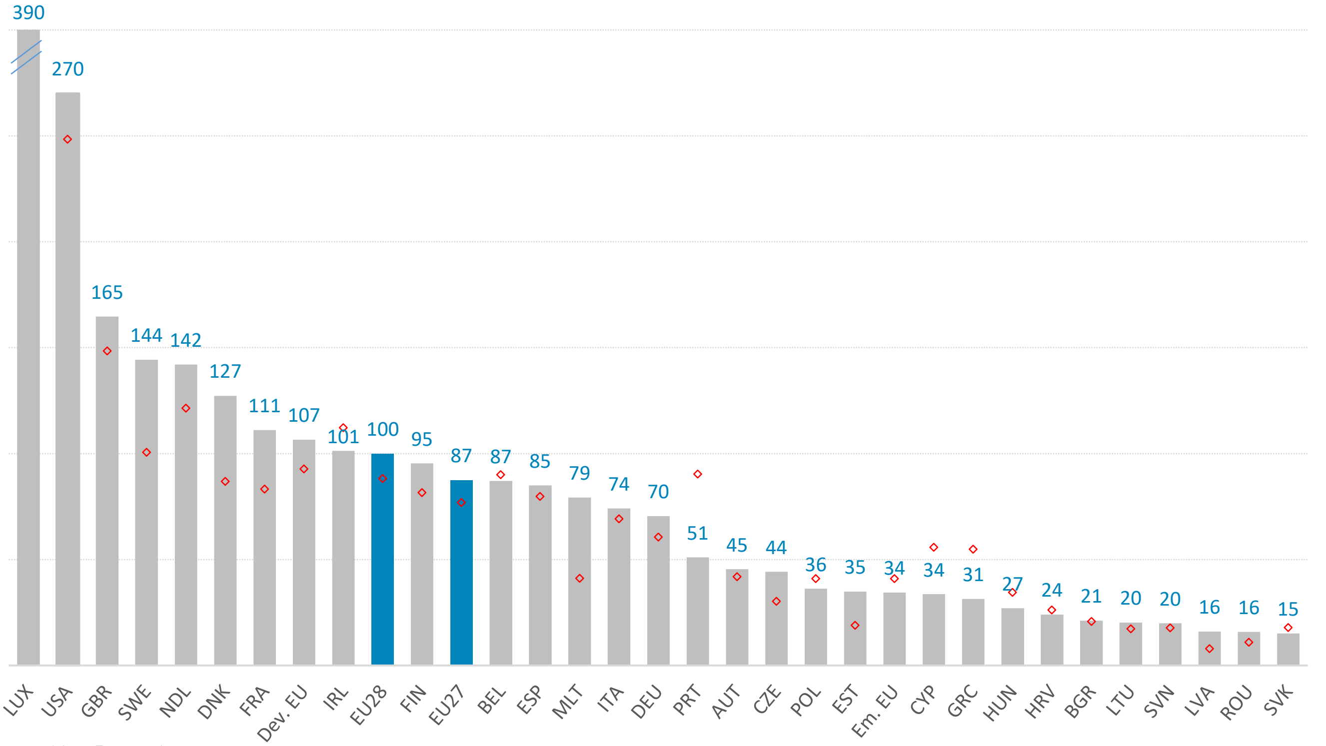


Fig.3 The range and change in the depth of capital markets

The average depth of capital markets relative to GDP across 24 different sectors of activity in the three years to 2018 compared to the three years to 2013. *Rebased to EU average = 100, the red marker shows the depth of capital markets in each country in the three years to 2013.*



Source: New Financial

A wide range

One way of thinking about capital markets union is that the range in the depth of capital markets across the EU is far greater than the difference in depth between the EU and the US, or between the EU27 and the UK. Fig.3 shows the wide range in the depth of capital markets across 24 sectors of activity in each country over the three years to 2018, rebased to the EU average of 100, compared with the three years to 2013.

Capital markets in the US are nearly twice as large relative to GDP as in the UK, which in turn is roughly twice as deep as in the rest of the EU. If the depth of capital markets in the EU28 today is 100, the depth of capital markets in the EU27 is just 87. Luxembourg has the deepest capital markets in the EU (390), mainly because of its role as a regional hub for investment funds, but in terms of size its capital markets are very small (just 2% of EU activity). The UK (165) has by far the largest capital markets in the EU and also the deepest of any large economy.

There are three clear groups of countries in terms of the depth of their capital markets. The first group is made up of wealthier countries in the north west of the EU such as the UK, the Netherlands, Sweden, France, and Denmark. These countries have capital markets that are significantly more developed than the EU average (mainly because of their large pools of pensions assets, stock markets and corporate bond markets).

The countries in the second group have relatively developed capital markets but less developed than the EU average (between 70% and 95% of the EU average). Three out of the four biggest economies in the euro area - Germany, Italy and Spain - have capital markets that are significantly less developed than the EU average. And finally, there is a long tail of smaller economies with much less developed capital markets (between 15% and 51% of the EU average). These countries are Austria, Greece, Portugal, Cyprus and the most recent member states to join the EU from the Baltic region and Central and Eastern Europe.

Fig.4 The depth of capital markets across EU countries

This table is a ranking of the overall depth of capital markets in each country across 24 sectors of the capital markets in the three years to 2017. It is divided into four groups, from most developed (top quartile) to least developed (bottom quartile). We have also included a selection of sector rankings across five broad groups (pools of capital; equity markets; bond markets; asset management; and private equity & venture capital) to highlight the different level of development in different countries.

	Rank	Country	Overall depth	Pools of capital	Equity markets	Bond markets	Asset management	Private equity & VC
Top quartile	1	Luxembourg	Top quartile	Top quartile	Second quartile	Top quartile	Top quartile	Top quartile
	2	UK	Top quartile	Top quartile	Top quartile	Top quartile	Top quartile	Top quartile
	3	Netherlands	Top quartile	Top quartile	Top quartile	Top quartile	Top quartile	Top quartile
	4	Sweden	Top quartile	Top quartile	Top quartile	Top quartile	Top quartile	Top quartile
	5	Denmark	Top quartile	Top quartile	Top quartile	Second quartile	Top quartile	Top quartile
	6	Ireland	Top quartile	Second quartile	Second quartile	Top quartile	Top quartile	Second quartile
	7	France	Top quartile	Second quartile	Top quartile	Top quartile	Top quartile	Top quartile
Second quartile	8	Belgium	Second quartile	Top quartile	Second quartile	Top quartile	Second quartile	Second quartile
	9	Finland	Second quartile	Top quartile	Top quartile	Second quartile	Second quartile	Top quartile
	10	Spain	Second quartile	Second quartile	Top quartile	Second quartile	Third quartile	Second quartile
	11	Malta	Second quartile	Second quartile	Second quartile	Third quartile	Second quartile	Second quartile
	12	Italy	Second quartile	Second quartile	Second quartile	Second quartile	Second quartile	Third quartile
	13	Germany	Second quartile	Second quartile	Second quartile	Second quartile	Second quartile	Second quartile
	14	Portugal	Second quartile	Third quartile	Third quartile	Second quartile	Third quartile	Third quartile
Third quartile	15	Austria	Third quartile	Second quartile	Second quartile	Second quartile	Second quartile	Third quartile
	16	Cyprus	Third quartile	Third quartile	Bottom quartile	Bottom quartile	Third quartile	Second quartile
	17	Czech Republic	Third quartile	Third quartile	Third quartile	Third quartile	Bottom quartile	Bottom quartile
	18	Poland	Third quartile	Bottom quartile	Third quartile	Third quartile	Third quartile	Third quartile
	19	Greece	Third quartile	Bottom quartile	Third quartile	Third quartile	Bottom quartile	Bottom quartile
	20	Croatia	Third quartile	Third quartile	Third quartile	Third quartile	Third quartile	Bottom quartile
	21	Hungary	Third quartile	Third quartile	Third quartile	Bottom quartile	Bottom quartile	Third quartile
Bottom quartile	22	Estonia	Bottom quartile	Bottom quartile	Bottom quartile	Third quartile	Second quartile	Third quartile
	23	Latvia	Bottom quartile	Bottom quartile	Third quartile	Bottom quartile	Bottom quartile	Second quartile
	24	Bulgaria	Bottom quartile	Bottom quartile	Bottom quartile	Third quartile	Bottom quartile	Bottom quartile
	25	Slovakia	Bottom quartile	Third quartile	Bottom quartile	Bottom quartile	Third quartile	Bottom quartile
	26	Slovenia	Bottom quartile	Third quartile	Bottom quartile	Bottom quartile	Bottom quartile	Bottom quartile
	27	Romania	Bottom quartile	Bottom quartile	Bottom quartile	Bottom quartile	Bottom quartile	Bottom quartile
	28	Lithuania	Bottom quartile	Bottom quartile	Bottom quartile	Bottom quartile	Third quartile	Third quartile

Source: New Financial Top quartile Second quartile Third quartile Bottom quartile

Driving growth

Before analysing the progress made by CMU over the past five years and outlining a manifesto for the future of CMU, it is worth asking why Europe needs deeper capital markets and what benefits bigger capital markets could bring to the European economy and European citizens in terms of investment, jobs and growth. Here is a selection of some of the potential benefits of bigger capital markets in Europe:

1. **A wider range of funding:** capital markets provide a valuable additional source of financing for companies that complements traditional bank lending and provides companies with a wider range of sources of potential funding. It reduces the economy's reliance on bank lending. For example, since the financial crisis, the growth in corporate bond markets in Europe has offset more than 90% of the decline in bank lending.
2. **Access to capital:** capital markets offer the right companies the ability to raise a larger amount of capital at a lower cost than borrowing from their bank. Through venture capital and equity financing, they provide risk capital to support innovation and high potential growth companies that banks are not designed to provide.
3. **Increase bank lending capacity to SMEs:** capital markets are not a realistic option for most small and medium-sized companies (SMEs) but wider use of capital markets by companies that are large enough to access them can help free up bank balance sheets and enable banks to focus lending to smaller companies that need it the most.
4. **Capital allocation & standards:** capital markets improve what economists call the 'allocative efficiency' of capital, by effectively crowdsourcing decisions about value and potential to a wide range of investors and channelling investment to those companies that can make the best use of it. The need to compete for capital and be accountable to investors helps improve discipline, operational standards, corporate governance, performance and transparency at companies (or governments) that issue bonds or equities.
5. **More flexible:** while capital raising can come to an abrupt halt in the wake of market disruption, capital markets rebound faster than bank lending. The flow of gross new bank lending in the eurozone has fallen by roughly 40% since the financial crisis, but issuance in European bond markets has nearly doubled relative to GDP since 2007, and activity in the equity markets has rebounded to the same relative levels as it was before the crisis.
6. **Long-term returns:** while markets are often volatile in the short term, investing in capital markets across a range of assets over the long term generates higher returns than keeping your savings under a mattress or in the bank, providing a better future income in retirement. Long-term pensions savings also significantly reduce the future economic burden of pensions on taxpayers and government budgets under pay-as-you-go pensions systems.
7. **Longer-term investing:** capital markets provide long-term investors such as pension funds and insurance companies with a wider range of assets to invest in that better match their liabilities. Annual pension contributions by employers and employees add up to billions of euros a year that can be put to work supporting the economy.
8. **Wealth creation:** capital markets help democratise wealth creation by enabling a wider range of people to invest in high growth and successful companies through their investments and pensions, particularly in equity markets.
9. **Addressing climate change:** public money and bank lending are not enough to finance the projects needed to reach the targets set by governments to reduce CO_2 emissions and to support a transition to a sustainable economy. Capital markets can close this gap by providing capital through a wide range of innovative instruments.
10. **Economic resilience:** the European economy doesn't have the same shock absorption capacity as the US and Canada because of its relatively under-developed capital markets. For every one percent drop in economic growth there is an 80 basis points (0.8%) decline in consumption in the EU, which is four times higher than the 18bps decline in the US. In the US, nearly three quarters of this decline is absorbed by capital markets compared to just one eighth in the EU.

Removing barriers

The previous page summarised why Europe needs more capital markets. This page summarises why Europe needs more *integrated* capital markets. It provides some examples of how the fragmented national patchwork of capital markets across the 28 members states of the EU translates into complexity, inefficiency and higher costs for European investors, individuals and companies. A reinvigorated and more ambitious CMU could mitigate, if not entirely remove, some of these barriers:

1. **Investment funds - fragmentation:** there are five times as many investment funds in the EU as in the US market (58,000 compared with 11,600) but US funds are seven times larger (with an average value of €1.8bn versus €250m), according to EFAMA. This raises the cost of investing in the EU for individuals and pension schemes.
2. **Investment funds - fees & performance:** average fees on passive and active mutual funds in the EU are nearly twice as high as in the US, according to PwC. Often, the same fund will charge different fees in different countries. The wide range in fees (which are twice as high in some EU countries as in others) acts as a drag on performance, with average performance in some markets a third lower over time than in others.
3. **Domestic bias:** nearly three quarters of all assets under management in the EU are held in funds that are only available for sale in that domestic market. This domestic bias is reflected in overall asset allocation: more than half of equity investments in the EU are held in the investor's domestic market, and in smaller markets this is as high as 75% to 90%. This domestic bias reduces returns, raises costs, and concentrates risk.
4. **Pensions:** the small scale of pensions schemes in the EU and fragmented legal and regulatory system between different countries increases the costs of managing them. Investment managers who want to manage money across the EU effectively need to have 28 different services for pension schemes in the EU.
5. **Venture capital:** the average venture capital fund in the EU (€56m) is just one third of the size as in the US, limiting the ability to invest at scale. The average investment in each deal of around €6.5m in the US is more than five times larger than in the EU27. This gaps widens in subsequent rounds of funding, limiting the emergence of European tech giants. At the end of 2017, there were 26 'unicorns' in the EU - start-ups that have reached a valuation of more than $1bn - compared with 59 in China and 109 in the US.
6. **Exchanges & market infrastructure:** there are more than 30 (mainly national) exchanges in the EU owned by 16 exchange groups, supported by 20 central securities depositories and 18 central counterparties. In the much bigger US equity market there are four exchange groups running 13 exchanges, supported by one CSD and one CCP. This raises costs for companies, investors and market participants, and reduces growth in smaller markets.
7. **IPOs:** more than 90% of companies in the EU that carried out an IPO in the five years to the end of 2018 listed on their home market. A further 2% of companies also did a dual listing on another EU stock exchange, but just 56 EU companies (less than 5%) chose to go public with their main listing on an exchange in a different EU country, according to analysis of Dealogic data by New Financial.
8. **National provision:** the national patchwork of securities markets adds an additional layer of cost and complexity. Local banks, insurers, exchanges and asset managers often enjoy some degree of regulatory protection from cross-border competition. This encourages domestic bias, raises costs for customers, and rewards inefficiency.
9. **Regulation:** there are more than 80 supervisors and regulators in the EU, with each applying a slightly different interpretation of EU rules and regulations. For all the progress made in supervisory convergence, small changes in rules effectively mean that there are still 28 separate markets in the EU.
10. **Wide range in cost of funding:** there is a wide range in the cost of funding for firms in the same sector and of similar size, profitability, and leverage between different countries, according to research by the IMF. A Greek firm may pay up to 250 basis points a year more on debt than a comparable French firm; an Italian firm may pay 80 basis points more than a similar Belgian firm. This gap is even wider for smaller firms.

A mixed bag

Depending on your point of view, CMU is either an ambitious project to map the challenges facing capital markets in the EU and lay the foundations for further growth in the decades ahead - or a missed opportunity for reform that avoids the difficult questions and that will do little more than tinker at the edges of the problem. This section looks at the progress made by the CMU initiative over the past five years. We have divided the analysis of progress into two parts: a critical view that argues CMU has overpromised and underdelivered; and a more positive approach (which we share at New Financial).

Overpromising and underdelivering?

Here is a summary of the widely held (but we think unfair) critique of CMU:

1. **Limited concrete achievement:** for all the noise and hard work, CMU made limited concrete progress. Over the past five years there have been lots of reports, consultations and expert groups, but the net output from CMU has been agreement on 12 new pieces of legislation in a market already suffering from reform fatigue. Many well-intended initiatives have got stuck in institutional wrangling between the European Commission, European Parliament and member states, and have been watered down or quietly shelved. To be clear, the creation of pan-European venture capital funds-of-funds, a revised Prospectus Directive to reduce the burden on smaller companies raising capital, a new securitisation regime, adjustments to Solvency II capital requirements for insurers investing in infrastructure, and a new Pan European Pension Product are welcome additions to EU markets, but it is unclear whether they fulfil the ambition of the past five years.

2. **A laundry list:** a big part of the problem was the lack of focus in the original CMU action plan, which has been criticised as a laundry list of 34 different initiatives. An additional nine follow up actions and 16 new initiatives were added in 2017. By trying to address too many problems at once, without a clear sense of prioritisation or the economic impact of each initiative, CMU diluted its potential for success. There is a sense in the industry that CMU has become a 'box ticking exercise' that has measured its success in terms of regulatory outputs, not market and economic outcomes.

3. **A lack of ambition:** a common criticism is that CMU has been too incremental, lacked ambition, and that most of the initiatives taken by the European Commission haven't been radical enough. It has focused too much on process over substance and designing markets and solutions on whiteboards that work better in theory than in practice - and not enough on the fundamental issues such as building deeper pools of capital. For example, the new prospectus regime with a lower burden of disclosure for growth companies looking to raise capital in the public markets will help, but will not lead to a fundamental shift because it fails to address the fundamental reasons why smaller companies tend not to go public. The project also lost some momentum after the Brexit referendum and the departure of its biggest cheerleader Lord Hill.

4. **Pulling the wrong levers:** CMU has focused too much on 'top down' measures at an EU level that will have limited impact on problems that are primarily national in nature, or been distracted by intractable challenges that will take decades to solve (such as the harmonisation of insolvency regimes). For example, while the Pan European Pension Product (PEPP) will give more choice to people across the EU that want to save for retirement, it will scarcely dent the problem of pensions provision. The reality is that the big levers to drive fundamental change in European capital markets such as pensions policy, taxation, and cultural attitudes to capital markets are beyond the remit of the European Commission.

5. **The wrong timeframe:** building bigger and better capital markets in Europe is a process that will take decades, not just a few years. But advocates of CMU have not helped themselves by talking about 'finishing' CMU in its first five years or claiming that it has largely achieved its aims. While CMU is a new name it represents a natural continuum of the European single market project from the 1990s and the Financial Services Action Plan from the early 2000s.

THE PROGRESS SO FAR - A MORE POSITIVE VIEW

Always look on the bright side of life

At first glance, critics of the progress made by CMU have a point, but we think the overall thrust of their criticism is unfair. Here is a more positive summary of the progress so far:

1. **Putting capital markets on the political agenda:** CMU has propelled capital markets up the political agenda across Europe, helping to position them as part of the solution to the economic challenges facing the EU after nearly a decade of capital markets being seen as a big part of the problem. It has been successful in starting the debate on the role capital markets play in the economy and their relevance to investment and economic growth, particularly in countries which have under-developed capital markets or which have traditionally been suspicious of them. The quality and substance of discussions at an EU and national level on issues such as pensions systems, long-term sustainability, or the reliance on bank lending has significantly improved over the past five years. For example, it would have been unthinkable just a few years ago for the finance ministers in France and Germany to launch an initiative (with the Netherlands) to assess how capital markets can help drive growth across the EU.

2. **Laying the foundations:** CMU has laid many of the foundations for the growth of capital markets in Europe over the next few decades. While the concrete outputs have been modest, a huge amount of work has been conducted at an EU and national level (we counted 74 different action points in the CMU brief, of which two thirds have been completed). If you look at CMU as a mapping process to review the progress so far with the single market, to identify the challenges and barriers in capital markets in the EU, and to stimulate political debate about the potential role of capital markets in the European economy, then it has achieved at least as much as it set out to achieve. A bolder approach to CMU may have generated more headlines, but it would also have quickly run into more roadblocks.

3. **A long-term learning process:** CMU is an inherently long-term project and it is unfair to measure progress over just five years. Building deeper, more efficient and more integrated capital markets will take decades and involve fundamental shifts in the economies of EU member states. Anyone expecting an all-singing and all-dancing capital markets union to have been completed by the end of 2019 was asking the wrong questions. At the same time, the process of understanding the shortcomings and limitations of the single market in financial services in 28 countries with vastly different financial systems has been a bruising but salutary process for the EU. Unpicking some of that framework and working out how to put it back together has been challenging and complex, but should help inform how to approach the next five to 10 years.

4. **A challenging backdrop:** it is only fair to consider the challenging geopolitical backdrop and macro-economic environment over the past five years when assessing the progress made so far on capital markets union. Although the EU economy returned to growth, political volatility in Europe and beyond has not been favourable and cooperation between member states has often been difficult. Issues such as Brexit and the rise in populism, along with legacy issues such as sovereign debt levels, have consumed much of the attention of policymakers and regulators at an EU and national level.

5. **A national prerogative:** it is unduly harsh to criticise the European Commission for making limited progress on CMU when the biggest levers that it might pull to accelerate the growth of capital markets such as pensions policy, tax and cultural attitudes are beyond its remit. It has made substantial progress in those areas that have been within its powers, and learned a lot about the limitations of those powers. We think this underlines the need for the next phase of CMU to focus not just on 'more union' initiatives (removing cross-border barriers within the EU) but also on 'more capital markets' (encouraging the bottom-up development of capital markets at a national level). A better balance between the Commission, the Parliament and members states should help accelerate progress in future.

Challenges at every turn

Given the wide range of national, cultural and institutional barriers in its path it is perhaps surprising that CMU has made as much progress as it has - particularly in terms of putting capital markets on the political agenda. Here is a summary of the main barriers to progress over the past five years that will need to be addressed by the EU and members states if they want to make more substantive progress in the future:

1. **Institutional & political wrangling:** one of the biggest obstacles to further progress has been the political wrangling between EU institutions and resistance from individual member states. The European Commission has sometimes given the impression that CMU is a project that it wants to impose on member states; the European Parliament has on occasion given the impression that CMU is another way for it to flex its political muscle; and national governments and finance ministries often seem to have forgotten what they agreed to in Brussels or at Ecofin meetings by the time they get back to their home country. A more collaborative approach to CMU with more buy-in from member states and smoother relations between EU institutions will be essential in future.

2. **Fragmentation & implementation:** this political friction has often been reflected in how different countries have applied and implemented EU legislation, often with the unwritten intention of protecting local market participants. While there has been huge progress over the past few decades towards a single market in financial services, small differences in implementing new and existing rules mean that there are still effectively 28 single markets. One senior official at the European Commission joked recently: 'The bad news is that the single rulebook is being implemented in 28 different ways. The good news is that we are making progress and after Brexit it will only be implemented in 27 different ways.'

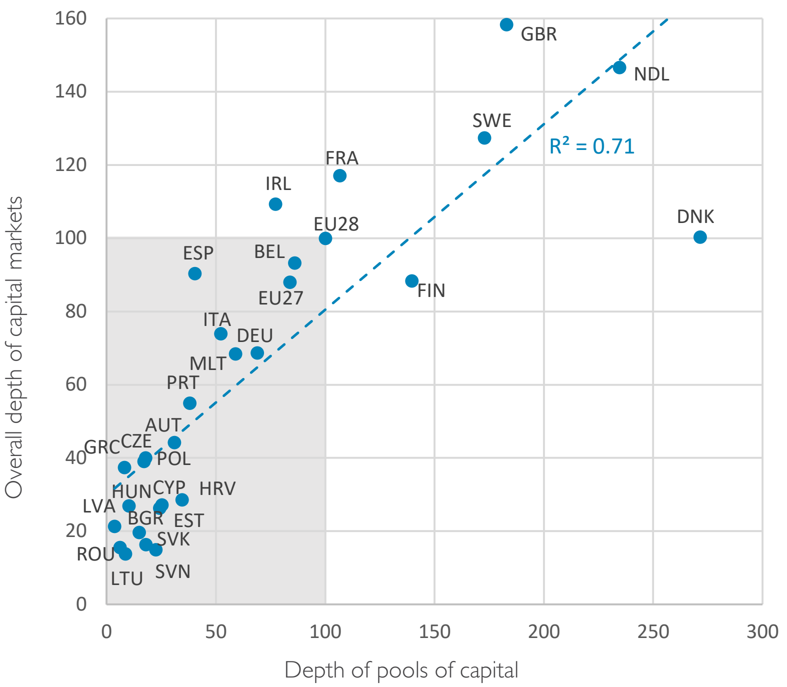
3. **Despite Brexit:** in the first few years CMU had a clear sense of direction and ambition under Lord Hill, the UK's European commissioner who oversaw the project as part of his brief on financial services. The politics of CMU were temporarily derailed by the Brexit referendum: while Brexit made the argument for CMU all the more compelling, it was unclear which countries would step up to fill the gap. The revised version of the CMU action plan in 2017 under Valdis Dombrovkis gave the project a new impetus (particularly around sustainable finance) but it is only in the past year or so that big member states such as France, Germany and the Netherlands have stepped up with a clear intent to redefine CMU under the NextCMU initiative.

4. **Vested interests:** the structure of the banking and finance systems in individual countries across Europe is deeply embedded in their political and cultural psyche, and the industry has significant political clout. Any suggestions that companies should look beyond banks for their funding, that savers should keep less of their money in the bank, and that pensions should be based more on investing have often run into a political brick wall in individual member states. We have come across vested interests in Germany who fully support CMU so long as it doesn't affect the three pillar German banking system; in France who fully support it so long as it doesn't involve fundamental changes to their pensions system; and in Italy and other countries who support it so long as it doesn't introduce too much competition into their local market. Overcoming these embedded positions will take many years.

5. **The lack of trust in the industry:** this structural resistance to change is supported in many countries by a political and cultural suspicion of 'capital markets'. A lack of trust in the banking and finance industry - particularly the international investment banking variety - means that for many policymakers across Europe 'more capital markets' is synonymous with more bonuses, more hedge funds and more financial crises. Given the impact of the financial crisis on the EU economy - and the behaviour of some market participants in the run-up to it - this suspicion is understandable. Rather than hoping it will go away, the capital markets industry will need to redouble its efforts to demonstrate how capital markets can become part of the solution instead of being part of the problem - and show that it is as focused on the interests of companies and consumers in the EU as it is on its own interests.

Fig.5 The importance of large pools of capital

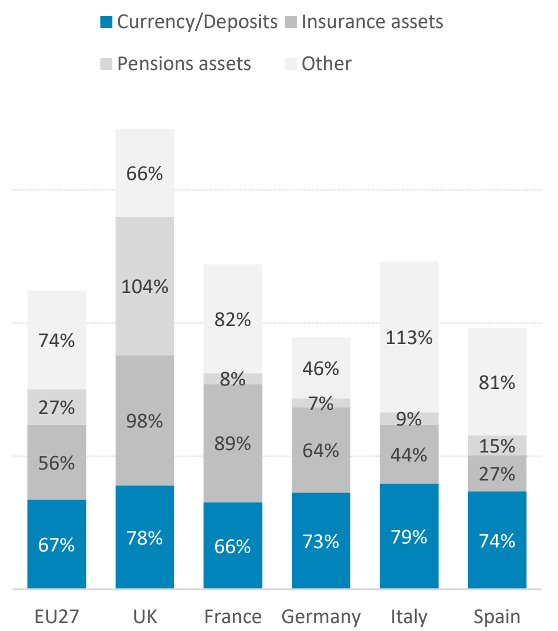
The correlation between pensions and insurance assets and overall depth of capital markets (exc pensions assets, insurance assets & household retail investments)



Source: ECB, New Financial

Fig.6 Pools of capital

The size of potential pools of long-term capital as a % of GDP in the EU27 and a selection of countries



Laying the foundations

You cannot have deep capital markets without deep pools of long-term capital. By far the strongest indicator of the depth of capital markets in individual countries is the depth of pools of long-term capital (pensions and insurance assets), according to our research (see Fig.5). This suggests that the single most important thing that policymakers across Europe should do to boost the size and depth of capital markets over time would be to take measures to increase the size and depth of formal pools of long-term capital. This supports our view that the big levers for deeper capital markets need to be taken at a national rather than an EU-wide level.

The correlation between the depth of long-term pools of capital against the overall depth of capital markets in Fig.5 shows that - broadly speaking - economies with deeper pools of capital such as the Netherlands, Sweden, and the UK have deeper capital markets, while countries with small pools of long-term capital relative to the size of their economy have capital markets that are much less deep than the EU average (in the bottom left). Every country with capital markets less developed than the EU average (except Finland) also has pools of capital that are less developed than the average.

While the value of pools of long-term capital in the EU27 has grown by nearly a quarter over the past five years, they are still relatively small. In the UK, pensions and insurance assets add up to just over 200% of GDP, which is well over double the EU27 average of 83% (see Fig.6, which shows the size of household financial assets in the EU relative to GDP). The biggest difference is in pensions, which represent over 100% of GDP in the UK but just 27% in the EU27. These numbers are flattered by the Netherlands, whose highly developed pensions system accounts for nearly 40% of all pensions assets in the EU27: if you remove the Netherlands, pensions assets represent just 17% of GDP. If larger economies like France, Germany and Italy really want deeper capital markets, they will need to focus on increasing the value of their pensions assets from their current low base of around 8% of GDP.

The bigger picture

Capital markets do not exist in a vacuum: they rely on a thriving private sector, an efficient and strong legal system, and high levels of trust in the rule of law. We created a composite index of 10 different measures of the wider business, legal and regulatory environment in different countries and compared it with the relative depth of their capital markets.

Wealthier countries in the north west of the EU dominate this ranking with Finland, Denmark, Sweden, the Netherlands and Germany at the top with an average score across the different indices of 84% (see Fig.8, which shows the scores and ranks for EU countries). The UK, which has the biggest capital markets in the EU and the deepest of any large economy, is ranked 6th with a score of 82%.

As a rule, the rankings for the most recent member states to join the EU from the Baltics and Central and Eastern Europe are much lower, with the exception of Estonia (12th) and Czech Republic (13th) that are well placed between large economies such as France and Spain.

We plotted these rankings against our ranking of the depth of capital markets (see Fig.8) and found a clear correlation between the depth of capital markets and the wider business, legal and regulatory environment. Broadly speaking, economies with deep capital markets such as Luxembourg, the UK, Sweden, the Netherlands, and Denmark score highly in the ranking of the wider business environment (in the top right of the chart), while economies with less developed capital markets have a lower quality business environment (in the bottom left).

The main outliers are Germany, which ranks 5th for business environment but only 13th for the depth of its capital markets, Italy (11th for capital markets; 20th for business environment), and Lithuania, which is bottom of the rankings for depth and 17th for business environment. If countries want deeper capital markets, they will need to ensure that they take a more holistic approach to reforming the wider economy.

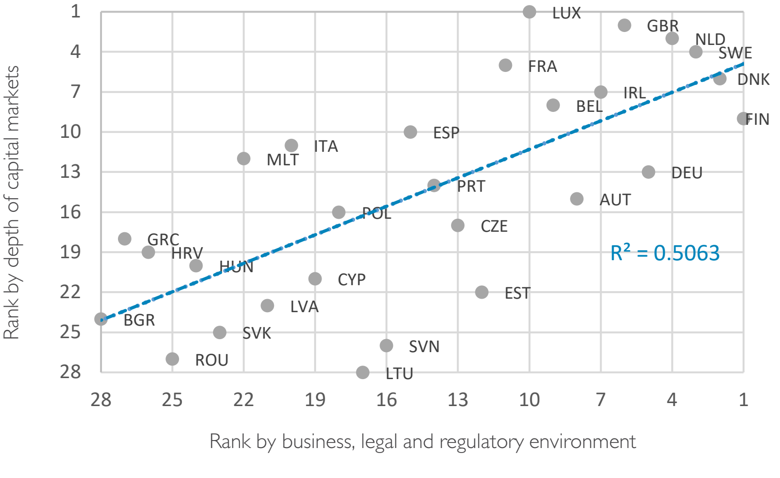
Fig.7 The wider business, legal and regulatory environment

Ranking of the wider business, legal and regulatory environment

Rank	Country	Average score %	Business environment rank	Government & regulation rank
1	Finland	85%	7	1
2	Denmark	85%	4	2
3	Sweden	84%	2	3
4	Netherlands	84%	5	4
5	Germany	83%	3	5
6	United Kingdom	82%	1	6
7	Ireland	79%	6	9
8	Austria	79%	8	7
9	Belgium	77%	11	8
10	Luxembourg	76%	10	10
11	France	75%	9	12
12	Estonia	72%	12	11
13	Czech Republic	70%	15	14
14	Portugal	69%	20	13
15	Spain	69%	14	16
16	Slovenia	69%	17	15
17	Lithuania	66%	13	21
18	Poland	66%	18	18
19	Cyprus	66%	23	17
20	Italy	64%	19	19
21	Latvia	64%	21	20
22	Malta	64%	16	23
23	Slovakia	63%	22	22
24	Hungary	58%	24	26
25	Romania	57%	25	25
26	Croatia	57%	27	24
27	Greece	56%	26	27
28	Bulgaria	53%	28	28

Fig.8 The importance of the wider environment

The correlation between the depth of capital markets and quality of the wider business, legal and regulatory environment



Source: ECB, New Financial

A renewed sense of direction

This section includes a series of policy suggestions for the next stage of capital markets union. A huge amount of the ground work has been laid for bigger and better capital markets over the past five years, but we think a renewed sense of ambition and urgency, combined with a more compelling case for the potential benefits of capital markets, and a more focused approach will help deliver a more effective CMU in future. We have divided these suggestions into five key principles that we think would help guide CMU, and then some thematic proposals - some of which are more practical than others.

i) Defining principles

Here is a summary of five key principles that we think could help guide a more effective and achievable CMU over the next five years and beyond:

1. **More 'capital markets' vs 'more union':** many of the big levers to drive growth in capital markets across Europe can only be pulled at a national and not an EU level. We think it is vital for the next phase of CMU to focus not just on 'more union' (removing cross-border barriers within the EU) but also on 'more capital markets' (encouraging the 'bottom-up' development of capital markets at a national level). While 'top down' initiatives at an EU level can help create more integrated capital markets and help drive growth in the scale and efficiency of capital markets, real change can only come through 'bottom up' initiatives at a national level taken by individual member states. The European Commission can play a valuable role in helping member states identify challenges, benchmarking countries against each other, and providing expertise and support to help address them.
2. **Making a better case for capital markets:** the EU should make a more compelling economic, political and social case for capital markets union. Too much of the debate over the past five years has been conducted at a technical level without a clear economic or political dimension. The creation of an EU-wide 'group of wise men and women' to work with member states to conduct a co-ordinated economic impact analysis of the potential benefits and pitfalls of more developed capital markets would provide more intellectual firepower and help inject more of a sense of urgency to the capital markets union initiative. At the same time, the potential benefits of capital markets would be more powerful if they were expressed in concrete terms and the impact they would have on the every day lives of individuals across the EU in terms of jobs, growth and wealth creation.
3. **A more focused approach:** over the past five years the CMU initiative has tried to solve too many problems at once. A shorter and simpler action plan based on a smaller number of clearly-prioritised projects with the biggest economic impact would provide a more practical programme for the next five to 10 years. This plan would combine cross-border initiatives (the 'more union' part of CMU) and national initiatives (the 'more capital markets' side of the equation). It could also include a clearly-defined 'twin track' approach that identifies challenging issues that could take decades to address (such as pensions, insolvency and tax issues) and maps out how to chip away at them over time alongside more urgent and achievable initiatives. While the work under CMU to develop sustainable finance is hugely valuable in its own right, we think it is vital that it does not distract the EU and member states from the underlying challenges facing capital markets in Europe.
4. **Competition & transparency:** a stronger focus on greater competition and improved transparency would accelerate the next phase of CMU. Many of the barriers to bigger and more integrated capital markets are the result of limitations on cross-border competition, implicit or explicit regulatory protection, and limited transparency for customers. A comprehensive audit of the barriers to competition that exist in different member states, combined with greater transparency across the industry, and more detailed benchmarking of how different countries compare with each other in different aspects of capital markets would encourage greater competition and concentrate minds at a national level on the economic cost of the status quo.
5. **An open CMU:** there is a danger that after Brexit the CMU initiative becomes more inward looking. In the initial CMU action plan in 2015, unlocking more investment from the rest of the world was included in the very first bullet point of what CMU aimed to achieve, but references to global investment have since been quietly shelved. While the EU will want to protect its interests and the integrity of the single market, it will be important to ensure that improving the EU's attractiveness as a destination for investment from around the world remain core to the project.

ii) Regulation, supervision and standards:

- **Towards centralised supervision:** a single markets supervisor across the EU would not create a fully-fledged CMU on its own, but it is hard to see how the EU can have a proper capital markets union without one. A staggered migration towards centralised supervision of the largest investment banks, asset managers, and infrastructure providers by the European Securities and Markets Authority along the lines of the Single Supervisory Mechanism under the banking union would help drive progress. A properly-resourced ESMA with a clear mandate and revised governance structure - working alongside national authorities - would accelerate supervisory and regulatory convergence, and help remove the biggest cross-border barriers to deeper capital markets. This may also open the door to a clearer system of proportionality, in which smaller firms on a purely domestic level operate within a similar but less burdensome framework.

- **Holding to account:** the progress of the CMU project should be monitored more closely with a better set of metrics based on market outcomes rather than the volume of regulatory or legislative activity. A clearer and shorter set of targets with defined milestones and deadlines could be monitored regularly by Ecofin or a separate organisation. A wider review of the cumulative impact of a decade of regulatory reform should also be undertaken to identify well-meaning measures that may have outlived their usefulness, had unintended consequences, or where the intended consequences have been more dramatic than planned. Closer cooperation between (and the potential merger of) DG FISMA and DG ECFIN would help embed the link between the real economy and the financial services industry.

- **A revised mandate:** policymakers at both an EU and national level should rethink and refine the mandate for supervisors and regulators. A clearer focus on ensuring a level playing field for competition in markets regardless of the nationality of market participants would help ensure that perceived and actually barriers to cross-border activity are reduced or eliminated. This mandate might include maximising the number of market participants and ensuring that all policy measures have a clear economic rationale.

- **A single set of standards:** the same level of information that investors want from issuers could be applied to the industry itself. A single set of standards for accounting, and for measuring and disclosing fees and performance across all sectors of the industry in all 27 member states would be a good start. It would force less efficient organisations to raise their game, drive competition, encourage consolidation and efficiency, and increase levels of trust in the industry.

- **From SMEs to scale-ups:** Europe doesn't have a problem with start-ups or a shortage of SMEs, but it does have a problem with funding for scale-ups and growth companies. Shifting the focus of EU-wide and national capital markets initiatives from SMEs to scale-ups (building on the EU's 'start-ups and scale-ups' initiative) backed up by a clear designation and comprehensive data gathering, would accelerate growth in this area and pave the way for the development of a pan-European regime for growth companies.

iii) Building deeper pools of capital:

- **Incentivising change:** the EU should develop a more rigorous pensions sustainability index across the three pillars of state, workplace and private pensions. This would include requiring governments and companies across the EU to publish their pensions liabilities each year calculated in the same way, and could be linked to fiscal incentives: if a country falls below a particular threshold, it could be mandated to take measures to improve (e.g. auto-enrolment, public pensions pools funded by bond issuance or asset sales etc). Whatever is lost in tax receipts from an increase in pensions contributions could be deducted from EU budget deficit targets.

iii) Building deeper pools of capital (continued):

- **A gradual approach:** individual countries should conduct impact assessments and feasibility studies to launch auto-enrolment workplace pension schemes, with gradual introductions, initially-low but rising contribution levels for employers and employees, and appropriate tax incentives (e.g. higher employer contributions to funded pension schemes could be offset against corporation tax). To avoid any dramatic short-term impact on public sector finances, pay-as-you-go schemes could shift one percentage point of employer and employee contributions into funded schemes each year.

- **Broaden the investment scope:** reviewing existing regulations to enable pensions funds and insurance companies to invest in a wider variety of assets that would help them build portfolios based on their investment horizons and risk profiles. This should include a regulatory framework that enables and encourages insurance companies, fund managers and pension funds to invest in both equity and debt of unlisted growth and scale-up companies.

- **Closing the exclusivity gap:** the returns from private capital and illiquid assets exceed the returns from public markets by as much as 5% a year, but these markets are effectively off limits to most individuals and smaller pension schemes. Reviewing regulations to enable wider access to private capital and illiquid assets and identifying the right vehicles to enable it would help close this gap and be a significant boost to wealth creation.

- **Nudge, nudge:** individuals can be nudged towards better pensions provision through the development of simpler pensions dashboards, pensions apps on their phones, or by including simple and accessible information on people's future pension income in their payslips. Renaming pensions as 'retirement savings' and adopting the Australian system of helping people understand them in terms of the likely impact on their lifestyle in retirement would also help make them more tangible to individuals.

iv) Market structure, exchanges & equities:

- **More consolidation:** the EU has too many stock exchanges and market infrastructure providers and not enough effective competition between them. Over the past few decades, attempts at consolidation between the 30+ exchanges in Europe have often been blocked by European and national authorities. Consolidation between exchanges to reduce the number of exchanges to a smaller group of perhaps four or five competing blocs - which could use a system of cooperation similar to airline code-sharing - would reduce costs and complexity and ensure closer collaboration between regulators and supervisors.

- **More competition:** competition between exchanges is episodic and mainly restricted to competing for trading volumes in the largest stocks. A smaller number of competing exchange blocs across Europe - with an umbrella exchange operator in each group operating a series of local 'gateway' markets - would create more effective competition for listings, trading, clearing and data. At the same time, regulators should address some of the hidden barriers to competition and encourage the maximum possible harmonisation of market rules between and within each exchange bloc. A consolidated tape would not solve competition issues on its own but it would improve efficiency and accelerate competition.

- **Building ecosystems:** the EU and national governments could work more closely with existing networks and accelerators run by exchanges - such as the Elite programme (UK), #IPOready (Ireland), or the La French Tech initiative (France) - to grow the ecosystems for scale-up companies involving issuers, intermediaries, investors, business angels, technical expertise, venture capital firms and universities. More targeted public co-investment in business angels and growth funds could be a catalyst for growth.

iv) Market structure, exchanges & equities (continued):

- **A single information hub:** a single pan-European platform for filing and distributing comparable information on issuers (a sort of 'EuroEdgar' modelled on the US system) would be a big step towards a single capital market. It could also include credit data on SMEs and growth companies, and act as a central portal for managing corporate governance and shareholder voting, reducing significantly the bureaucracy and costs of cross-border investing.

- **A single platform:** a single pan-European information hub for funds and other financial services such as crowdfunding or insurance would provide much more transparency and comparability. It would shine a spotlight on less efficient providers, encourage more competition and cross-border participation, and reduce fragmentation. The platform could also provide asset managers and other market participants a single point of entry for registration, notification, marketing and tax reporting for all their operations across the EU.

v) Tax and incentives:

- **Addressing the debt / equity bias:** debt funding for companies attracts tax relief but equity funding is taxed four times. The EU can build on its work so far under the Common Consolidated Tax Base to incentivise equity funding through growth and investment allowances - particularly for growth companies - and make the costs of raising equity capital tax deductible. It could also investigate the feasibility of limiting the tax deductibility of debt finance to a particular level of leverage: for example, under President Trump's recent tax reforms, the net interest deduction in now limited to 30% of Ebitda, and in a few years that will fall to 30% of Ebit.

- **A longer-term focus:** there are many examples of successful tax incentives to encourage longer-term investing in equities such as indexation of gains for capital gains tax, taper relief for entrepreneurs and long-term investors, or tax-friendly regimes for investing in growth companies. Countries should be encouraged to adopt variations of these schemes in the context of existing national tax regimes.

- **A common approach to taxing pensions:** a review to encourage the harmonisation of the tax treatment of pensions based on how and whether contributions, returns and benefits are taxed would help reduce complexity and cost for individuals and intermediaries. While the most common model is EET (exempt, exempt, taxed), nearly half of EU countries operate variations from TEE, to TET, TEE, and even EEE. This could be phased in over, say, 10 or 20 years.

- **A commercial imperative:** all proposals for reform and new regulation should include not only an economic rationale but also a commercial imperative: not just a cost benefit analysis, but specific ways to incentivise market participants to adopt them and link their behaviour to them.

- **Education, education, education:** policymakers and the financial industry often call for better financial education and financial literacy campaigns to encourage better understanding of basic finance (such as pensions and compound interest). However, while teaching the basics as part of a wider civic education may be useful, academic research shows that financial education has very limited value and may even be harmful (people who think they understand more than they actually do about investing perform worse than random). An alternative focus on numeracy (no-one should be able to leave school or university without understanding percentages) and on simple product specific financial education at the point of sale would have a far bigger impact (if someone is about to buy a fund online, they could watch a quick online tutorial about 'how to choose a fund' as part of that process).

SOME QUESTIONS FOR INDIVIDUAL MEMBER STATES

Driving growth from the bottom up

One of the key messages in this report is that capital markets union can only work if it successfully combines 'top down' measures at an EU level to improve the level of integration in European capital markets with 'bottom up' initiatives by individual member states to increase the capacity of capital markets. Here is a selection of questions for national governments, finance ministries, regulators and politicians to encourage debate about what measures individual member states could take to help drive bigger and better capital markets from the bottom up:

1. **Access to funding:** do companies in your country who want and need capital to invest in their business have sufficient access to a diverse range of short- and long-term funding? How reliant are companies on bank lending to finance their business and how does this compare with other countries? Are you confident that banks in your country are healthy enough to provide that funding over the course of an economic cycle? And what other sources of funding could step in to fill that potential gap?

2. **Savings vs investments:** how much of your citizens' financial assets are held in bank savings and how much is invested? Are you confident that bank savings are the best way to help drive wealth creation? What would be the potential impact (including the benefits and trade-offs) if a significant part of those savings were moved into other forms of investment?

3. **Pensions:** how sustainable is your current pension system across all three pillars (state, workplace and private pensions)? What is the balance between pay-as-you-go and funded pensions and how does that compare with other EU member states? What measures could you take over a 25 year timeframe to shift that balance? What impact would it have on your economy and public finances if more people were making annual contributions to their pensions and building a bigger pool of long-term capital that could be invested in your economy?

4. **Market infrastructure:** is your market infrastructure (stock exchanges, settlement, clearing etc) appropriate for an economy and market of your size? What barriers - if any - does your market infrastructure present to the future development of your financial markets and to cross-border investment in your economy?

5. **Venture capital & risk capital:** do high potential growth companies have enough access to early stage risk capital? Do they have sufficient access to other sources of risk capital and if so which sources? Is the level of equity funding through the stock market and IPOs in your economy sufficient to meet demand? And are there measures that you could take to boost demand?

6. **Cross-border investment:** how important is cross-border investment to your economy? Can domestic sources of capital provide all the funding your economy needs? What barriers - if any - do your tax, regulatory and legal systems present in terms of your economy's attractiveness to foreign investors?

7. **Regulation:** how well regulated is your economy and your financial system? On what metrics? And how does this compare to other countries in the EU and the rest of the world? What barriers - if any - does your regulatory system and implementation of EU law present to growth and investment?

8. **Tax:** what is the balance in your economy between the taxation of labour and capital? Do you have any tax measures that disincentivise investment? And without fundamentally changing your tax system, are there changes that you could make to incentivise more investment? And if so, which countries could provide examples of what does and doesn't work?

9. **Legal system:** How comfortable are you with where your country ranks in international rankings of the rule of law, complexity and timeliness of legal process, and issues such as corruption and transparency? What barriers - if any - does your legal system present in terms of investment and growth?

10. **Regional cooperation:** how could regional cooperation with other EU member states help boost your economy? What form might this co-operation take in the banking and finance sector? Do you have the right systems and structures in place to encourage and facilitate this sort of cooperation?

METHODOLOGY & FURTHER READING

Methodology:

Our sample:

We analysed the size and depth of capital markets in the following 24 different sectors of activity in all 28 EU member states:

> Pools of capital: pensions assets, insurance assets, household retail investments (exc pensions, insurance, cash deposits & unlisted equity)
> Equity markets: stock market, initial public offerings, secondary equity issues, convertible bonds, equity trading volumes
> Bond markets: corporate bond market value, investment grade bond issuance, high-yield bond issuance, bank lending relative to corporate bonds
> Loans & securitisation: value of outstanding securitisation, securitisation issuance, leveraged loan issuance
> Assets under management: assets under management, investment funds by domicile
> Corporate activity: M&A by target nationality, M&A by acquiror nationality, domestic M&A
> Private equity & venture capital: private equity activity, venture capital activity, private equity fundraising

Measuring depth:

In each sector and country we measured the value of activity as a percentage of GDP on a three year rolling basis from 2004 to 2018 to iron out the annual volatility in capital markets. To enable a comparison in depth between different sectors we rebased these percentages in each sector to the EU average, with 100 representing the average depth across the EU in the three years to the end of 2014 (we use 2014 as our baseline because that is the first year that we published our analysis and it enables us to track growth).

For example, the value of EU stock markets in the three years to 2014 was 67% of combined EU GDP. We rebased this 67% to 100, meaning that in any given period a country with a score of 50 has a stock market that is half as deep relative to GDP as the EU average in the three years to 2014, and one with a score of 200 is twice as deep.

While this methodology has the advantage of simplicity, in a handful of countries with a particularly large sector relative to GDP (for example, investment funds by domicile in Luxembourg) it can distort the overall ranking. To reduce these distortions, we capped each metric at two standard deviations from the mean for every country. This reduces the distortion of a few outsize sectors more fairly than not including the metric at all.

Further reading:

Here is a selection of recent reports on and around the theme of capital markets union:

Unlocking the growth potential in European capital markets - *New Financial, June 2019*

CMU 2.0: what next for capital markets union? - *New Financial, July 2017*

Savings and sustainable investment union - *NextCMU high level expert group, October 2019*

Capital markets union: key performance indicators - *AFME, October 2019*

Rebranding capital markets union - *CEPS, June 2019*

Transforming Europe's capital markets - *Markets4Europe, September 2019*

Braver, greener, fairer: memos to the EU leadership - *Bruegel, July 2019*