A NEW VISION FOR EU CAPITAL MARKETS

ANALYSIS OF THE STATE OF PLAY & GROWTH POTENTIAL IN EU CAPITAL MARKETS

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> This report presents a new vision for EU capital markets and identifies the potential for game-changing growth to support investment, jobs, and sustainable growth. We estimate that an additional 4,800 companies in the EU27 could raise an extra €535bn per year in the capital markets, and that an additional €14tn in long-term capital could be put to work in the EU economy to help support a recovery.

A new vision for EU capital markets

This report outlines a bold and ambitious vision for capital markets across the EU and highlights the potential benefits of deeper capital markets to the EU economy and national economies in concrete and practical terms. It analyses how capital markets can help support the economy, reduce pressure on banks and complement bank lending, and create more long-term wealth for European households. In the context of 'strategic autonomy', the report paints a vision of the sort of capital markets the EU needs to fully support the sort of companies and growth that it wants, without having to rely on funding or activity from other countries. We hope it helps inject a greater sense of urgency and ambition across the EU to develop bigger and better capital markets.

Bigger capital markets are not an end in themselves. They help diversify the sources of funding for companies; reduce the reliance of the EU economy on bank lending; increase the availability and scale of risk capital to support innovation and growth; help companies, governments, and individuals managed increased risk; boost the pools of long-term capital that could be put to work in the economy; and help reduce the increasingly unsustainable burden of future pensions provision. In addition, capital markets will need to play a much bigger role in the coming years in supporting a post-Covid recovery and financing the transition to net zero.

The report analyses the current state of EU capital markets by measuring the size of EU capital markets; the depth of capital markets in each country in more than 20 sectors; the structure of household financial assets, companies' funding sources; and the available pools of long-term capital in the EU. But most importantly in measures the growth potential in capital markets across the EU27. We express this growth in concrete terms: how many more companies in each country could potentially access capital markets and how much more money they would be able to raise. To pick one example, we estimate that around 370 additional companies in Germany could benefit from an additional €1bn in venture capital each year. Another way of looking at this is that 370 high growth companies a year in Germany are not getting that investment today. For pools of long-term capital - pensions and insurance assets - we have expressed the growth potential in terms of the increase in assets per household.

The report has five sections:

1) Introduction, summary, and headline conclusions
2) A new vision for EU capital markets
3) The current state of EU capital markets
4) The growth potential across sectors and countries
5) Context & policy recommendations

What if…?

The report highlights an ambitious but achievable growth scenario. In each sector we ranked EU countries by the value of activity relative to GDP and divided them into quartiles. We then asked: 'what if capital markets in each country were as developed as the average of the more developed countries in the quartile above?'. While this growth may seem improbable from where we are today, it is based on what other member states in each sector have already shown is perfectly possible. The surge in activity in some sectors last year also shows that in some cases our numbers are underestimates. This growth - or even modest progress towards it - will have a significant impact on national economies and play a vital role towards a sustainable and green recovery. We think that with a renewed commitment from EU policymakers, national authorities, and market participants, this growth potential is realistically achievable.

I would like to thank Eivind Friis Hamre for his valuable contribution to data collection and analysis, William Wright for his support and feedback, Dealogic for providing access to much of the data, and our members for supporting our work on bigger and better capital markets. Any errors are entirely my own.

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SUMMARY

Here is a short summary of this report:

1. **A bigger role:** Brexit, the Covid crisis and the climate crisis require capital markets to play a much bigger role in the coming years. This report analyses the current state of capital markets across the EU, outlines an ambitious new vision for EU capital markets, and highlights the huge potential for growth in capital markets in each country.

2. **Game-changing growth:** there is huge potential for growth in capital markets across the EU27. On our ambitious but achievable analysis, an additional 4,800 companies in the EU27 could raise an extra €535bn per year in the capital markets - not far short of double the current levels of activity. This growth (or significant progress towards it) would significantly reduce the reliance of the EU economy on bank lending, drive innovation, and boost investment in jobs and growth.

3. **A more sustainable future**: our analysis shows the potential to transform pools of long-term capital in the form of pensions and insurance assets that the EU needs to provide for a more sustainable future. An additional €14tn in long-term capital could be put to work in the EU27 economy - roughly double today's levels - with the average value of long-term capital per household rising from around €63,000 today to €136,000.

4. **A smaller global footprint:** Brexit has significantly reduced the EU's global footprint in capital markets and could undermine its longer-term influence on the global stage. The EU's share of global activity has fallen from 22% before Brexit (the second largest block and around half the size of the US) to just 14%. In the longer term, without urgent reform, the EU's share will shrink to around 10%.

5. **Mind the gap:** post-Brexit capital markets in the EU27 are smaller and relatively underdeveloped. This limits the sources of funding for companies and the opportunities for investors. On average, capital markets across the EU27 are half as large relative to GDP as in the UK, which in turn is roughly half as developed as the US. In their current form, EU capital markets will struggle to fuel a post-Covid economic recovery and the green transition.

6. **A wide range in depth:** there is a wide range in the depth of capital markets across the EU. The good news is that there are a number of countries in the EU27, such as the Netherlands, Sweden, Denmark, and France with well-developed capital markets that can lead the way in terms of the future growth across the EU27. On the other hand, capital markets in large economies such as Germany, Italy, and Spain are significantly underdeveloped and could play a much bigger role in funding a green and sustainable recovery.

7. **The reliance on banks:** companies in the EU are still heavily reliant on bank lending for their funding despite some progress over the past decade. In the US, companies use corporate bonds for three quarters of their borrowing, three times more than the level in the EU27. Banks will be unable to provide the necessary funding for European companies on their own post-Covid and in future crises.

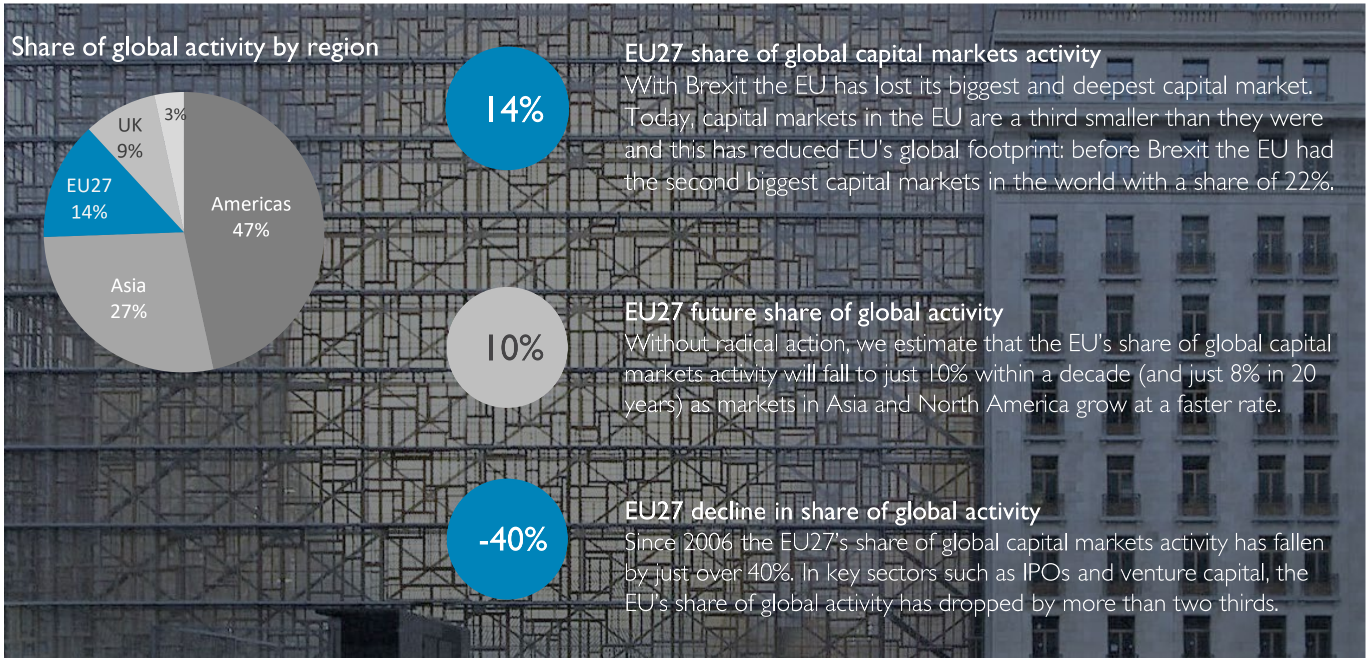
8. **Deeper pools of capital:** deep pools of long-term capital such as pensions and insurance assets - as well as direct retail investment - are the starting point for deep and effective capital markets. But pensions assets in the EU27 are a third as big relative to GDP as in the UK. Shifting more savings from bank deposits to investments would deploy more patient capital to help drive a more sustainable recovery in the longer term.

9. **Fuelling the growth economy:** the EU doesn't have a start-up problem but it does have a problem channelling investment into high growth and scale-up companies that drive job creation. On our analysis, nearly 3,260 additional companies a year could benefit from an extra €6bn annually in venture capital funding - double current levels - and the number of companies listed on growth stock markets could quadruple.

10. **Laying the foundations:** EU policymakers and regulators should focus on: a) redefining the framework to improve supervision, monitoring, and accountability b) building deeper pools of capital and boosting retail participation c) improving market infrastructure and the functioning of markets d) gaining political support and building capital markets from the bottom up, and e) increasing attractiveness, competitiveness, and international cooperation.

KEY TAKEAWAYS: EU CAPITAL MARKETS TODAY

>>> THE GLOBAL PERSPECTIVE



>>> THE STATE OF EU27 CAPITAL MARKETS

75%

The reliance on bank lending
Three quarters of all corporate borrowing in the EU27 is from bank lending, compared with 53% in the UK and 26% in the US. This reliance on bank lending reduces the diversity and flexibility of funding for European companies and acts as a drag on EU growth.

51%

The depth of capital markets in the EU27 relative to the UK
Capital markets in the EU27 are just half as large relative to GDP as in the UK, which in turn is around half as developed as the US across 24 sectors of capital markets activity. While capital markets in the EU27 have grown rapidly since the financial crisis, there is still significant scope for growth.

50%

The size of pools of long-term capital as a % of GDP in the EU27 relative to the US
Total financial assets in the US are twice as large as in the EU27 relative to GDP (US = 529% of GDP; EU = 264%). This is largely explained by the fact that both pensions assets and direct investments in funds, stocks, and bonds are more than three times the size as in the EU27.

32%

The percentage of household financial assets that are held in bank deposits
Just under a third of all household financial assets in the EU27 are sitting in the bank earning limited or negative returns. A small shift from bank deposits to investments would unlock huge amounts of capital that could be put to more productive use in the economy and generate better returns for savers in the longer term.

56,000

Number of investment funds in the EU27
There are more than five times as many investment funds in the EU27 as in the US even though the value of US funds is more than twice as large. This reflects the fragmentation of the EU market and translates into inefficiencies and higher costs for European investors.

31

The number of listing venues in the EU27
There are 31 different listing exchanges in the EU27 for companies to raise money, compared with just two in the US market, which is roughly four times bigger by value. This fragmentation acts as a drag on equity financing.

>>> DRIVING GROWTH

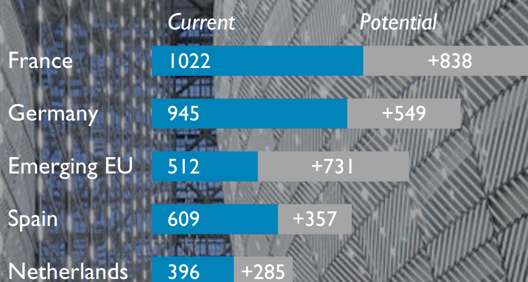
4,800

>>> additional companies in the EU27 a year could use capital markets for funding

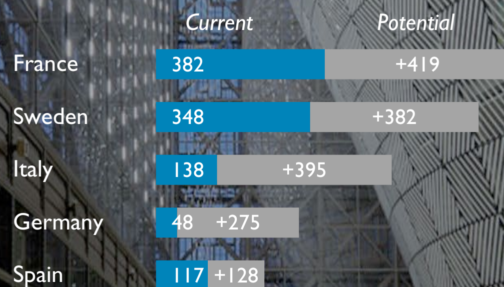
More than 4,800 additional companies a year could access capital markets to raise money in the equity, venture capital, corporate bond or leveraged loan market.

This is a 87% increase on current numbers and would significantly reduce the reliance of companies in the EU on banks that will struggle under the weight of the Covid crisis. This increase in capital markets funding would play a vital role in helping fuel a post-Covid recovery.

i) Potential growth in the number of EU27 companies that could access capital markets



ii) Potential growth in the number of EU27 companies listed on SME / growth markets



Note: we have used images of the Europa Building - the home of the Council of the European Union - as this is where many of the difficult decisions on the future of EU capital markets will need to be taken.

>>> A SHOT IN THE ARM

€535 bn

The additional amount of funding from capital markets each year for EU27 companies

Companies in the EU27 could realistically raise an additional €535bn in funding a year from the capital markets. That represents a 86% increase on current levels of activity and a shot in the arm of more than 3.5% of GDP a year.

>>> LONG-TERM GROWTH

€14 trillion

The potential increase in pools of long-term capital in the EU27

Pools of long-term capital in the form of pensions and insurance assets in the EU27 could more than double. This capital could be put to more productive use in the European economy, and would translate into an increase in long-term assets per household from around €63,000 today to €136,000.

>>> THE POWER OF EQUITY

7,230

The potential increase in the number of listed companies in the EU27

The number of companies in the EU27 listed on stock markets could more than double from current levels of around 6,850, adding nearly €8 trillion in market capitalisation. Companies could raise an additional €90bn a year on EU27 equity markets.

200+

Additional IPOs a year raising an extra €17bn

At least 200 additional companies a year could raise growth capital through an IPO. This is an underestimate: including 2021 data in our analysis translates into growth potential of 450 additional companies raising an extra €55bn a year in IPOs.

>>> UNTAPPED POTENTIAL

3,260

The number of high potential firms in the EU27 missing out on venture capital funding

We estimate that 3,260 additional high growth companies in the EU27 could access an extra €6bn a year in venture capital funding. That is another way of saying that 3,250 high-potential firms in the EU27 today are missing out on investment in their future growth. This is likely an understatement: including 2021 data in our analysis translates into growth potential of nearly 4,000 companies raising an additional €11bn a year.

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A new vision

Building bigger, deeper, and more integrated capital markets in Europe cannot be magically achieved overnight. Capital markets union is a long-term project that will take decades to achieve. As Europe lays the foundations for a single capital market it is important to focus on the practical barriers and achievable objectives. But it can be easy to get lost in the detail and too focused on the short-term challenges - and to forget that there is nothing intrinsic to being European that means you *cannot* have vibrant, diverse, and deep capital markets.

We think that alongside this, it is vital to paint a bolder and more ambitious aspirational vision for what EU capital markets *could* look like and the impact that could have. This section outlines five structural forces that could shape that vision and what different sectors of EU capital markets could look like in the next few decades. Some of the numbers look very bold but they are based on historical trends and conservative estimates of growth. We think the vision of capital markets outlined in this section would create a virtuous circle for EU citizens, the EU banking and finance industry, and the wider EU economy.

1) Structural forces

>>> Towards single supervision
You cannot magic a single capital market in the EU out of thin air by creating a single markets supervisor but ultimately you cannot have a genuine single market without one. The first step of ensuring single supervision across the EU would significantly reduce the fragmentation of EU capital markets. The next step of creating a single central supervisor for larger firms and international activities is a long-term prerequisite for anything resembling a single market. This supervisor would pool expertise from across the EU, have independent governance and accountability to the European Parliament, and work closely with the other European single supervisors with similarly enhanced mandates for banking, pensions, and insurance. It would also work closely with national authorities, who would continue to oversee smaller companies and more domestic activities.

>>> Specialist pan-European hubs
The post-Brexit relocation of activity from the UK to different financial centres across the EU is an opportunity to redraw the map and help create a series of specialist financial hubs instead of a series of competing sub-scale financial centres. These hubs would build on their existing expertise and capacity, providing services across the EU in the same way as different hubs in the US focus on different markets (New York for capital markets, Boston for asset management, Chicago for derivatives and the West Coast for venture capital).

For example, Dublin and Luxembourg would be the hubs for investment funds and alternatives, Frankfurt would be the hub for banking and clearing, Amsterdam for trading platforms, and Paris for fintech, asset management, and private equity. Smaller hubs could either specialise in even more specific areas such as cybersecurity or host support functions. National financial centres would continue to service local domestic activity, but could also become sectoral hubs of expertise based on their local economies.

>>> Towards net zero
The transition to a more sustainable economy and towards net zero will require such enormous financing over the next few decades that bank lending and government money will not be enough on their own. Capital markets will need to step up and scale up whether they like it or not, but in their current form capital markets in the EU will not be able to address this challenge. Europe will need to build on its existing head start in sustainable finance (the EU has a 35% share of global ESG bond issuance, for example) and set a global example in sustainable finance, with an open taxonomy that actively encourages cross-border investment and capital raising.

The EU will need to channel trillions of euros from pensions, insurance and individuals into tackling climate change to avoid being over-reliant on investment from around the world. The aim by 2030 (when many firms are supposed to have halved their emissions) is for sustainability to have been such a powerful force in EU capital markets that it no longer needs a 'green taxonomy' or a separate label called 'ESG'.

A single market?
Comparison of EU27 and US market structure in equities

Metric	EU27	US
Market value	€11 trillion	€45 trillion
# Exchange groups	22	7
# Listings exchanges	31	2
# Trading exchanges	36	16
# CCPs	18	1
# CSDs	22	1

Source: New Financial

>>> Consolidated market infrastructure

One of the main keys to unlocking a single capital market is the radical simplification of market infrastructure. Instead of a complex patchwork of national infrastructure with limited competition, the EU would migrate towards a series of three to five competing blocks of market infrastructure and exchange groups with a more consolidated post-trade infrastructure, perhaps with each group having its own CCP and CSD. This complexity is repeated across bond markets, derivatives, and regulation – see our report on *'The problem with European stock markets'.*

Each of these groups would not only merge the exchanges within them but also the markets they operate, creating a series of genuine single markets that would be deeper, more liquid and more efficient. Each country in these groups would have a local exchange access point that reflects the needs of the local markets but which feeds directly into the bigger market within each group. This consolidation in infrastructure would be backed up by a consolidated tape for trading in each asset class, and a single open data source for financial and non-financial information on all issuers across the EU.

>>> Digitisation and technology

Digitisation and the exponential progress in technology will transform the economics and processes of banking, finance, and capital markets in the coming decades. This presents EU policymakers with an opportunity to embrace the future rather than try to resist it. Technology will massively reduce the back office costs of capital markets, feeding through into less complexity and much lower fees. For example, moving settlement on to the blockchain could eliminate the need for large parts of market infrastructure and the services around it. As Europe's fintech start-ups mature into established businesses they will offer low cost services across the EU, forcing incumbent banks and other providers to reform and consolidate.

These technologies – blockchain, cryptocurrencies, and mobile – will be a democratising force in capital markets for EU citizens, driving more engagement and higher participation. Open finance and digital IDs will drive competition in the industry across borders.At the same time, advances in artificial intelligence and big data will help create more personalised products, as well as much cheaper and richer data analysis.

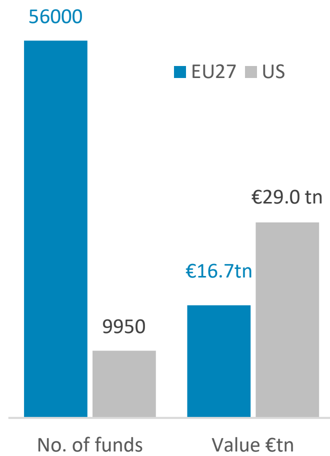
2) A sector-by-sector vision

>>> Pools of long-term capital

You cannot have deep capital markets without deep pools of capital yet in the EU pensions assets are just one third as big relative to GDP as in the UK and one fifth as large as in the US. The introduction of a comprehensive pensions dashboard across the EU would highlight the long-term unsustainability of pay-as-you-go pensions provision in many of the largest economies in the EU. This in turn could lead to the gradual introduction of auto-enrolment workplace pensions across the EU, ideally based on the large, collective, low cost industry-wide model used in the Netherlands.

Within a decade, roughly three quarters of the EU workforce would be covered by a workplace pension, and pensions could more than double from just over 30% of GDP today to over 75% (about a third of where Denmark is today). This would translate into a huge pool of over €11 trillion in pensions assets, and nearly €30 trillion in long-term capital including insurance, much of which could be put to work in the EU economy.

A single market?
Comparison of investment funds in the EU27 and US



Source: EFAMA, ICI, ESMA

>>> Investment funds

In the past decade, the value of investment funds in the EU27 has doubled in nominal terms but with more competition, the roll-out of auto-enrolment pensions, the creation of a single supervisor, and the removal of cross-border barriers to distribution, this could easily triple in the coming decade. That would translate into roughly €50 trillion in investment funds in today's money.

This would be accompanied by radical consolidation and massive reductions in costs. There are five times as many investment funds in the EU today as there are in the US, although the US market is nearly twice as large by value. If the number of funds in the EU halved (to a mere 28,000), the average fund size would increase six fold to around €1.8bn, improving the efficiency of the industry. This would be combined with technology and more competition to significantly reduce the fee gap on funds between the EU and the US. EU citizens pay billions of euros a year in fees that eat into their long-term returns: EU investors pay more than double the fees as their US counterparts (roughly 1.4% vs 0.6%).

>>> Asset management

The surge in pensions assets and investment funds in the EU would fuel rapid growth in the EU asset management industry, with assets under management potentially tripling from €13 trillion in 2020 to €40 trillion in the next decade in today's money. EU asset managers would no longer be able to rely on captive distribution networks or the protection from national barriers to support their business model, which would encourage consolidation.

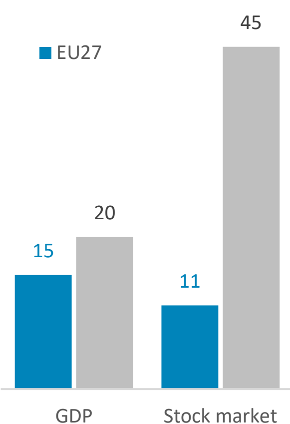
This could reduce the number of asset management firms in the EU by around a third from today's level of 3,100 to (just) 2,000. This consolidation would benefit large EU asset managers giving them a stronger foothold for their global business (in much the same way that US asset managers today enjoy a home market advantage). Paris could overtake the UK as the main centre for managing investment fund assets by 2030 and as an overall asset management centre by 2040.

>>> Retail participation

To the vast majority of EU citizens, capital markets are remote and abstract. The increase in workplace pensions, the rapid reduction in the cost of investing, and the democratising power of technology would lead to a significant increase in engagement and participation by individuals that would put EU citizens at the heart of capital markets union. Around three quarters of EU workers would be indirectly engaged with capital markets through their pensions within a decade of rolling out auto-enrolment workplace pensions, and the number who own individual funds (that they could choose through an EU-wide fund selection app) or individual stocks would be much higher than today's levels of less than 10%.

This would be backed up by an EU-wide programme of regular financial health checks, and would help create a virtuous circle with EU citizens taking more control of their money and engaging with it more actively to ensure that it is invested more sustainably. *See our concept paper on financial health checks here.*

A transatlantic divide
Comparison of GDP and stock markets in the EU27 and US (€ trillion 2021)



Source: IMF, FESE, WFE

>>> Stock markets

The most obvious shift in EU capital markets by the 2030s would be the rapid growth of stock markets. Today, the US economy is a third larger than the EU but its stock market is four times bigger. The consolidation of European stock exchanges and market infrastructure, growth in the domestic investor base, and gradual abolition of the tax differential between debt and equity funding would mean that the value of EU stock markets would more than double in the next decade to around €25 trillion. The number of listed companies would recover to its pre-crisis peaks of over 6,000 (an increase of around 50%) - redressing some of the imbalance between private and public markets - and the value of companies listed on designated growth markets would more than triple to around €250bn, providing vital growth funding to small but high potential companies.

>>> IPOs

The shift in scale and structural changes in EU stock markets would provide much deeper, more efficient, and more liquid markets for companies to raise money. The annual value of IPOs would at least double to a steady run rate of around €50bn a year (up from an average of €22bn a year over the past decade). If that sounds unlikely, it is in line with the record (and probably one-off) surge last year, which saw €47bn in IPOs – and it's roughly equivalent to the depth of the Swedish IPO market today. This surge in capacity would provide the largest tech companies in the EU with a big enough listing venue, removing the need to list in the US, and dozens of the estimated 180 unicorn tech firms in the EU today would list in the coming decade. The depth and scale of EU markets would also begin to attract more international issuers.

>>> Corporate bonds

EU companies have been reducing their reliance on bank lending and embracing the corporate bond market over the past decade, but progress has been painfully slow. Bank lending accounts for 75% of all corporate borrowing today, down from 85% in 2011. Assuming this shift accelerates – perhaps backed up by the emergence of the EU as a benchmark issuer in its own right - in a decade or so EU companies would be raising nearly €700bn a year in the corporate bond market (more than double today's levels), and the split between bank lending and bonds would be closer to 60/40, or roughly where France is today. This would relieve huge pressure on European banks, enabling them to clear their balance sheets of loans that could be more sensibly provided by capital markets and focus instead on SME lending. The shift from bank to market-led financing would also encourage the consolidation of the EU's fragmented and inefficient banking system, which would be boosted by the completion of banking union, the creation of a pan-European deposit guarantee scheme, and a single agency and management company for legacy non-performing loans.

>>> Venture capital

The EU has some of the most innovative entrepreneurs in the world but the venture capital industry in the EU is fragmented and sub-scale. Backed up by more local pension fund money, tax incentives, and widened access to private capital for retail investors, the VC industry in the EU would flourish. It could more than quadruple to around €40bn to €50bn of investments a year supporting high-growth and high-potential companies in every corner of the EU. Crucially, this growth would enable European companies to access growth capital at scale in second, third, and fourth rounds of fundraising, helping to drive the pipeline of EU unicorns. If that sounds fanciful, it's in line with the surge in activity in Europe in the past year, and relative to GDP it is only half the level of where markets like Finland and Sweden are today.

Driving sustainable growth

Before diving into the state of capital markets in the EU27 and the growth opportunity, it is worth pausing to ask why companies in the EU and around the world use the capital markets and what benefits capital markets offer to companies, individuals, and the wider economy in terms of investment, jobs, and growth. Here is a summary of some of those benefits:

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. This reduces the economy's reliance on bank lending, and allows companies to diversify both the sources of the capital they use and the term over which they borrow, reducing risk in their capital structure.

2. **Economic resilience:** capital markets help increase what economists call the 'shock absorption' capacity of the wider economy. The impact of an economic downturn is transmitted less quickly and directly to individuals in economies with more developed capital markets, such as the UK, than those that rely more heavily on bank lending such as EU27 countries, and they tend to recover more quickly.

3. **Access to capital:** capital markets offer the right companies the ability to raise a larger amount of capital at a lower cost and for a longer period than borrowing from their bank. Through equity financing, they provide companies with risk capital to support innovation and growth that banks are not designed to provide.

4. **Increase bank lending capacity to SMEs:** capital markets are not a realistic option for most small and medium-sized companies (SMEs) in the EU, 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 on lending to smaller companies that need it the most. Freeing up banks to support SMEs is more vital than ever.

5. **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 use capital markets.

6. **More flexible:** while capital raising can come to an abrupt halt in the wake of market disruption, capital markets rebound faster than bank lending. In economies with more developed capital markets, the flow of financing to companies increased more quickly in response to the Covid crisis: in the 12 months after the outbreak of Covid, the flow of bank lending and capital markets funding increased by 37% in the UK but by only 1% in the EU.

7. **Long-term returns:** the past few years have shown how volatile markets can be in the short term but investing in capital markets across a range of assets over the long term generates higher returns than keeping your savings in the bank (particularly with rising inflation), providing a better future income in retirement. Long-term pension savings reduce the future economic burden of pensions on EU taxpayers, government budgets, and employers.

8. **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 would add up to tens of billions of euros a year that can be put to work supporting the economy in much needed areas such as investment in infrastructure.

9. **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. Over time, money that it is invested in capital markets grows faster than money that is deposited in the bank.

10. **The climate emergency:** public money and bank lending are not enough to finance the projects needed to reach the targets set by governments to get to net zero and to support a transition to a more sustainable economy. Capital markets can close this gap by providing capital through a wide range of innovative instruments.

PART 3 – EU CAPITAL MARKETS TODAY

The current state of EU capital markets

In this section we analyse the current state of EU capital markets. In particular we look at the state of play in EU capital markets: the size and depth of capital markets across the EU; how companies in the EU are funded and their reliance to bank lending; and pools of long-term capital in the EU.

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THE SIZE OF EU CAPITAL MARKETS

That shrinking feeling

The first step in assessing the current state of EU capital markets is to look at the EU's global position in banking and finance and the size of its capital markets relative to other regions as measured by its share of global financial activity. Fig 1a) shows the distribution of global activity in the three years to 2020 across regions.

Without the UK, the EU's global footprint is significantly smaller and shrinking. The EU accounts for 14% of global financial activity compared to around 23% before Brexit. This puts the EU well behind the US and Asia. Its share is one third the size of markets in the US (43%) and half the size of those in Asia (27%).

Given that the EU27 economy accounts for roughly 18% of global GDP, its share of 14% shows that it is punching below its weight. We estimate that without a renewed sense of urgency, in 10 to 20 years time the EU27 will account for less than 10% of global activity. China will overtake the EU27 much sooner – today their markets are about the same size.

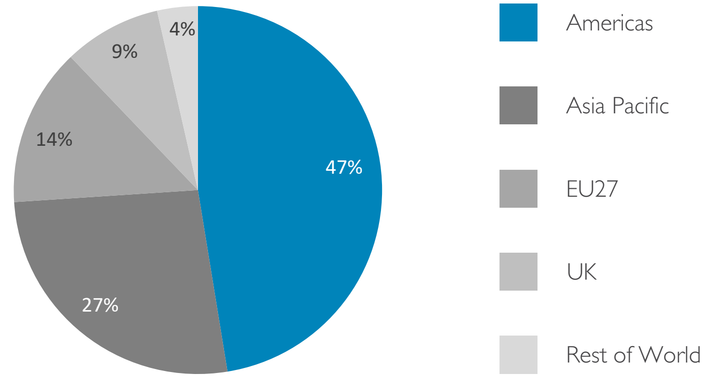
Within the EU capital markets are fragmented. Capital markets are small in most member states with activity concentrated in the biggest economies (Fig.1b). France has taken the place of the UK as the largest capital market in the EU accounting for 23% of total activity and Germany is second with 20% - effectively creating a duopoly with 43% of all EU activity.

This concentration is also present across different sectors: the Netherlands, Denmark, and Sweden account for roughly two thirds of all pension assets, while France, Italy and Germany account for two thirds of all insurance assets and household retail investments.

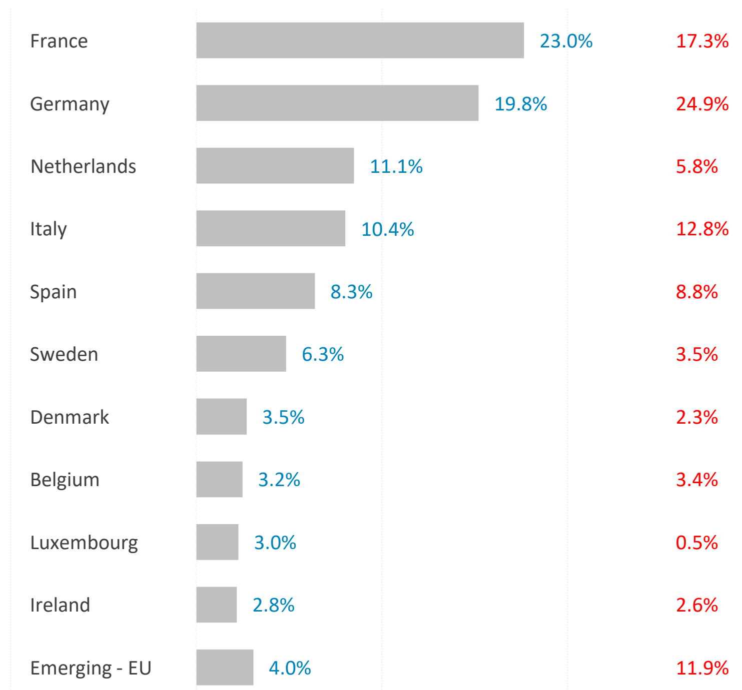
The fragmentation in EU capital markets increases complexity and leads to inefficiency, lower levels of competition, and higher costs for businesses and citizens. The EU economy is less diverse missing on higher growth and higher value creation. Less capital is flowing through and across the economy and business have access to lower levels of funding.

Fig.1 The size of EU banking and finance

a) The share of global financial activity by region in the three years to 2020



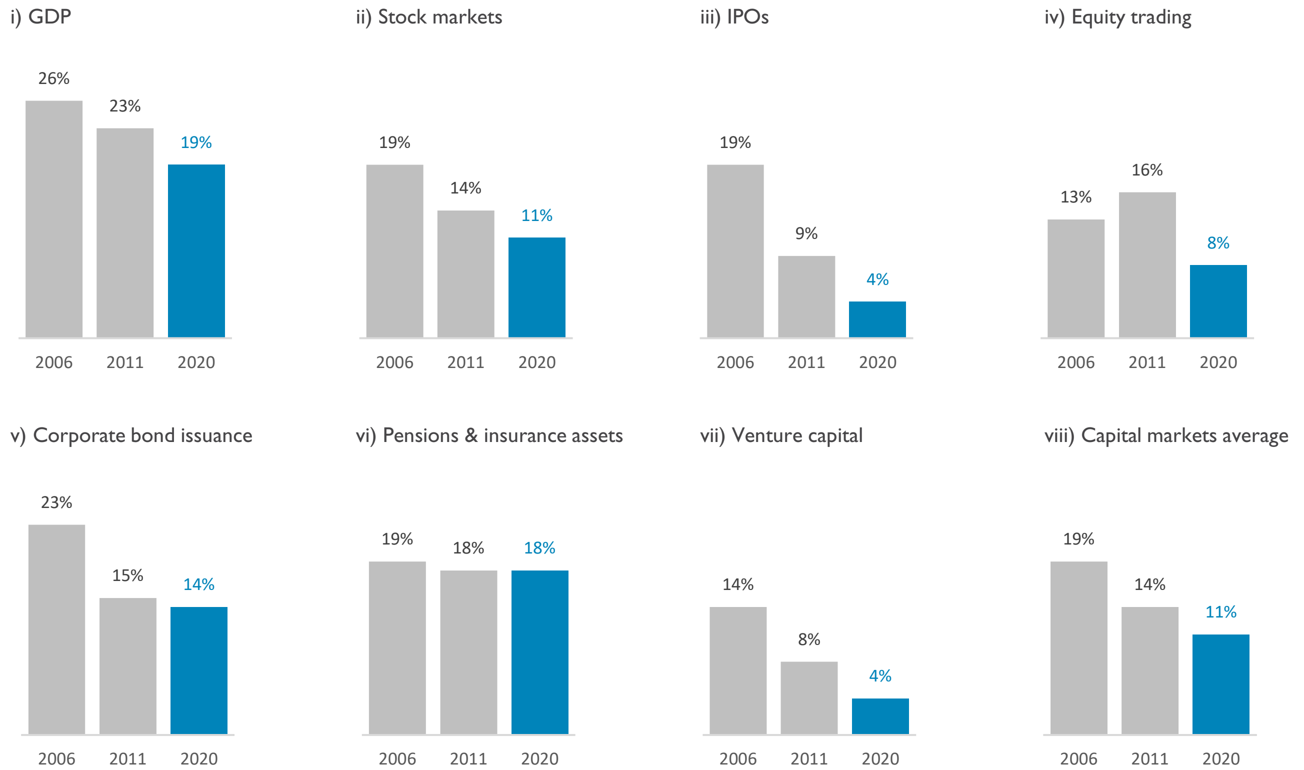
b) The share of financial activity in the EU27 by country in the three years to 2020
Note: the column in red shows each country's share of EU GDP



Source: New Financial
Note: For a few sectors data for 2020 were not available we used 2019 data

Fig.2 EU27 share of global activity

A selection of metrics showing the EU27's declining share of global activity from 2006 to 2020



Source: New Financial analysis

Running backwards

One of the most concerning but often overlooked developments in EU capital markets is that they are shrinking in a global context. Our analysis shows that since 2006 (just before the global financial crisis), the EU's share of global capital markets activity has dropped by over 40% from 19% to just 11%. This is a much steeper decline than the fall in the EU's share of global GDP over the same period of little more than a quarter - and faster than what we had forecast as recently as a few years ago (we thought we were being overly pessimistic in 2019 when we said the EU's share may fall to just 11% by 2030).

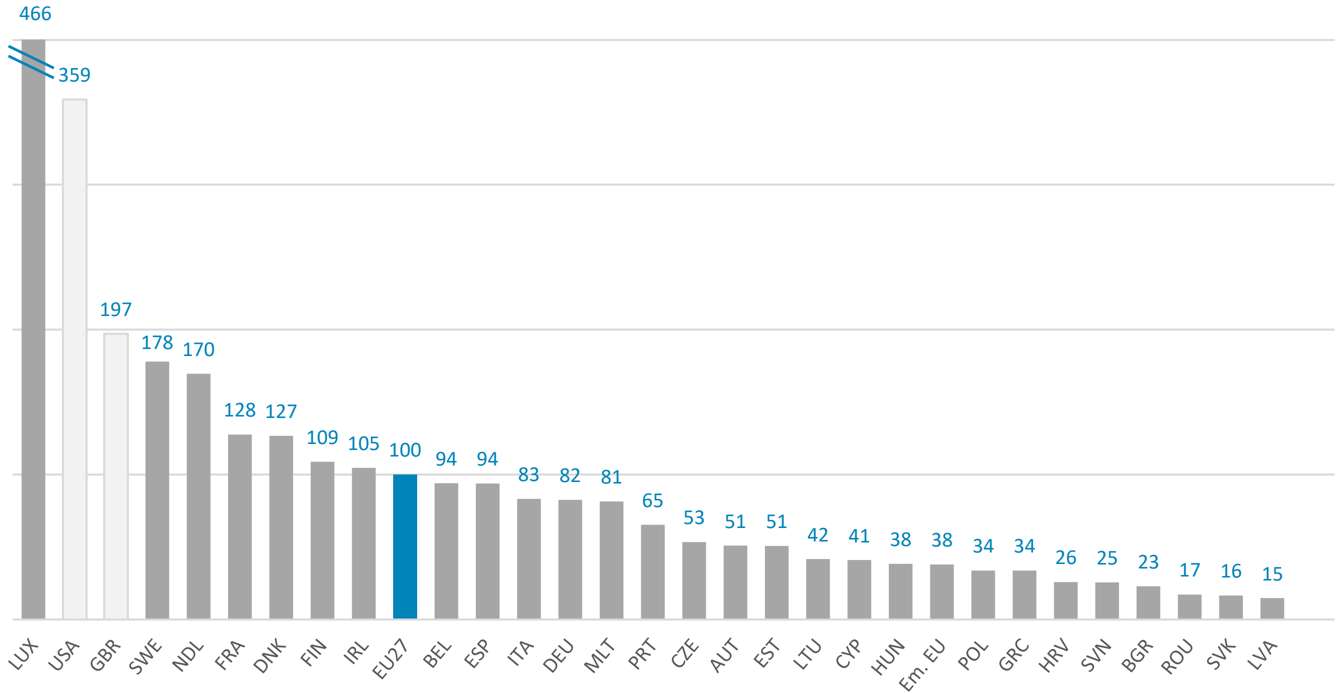
The decline of the EU's share is almost universal - the only sector where it accounts for a higher proportion of activity today than in 2006 is high-yield bond issuance. The decline is most pronounced in IPOs and venture capital where the EU's share of global activity has fallen by three quarters and two thirds respectively. This is particularly concerning as these are the two sectors most associated with the financing of innovative growth companies.

Over this period the actual value of activity in every sector has increased in real terms, but at a significantly slower rate than in the US and much faster growing Asian markets. This should raise several concerns and questions for EU policy makers. First, to what extent is the fragmented nature of EU capital markets acting as a drag on growth in funding for companies in the EU? Second, has the barrage of post-crisis reforms over the past decade created an environment that focuses too much on stability at the expense of enabling financing of the economy via capital markets? At the same time, third, what impact does this shrinkage have on the concept of 'strategic autonomy' across the EU economy? To what extent can European banking, finance, and capital markets provide the EU economy with the sort of support that it needs? And, finally, what influence will the EU have on global standards in future if it accounts for a small and shrinking share of global activity?

THE RANGE IN DEPTH IN EU CAPITAL MARKETS

Fig.3 The range in depth of capital markets in the EU

This chart shows the average depth of capital markets across 24 different sectors of activity over the three years to 2020
Rebased to EU27 average = 100



Source: New Financial

A wide range

EU capital markets are much less developed than capital markets in the US and the UK and there is a wide range in depth of capital markets across the EU. This range is far greater than the difference in depth between the EU27 and the US, or between the EU27 and the UK. Fig.3 shows the average depth of capital markets across 24 sectors of activity in each country over the three years to 2020, rebased to the EU27 average of 100.

Capital markets in the US (on 359) are nearly two thirds larger relative to GDP than in the UK (on 197) which in turn is roughly twice as deep as the EU27 (100). Luxembourg has the deepest capital markets in the EU (466), mainly because of its role as a regional hub for investment funds and as the domicile for lots of companies using the corporate bond markets, but in terms of size its capital markets are very small (around 3% of EU activity and just 0.5% of EU GDP). The UK had by far the largest capital markets in the EU and also the deepest capital markets 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 Sweden, the Netherlands, France, Denmark, and Finland. These countries have capital markets that are significantly more developed than the EU average and they underline that there is nothing intrinsic about being European that means you cannot have well-developed capital markets.

The countries in the second group have relatively developed capital markets but less developed than the EU27 average (between 65% and 94% of the average) and in many cases there is a big disparity between the depth of capital markets and the size of their economy. Three out of the four biggest economies in the euro area - Germany, Italy and Spain - have capital markets that are less developed than the EU average. Finally, there is a long tail of smaller economies with much less developed capital markets, including Austria, Greece, and the most recent member states to join the EU from Central and Eastern Europe.

Kicking the habit

While there are some encouraging signs that companies in the EU have begun to reduce their reliance on bank lending over the past decade, the EU economy is still heavily exposed to a struggling banking sector. Fig.4 shows the extent to which companies in the EU, the UK, and the US rely on bank lending as a source of funding.

On average, bank lending represents 75% of corporate borrowing for EU companies and bond markets account for 25%. This is the inverse of the US, where bank lending accounts for just 26% of corporate borrowing. In the UK corporate bonds represent nearly half of all corporate borrowing.

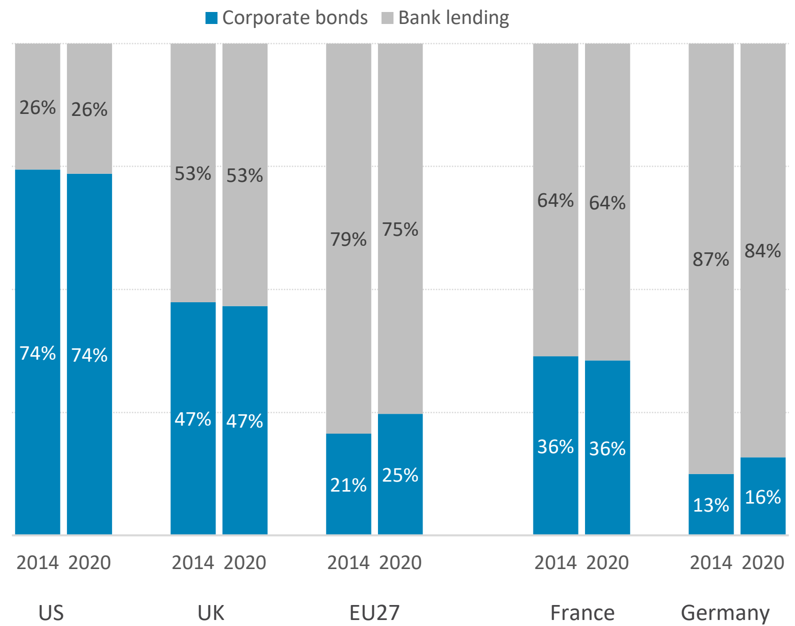
There is a wide range in the level of adoption of corporate bond markets in the big five economies in the EU. On the one hand, in France, corporate bonds represent a significant part of corporate borrowing (36%). On the other, corporate bond markets are far less developed in Germany, Italy, and Spain, where companies rely on bank lending for more than 80% of their borrowing.

The reliance on bank lending and the slow progress towards more capital markets financing is more evident in the way companies in the EU are funded. Fig.5 shows the structure of the liabilities of non-financial companies in the UK, the EU27, and in the three of the biggest EU27 economies.

Bank loans represent more than a quarter (28%) of the total liabilities of non-financial companies in the EU27, whereas listed shares and debt securities account for a fifth of all corporate financing. EU companies have a preference for unlisted shares and other non-public equity instruments which account for nearly 40% of all non-financial corporates' liabilities. Companies in the UK divide their liabilities more evenly. Bank loans, listed shares, and unlisted equity represent around a quarter of corporate liabilities. The combined share of bonds and listed shares is more than a third versus just 20% in the EU27.

Fig.4 Bank lending vs corporate bonds

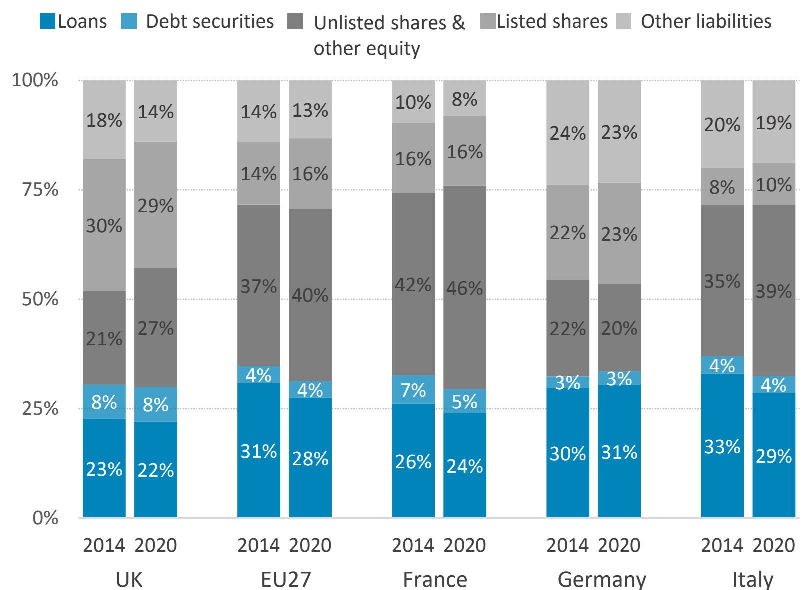
Corporate bonds as a % of corporate borrowing in the US, EU27, UK, France and Germany



Source: ECB, BIS, Dealogic, US Treasury, New Financial

Fig.5 How companies are funded

The distribution of total liabilities of non-financial corporations in the UK and EU27



Source: Eurostat, ONS, BoE

A long way to go

The starting point for deep and effective capital markets is deep pools of long-term capital - but households in the EU27 are just as dependent on bank deposits as companies are on bank lending. Fig.6 shows how households in the EU27 invest their financial assets.

Households in the EU27 divide their financial assets (excluding property) roughly equally in three parts. Nearly a third (32%) of their financial assets are in bank deposits - nearly three times the level in the US. A third of assets are held in pensions and insurance products. And the rest is invested directly in stocks, bonds, and funds. This ratio has remained stubbornly unchanged since 2014.

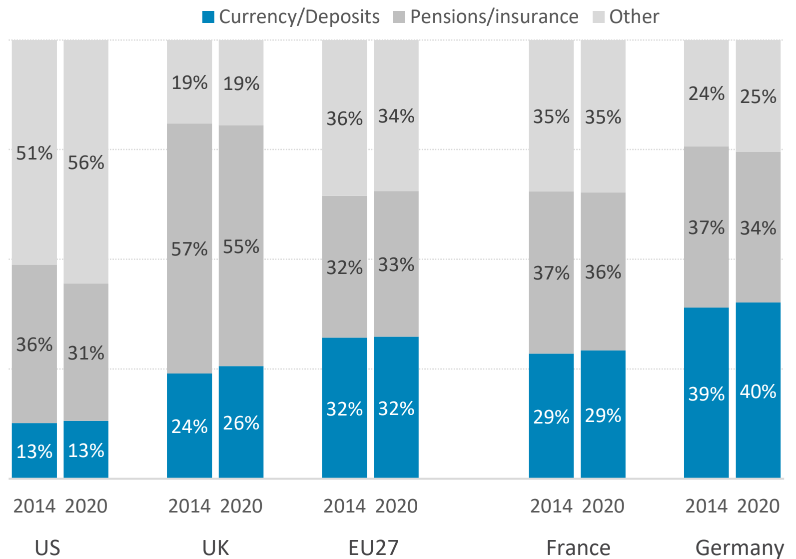
There is a wide range across the EU27. In the Netherlands, Denmark, and Sweden the share of bank deposits is relatively small and well below the EU average, with an outsized share held in pensions assets. In nearly three quarters of the EU27 member states the share of bank deposits is above the EU average ranging from a third to more than 60% of total household financial assets.

While the share of long-term pools of capital in the EU27 has grown by more than a quarter since 2006, the share of investments in stocks, bonds, and funds has fallen. If households in the EU27 reduced their preference for bank deposits to the same level as in the UK, it would free up more than €2 trillion that could be invested in the wider economy.

Fig.7 shows the total size of financial assets in the EU27, the US, the UK, France, and Germany relative to GDP. Total financial assets in the US are twice as large as in the EU27 relative to GDP. This is largely explained by the fact that both pensions assets and direct investments in funds, stocks and bonds, are more than three times the size as in the EU27. The difference in pensions assets also explains why total financial assets in the UK are so much bigger than in the EU27 relative to GDP (349% vs 264%) and much bigger compared to the other big economies in the EU27.

Fig.6 How households invest their assets

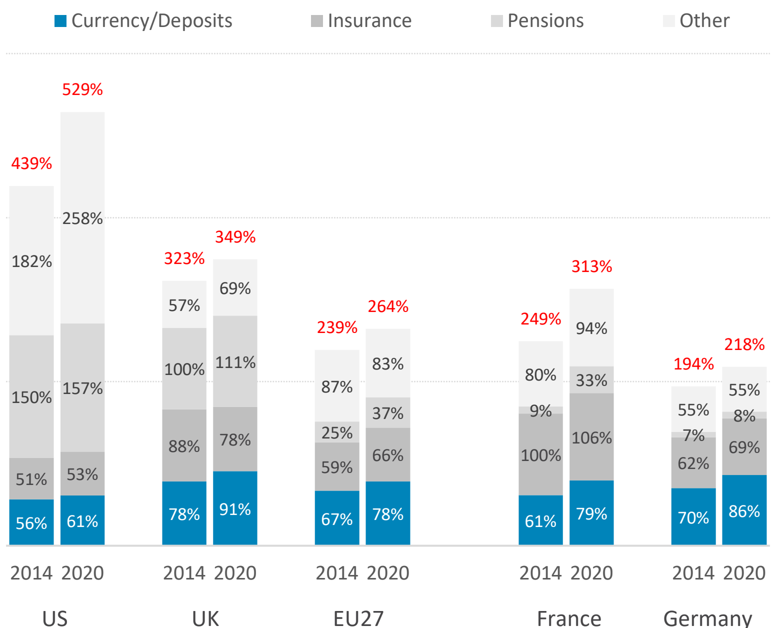
The allocation of household financial assets in the EU27, US and the UK



Source: Eurostat, ONS, Federal Reserve, New Financial

Fig.7 Pools of capital

The size of potential pools of long-term capital as a % of GDP in the EU27, US and the UK



Source: ECB, ONS, OECD, Insurance Europe, New Financial

PART 4 - MEASURING THE GROWTH POTENTIAL

The growth opportunity in EU capital markets

In this section we analyse the huge but realistically achievable opportunity for growth in selected sectors of EU capital markets and in selected countries.

How we measured the growth potential Page 19

The growth opportunity in pools of capital Page 20

The growth opportunity in IPOs Page 21

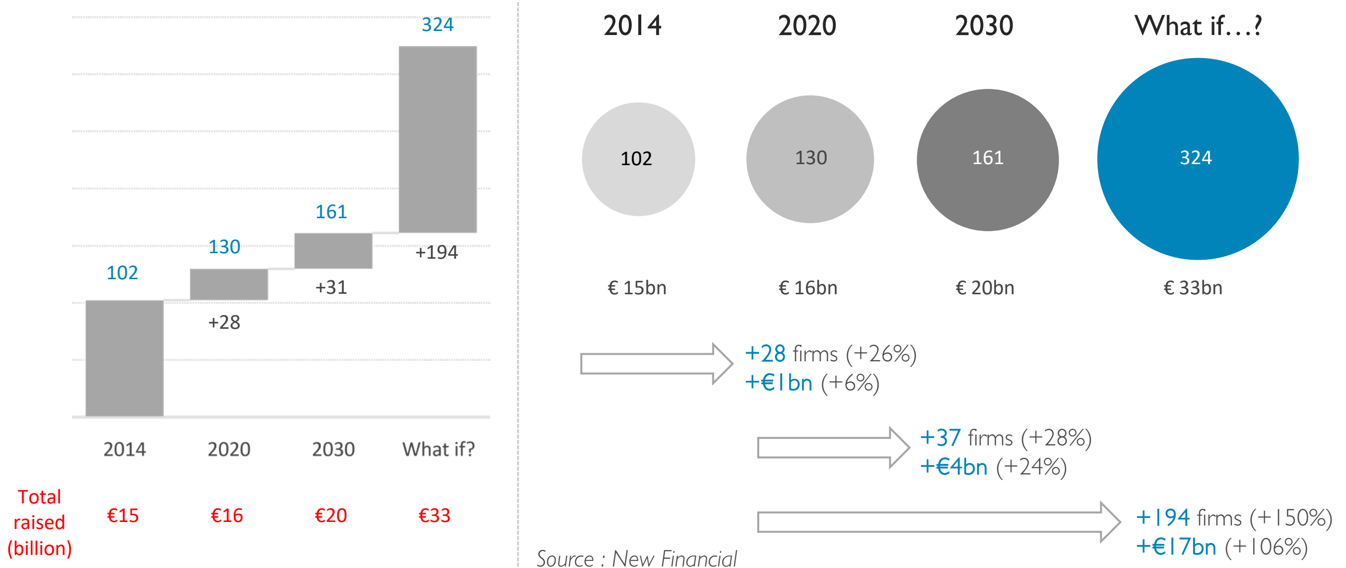
The growth opportunity in corporate bonds Page 22

The growth opportunity in venture capital Page 23

The growth opportunity in SME/Growth markets Page 24

Fig.8: An example: measuring the growth potential for the IPO market in the EU27

How we estimated the growth potential for the IPO market in the EU27 (*Note: We use a three year rolling average for 2014 and 2020)*



Source : New Financial

Game-changing growth?

Here is an outline of how we calculated the 'game-changing' potential growth in EU capital markets and how we present this analysis in this report using the IPO market as an example. First, we started with where we have come from in the year before the launch of CMU: in the three years to 2014, an average of 102 companies in the EU27 raised nearly €15bn a year in the IPO market.

Second, we looked at where we are today: in the three years to 2020, an average of 130 companies a year raised around €16bn a year. In other words, the IPO market has grown by around 27% in terms of the number of companies in the EU27 going public and by just 6% in terms of money being raised. Then, we estimated where we are likely to be in 10 years. For each country we made the conservative assumption that real GDP will continue to grow over the next decade at half the rate it did in the 20 years, and that the depth of the IPO market will keep growing at half the rate it did in the past 15 years. This translates into an additional 37 companies a year going public in the EU raising an additional €4bn a year.

While this growth is welcome, it's not really going to move the dial. So we ran a 'what if…?' scenario using the same simple methodology we used in our previous reports. We measured the value of IPOs as a percentage of GDP for each country and divided them into quartiles. Within each quartile, we calculated the weighted average value of activity as a percentage of GDP. For example, based on the three years to 2020, France is in the third quartile with an IPO market of 0.06% of GDP. The average depth of the IPO market for countries in the second quartile (which includes Germany, Denmark, and Italy) is 0.14% of GDP a year. If France were to increase the depth of its IPO market to this level - and there is no particular reason why it shouldn't have a market as deep as Germany or Italy - it would involve IPO volumes of nearly €3.3bn a year, growth of around 120%, and an increase in funding of around €2bn a year. This translates into an additional 13 French companies a year doing an IPO, based on the average size of IPOs in the EU.

On this basis, the number of IPOs in the EU27 could more than double to around 324 a year (an additional 195 or so companies a year) and the amount of money being raised would jump from around €16bn a year to €33bn. While this growth may look improbable, we believe that it is perfectly achievable given that a number of EU countries have shown it can be done. We repeated this exercise for each country and each sector to create a more ambitious vision for capital markets across the EU.

A deeper pool

While the relatively small pools of long-term capital in many countries across the EU presents many challenges for policymakers, it also represents a huge opportunity for growth.

We analysed the potential growth in pools of long-term capital (that is funded pensions assets and insurance assets) in each country based on two growth scenarios: one based on historic growth trends over the past 10 years, and one based on ranking countries by depth relative to GDP, dividing them into four quartiles, and then estimating what could be achieved if pensions and insurance assets in each country increased in depth to the average level of countries in the quartile above. To make this growth more tangible, we expressed it in terms of the growth in assets per household in thousands of euros.

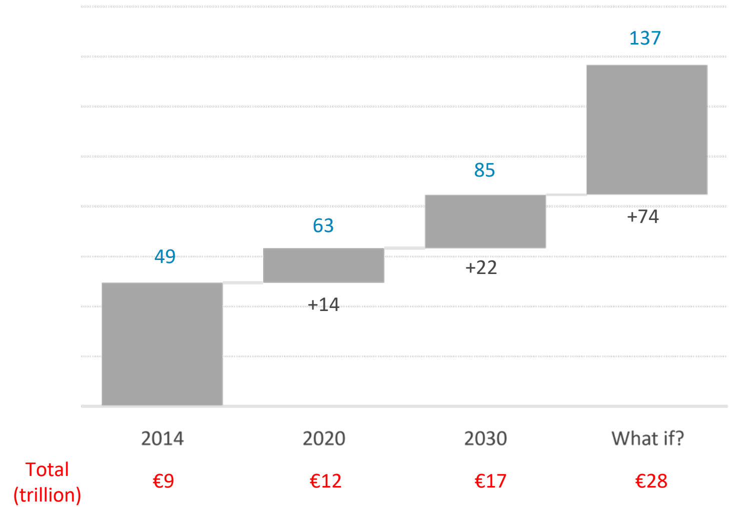
Fig.9 shows the growth potential in pensions and insurance assets in the EU27. In the three years to 2014, the average value of long-term assets per household in the EU27 was €49,000. This had increased to around €63,000 in 2020. We estimate that over the next 10 years the average will grow by nearly a third to €85,000 - an additional €22,000 for each household in today's money.

But if each country had pools of capital as large relative to GDP as in the countries in the quartile above, pensions and insurance assets would more than double to €137,000 per household (an increase of €74,000 per household). This translates into an additional €14.3 trillion in long-term capital in the EU27 that would significantly lower the future pensions burden and could be put to work in the wider EU economy.

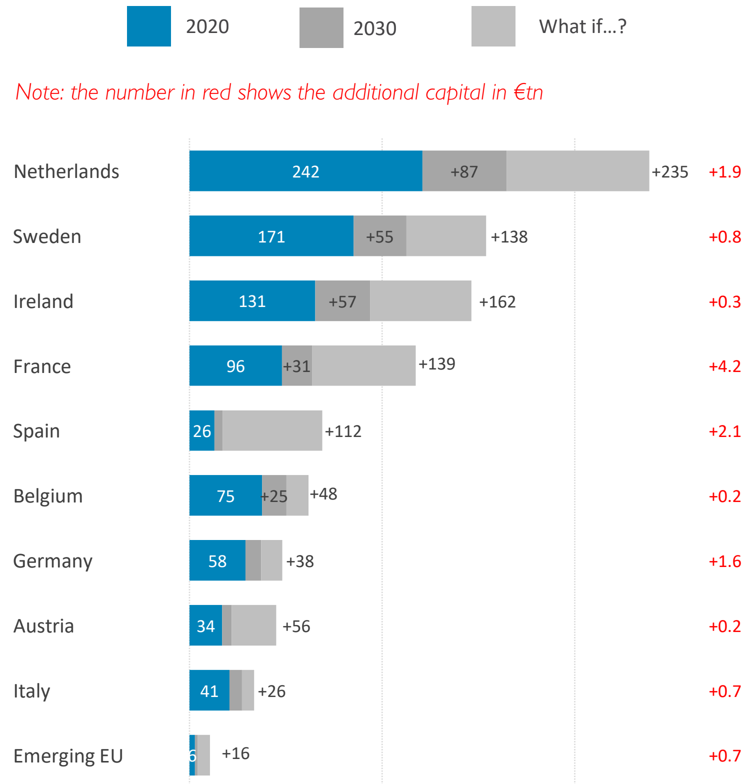
At a country level, there is a wide range in the growth potential. Long-term assets per household would increase in today's money by between €26,000 and €235,000 in large economies such as France, Germany, Italy, Spain, and the Netherlands. In smaller EU economies such as Austria, Greece, Portugal and the most recent member states to join the EU longer-term assets per household would increase by between €6,000 and €93,000.

Fig.9 The growth opportunity in pools of capital

i) The growth opportunity in pools of long-term capital per household in the EU27 (pensions and insurance assets) expressed in terms of additional assets per household in thousands of euros



ii) The growth opportunity in pools of long-term capital per household in a selection of countries: potential additional assets per household in thousands of euros



Source: New Financial

Full steam ahead?

The number of new companies listing on stock markets is a simplistic but useful indicator of the depth of capital markets, and our analysis shows there is huge potential in the EU27. Fig.10 shows the growth potential in the IPO market in terms of additional billions in funding and additional number of companies raising funds per year in the EU27 and in different countries.

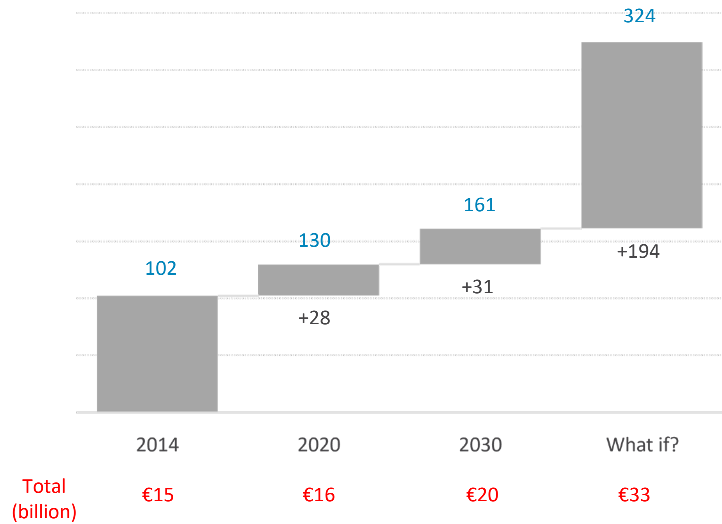
In the three years to 2014, an average of 102 companies raised nearly €15bn a year in the EU IPO market. By 2020, an average of 130 companies a year raised nearly €16bn a year. In other words, the number of companies going public in the EU27 has grown by around 26% and the amount of money being raised had gone up by 6%. On our conservative growth scenario it would translate into an extra 31 companies a year going public and raising an additional €4bn a year.

While this growth is welcome, it's not really going to move the dial. Under our 'what if…?' scenario, the number of IPOs in the EU27 would more than double to around 324 a year and the amount of money being raised would jump from €16bn a year today to around €33bn. These figures are likely to be an understatement as 2020 was hugely affected by COVID. We estimate that in the three years to 2021, the average value of IPOs will be at €24bn and the number of companies at 181. This translate into a growth potential of 450 additional companies raising an extra €55bn a year.

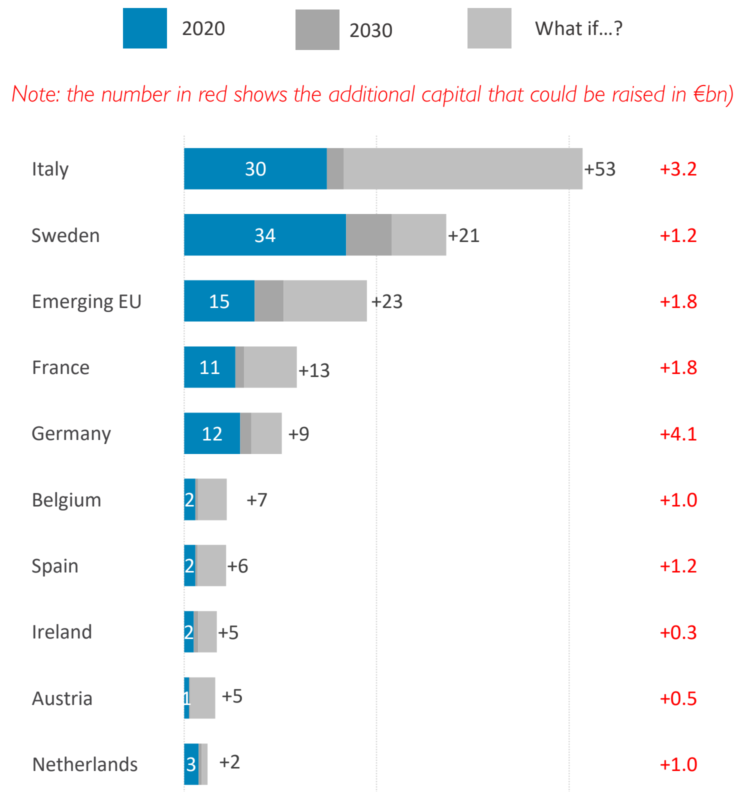
The potential for big EU economies is huge. In France an additional 13 companies a year would go public raising an additional €2bn a year compared to an average of 11 companies going public today raising €1bn. In Italy the number of companies would increase by 53 a year, from 30 today, raising an extra €3bn a year. In Germany the number of companies would increase from 12 raising €6bn to 20 raising an additional €3bn per year. The IPO market in emerging EU economies would also grow significantly: the number of companies going public per year would more than double.

Fig.10 The growth opportunity in IPOs

i) The growth opportunity in IPOs in the EU27, expressed in terms of additional companies



ii) The growth opportunity in IPOs in a selection of countries: potential additional number of companies



Source: New Financial, Dealogic

A fundamental shift

Corporate bond issuance in the EU has grown at a faster rate than equity issuance since the financial crisis. Although a gradual normalisation of interest rates will have an impact on bond markets in future, in most EU countries there is scope for further growth as corporate bond markets are relatively underdeveloped.

Fig.11 shows what the growth potential in corporate bond issuance looks like in percentage terms and in euro value in a selection of countries and the EU27 under our 'what if' scenario. In the three years to 2014, an average of 596 companies in the EU27 issued nearly €264bn a year in bonds. In the three years to 2020, an average of 576 companies a year raised nearly €345bn a year from the bond market. This is roughly 30% growth in value and a small decrease in the number of companies issuing corporate bonds.

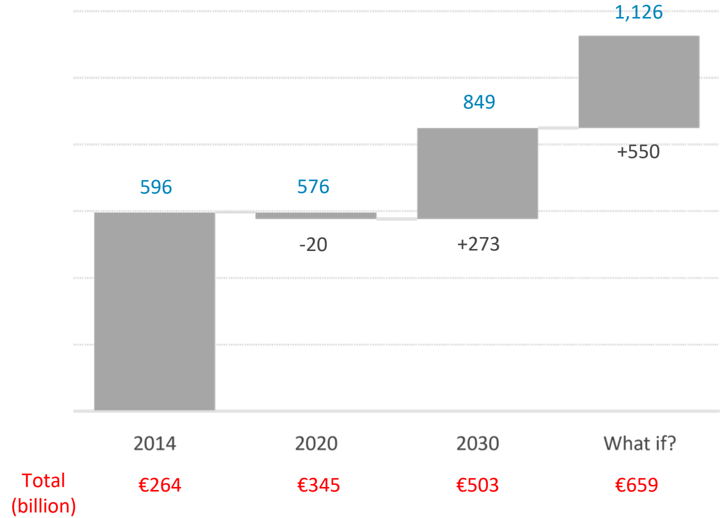
Under our conservative growth scenario, we estimate that over the next decade, an additional 273 companies in the EU27 would issue bonds each year raising an extra €158bn a year. This is an increase of nearly 50% on the current number of companies raising money from the bond markets.

On our 'what if?' scenario, we estimate that 550 additional companies would raise an extra €314bn a year. This means that the number of companies using the bond markets today to raise money would double to more than 1,100 companies and the amount of money raised would nearly double to €659bn. This would significantly reduce the reliance on bank lending.

At a country level, the number of companies issuing bonds every year in Germany would grow by three quarters, raising an additional €76bn a year. In Italy the number of companies would more than double, adding an extra €40bn in bond issuance a year. In smaller emerging EU economies the growth potential is huge. The number of companies raising money in the bond markets could nearly triple, from just 25 today to 71 companies, and the amount of money raised from €10bn to €27bn a year.

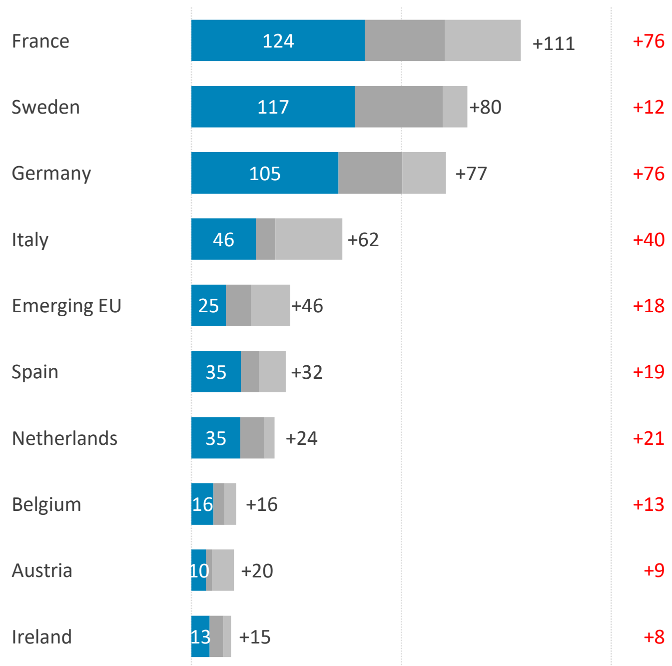
Fig.11 The growth opportunity in corporate bonds

i) The growth opportunity in corporate bond issuance in the EU27, expressed in terms of additional companies



ii) The growth opportunity in corporate bond issuance in a selection of countries: potential additional number of companies

Note: the number in red shows the additional value in €bn under 'what if…' scenario)



Note: Numbers are the sum of the growth potential in high yield and investment grade bonds
Source: New Financial, Dealogic

Financing the growth economy

Venture capital is a valuable source of funding for new and high potential companies, but venture capital investment in the EU is less than a tenth as developed as in the US. This presents big challenges for the EU27 economy but it is also a huge opportunity for growth.

Fig.12 shows what this growth potential looks like in terms of the number of companies getting venture capital funding and in euro value in a selection of countries and the EU27 under the two different scenarios. In the three years to 2014 an average of 2,914 companies a year across the EU27 used venture capital to finance their business, raising about €3bn a year.

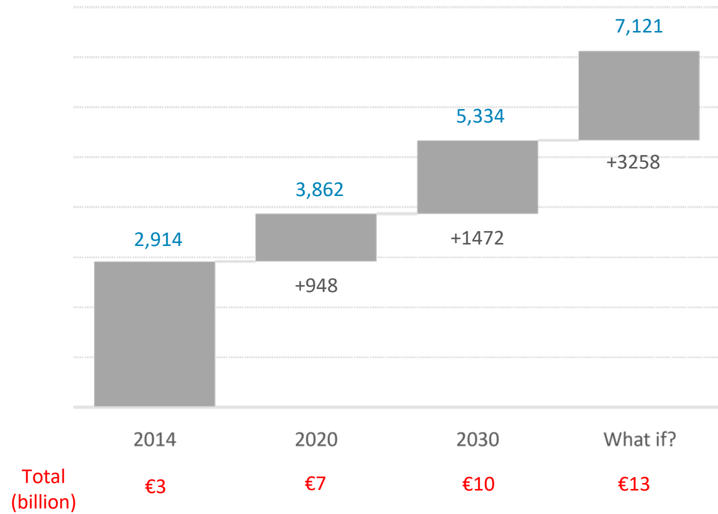
By 2020, this had increased to just under 3,900 companies a year raising about €7bn a year. This is a significant improvement: the amount of venture capital has doubled and the number of companies increased by a third. We estimate that over the next decade, an additional 1,472 companies would get venture capital investment each year raising an extra €3bn a year.

These numbers are only a slight improvement compared to what could be achieved. On our 'what if?' scenario, nearly 3,260 additional companies would raise an extra €6bn a year. The total value of venture capital investment would be just above €13bn. That's nearly double current levels. These figures are likely to be an understatement. If we include a strong rebound in activity in 2021 in our forecasts, the longer term growth potential adds up to an additional €11bn a year in venture capital and an extra 3,500 companies getting funding.

Not surprisingly, in countries where the venture capital industry is relatively underdeveloped, growth will be bigger. For example, in Italy the number of companies getting venture capital investments every year would increase to nearly 475 raising roughly €700m compared to just 120 companies today raising €250m. In emerging EU economies, the number of companies and the amount of money raised would more than double.

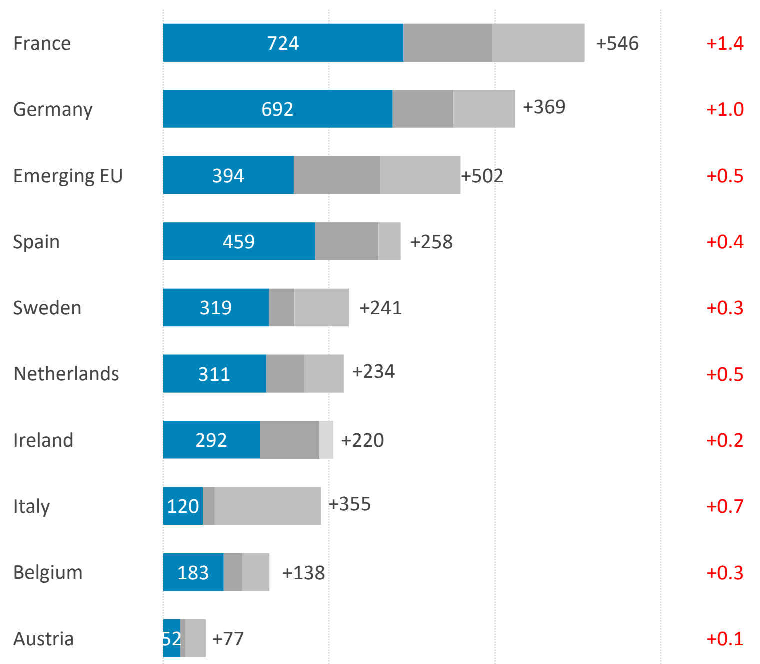
Fig.12 The growth opportunity in venture capital

i) The growth opportunity in venture capital in the EU27, expressed in terms of additional companies



ii) The growth opportunity in venture capital in a selection of countries: potential additional number of companies

Note: the number in red shows the additional value in €bn under 'what if…' scenario)



Source: New Financial, Invest Europe

Bridging the gap

One of the goals of the European Commission in the context of the capital markets union is to promote SME and growth markets so that it becomes easier for small and medium-sized companies to raise capital in public markets. Greater access to equity funding will be critical in the post-Covid recovery. We identified significant but achievable growth potential in these markets for every country in the EU.

Fig.13 shows what the growth potential in SME growth markets looks like in terms of the number of additional listed companies and in euro value in a selection of countries and the EU27 under our 'what if?' scenario. We were not able to estimate what markets will look like over the next ten years due to lack of historical and consistent data across countries.

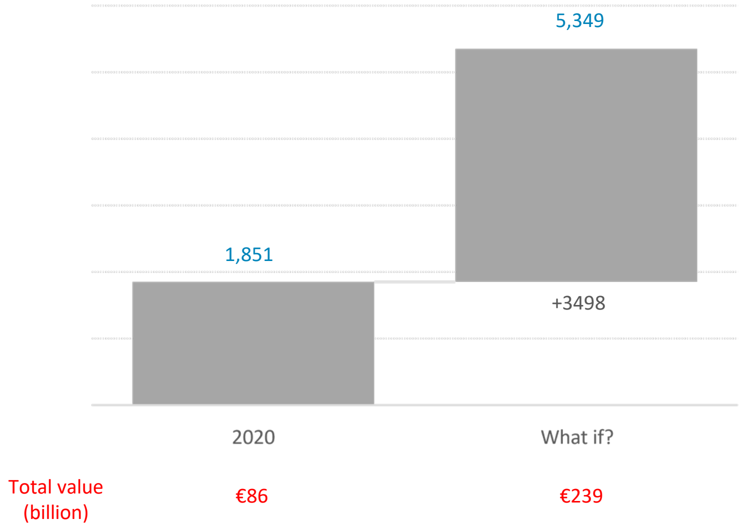
In 2020, just over 1,800 companies were listed on SME / growth markets across the EU27 with a combined market capitalisation of €86bn. To put that into perspective, in the UK, roughly 820 companies are listed on AIM with a market cap of €109bn which is significantly bigger than the total value of all companies listed on all growth markets in the EU27 of €86bn.

We estimate that if SME / growth markets in every country were as deep relative to GDP as in the countries in the quartile above, it would translate into a total of 5,349 companies listed in the EU27 worth around €239bn. This is nearly three times more companies listed on SME / growth markets than there are today and a combined market capitalisation roughly three times bigger than today.

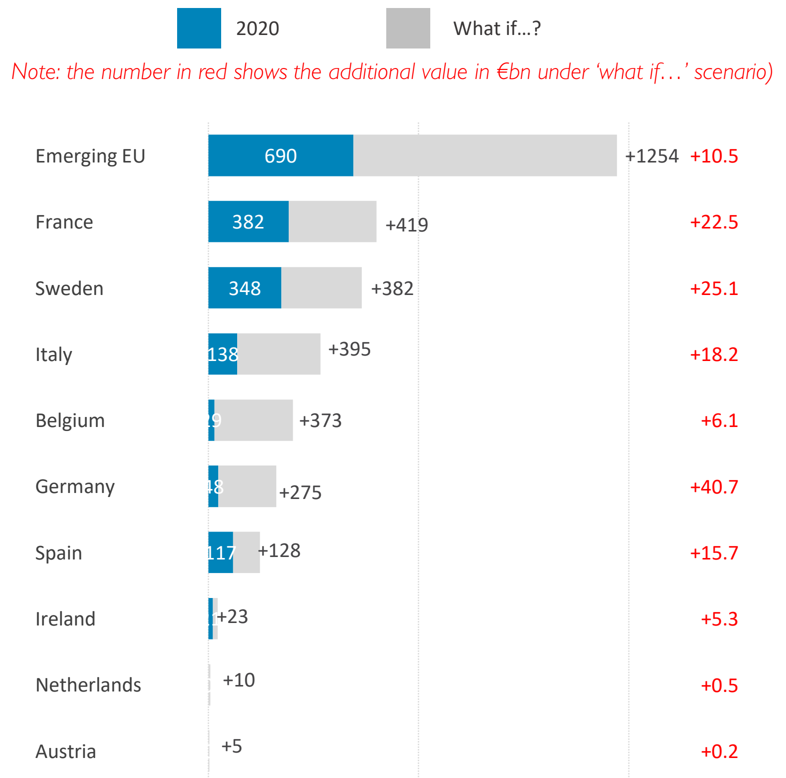
SME / growth markets in large economies such as Germany, Italy, and Spain would be significantly bigger. In Germany a total of 323 SMEs would be listed on Deutsche Börse's Scale compared to just 48 in 2020, an increase of €41bn in total market value. An additional 395 Italian and 128 Spanish SMEs would have access to public markets, with a combined additional value of €34bn. In emerging EU economies the number of SMEs listed would jump from 690 today to roughly 2,000.

Fig.13 The growth opportunity in SME / growth markets

i) The growth opportunity in SME / growth markets in the EU27, expressed in terms of the additional number of listed companies



ii) The growth opportunity in SME growth markets in a selection of countries: potential additional number of listed companies



Source: New Financial

How to drive growth

This report has outlined a new vision for EU capital markets and highlighted the huge but realistically achievable growth potential in selected sectors of capital markets across the EU. In the next few pages we present a selection of areas we think the EU should focus on over the next decade with some policy recommendations which are a combination of our research, workshops, and events as well as the valuable contributions from recent projects such as the Next CMU initiative and the High-Level Forum on CMU. Some of the suggestions are more practical than others but we hope they all provide a good indication of the best direction of travel for the future of EU capital markets.

Policy recommendations Page 26-29

How to drive growth?

This report has highlighted the huge growth potential for EU capital markets. In order to achieve this growth we think the EU should focus on five key areas over the next decade:

1) Rethinking the supervisory and regulatory framework

Redefining the overall framework: The EU needs to make its framework fit for a new world. New technologies are challenging established players, Brexit is now a reality, geopolitical tensions are increasing, and the Covid and climate crisis require the finance industry to play a much bigger role in the future. While the EU is reviewing many areas of legislation, it needs to take a more holistic approach. First, it needs to assess the cumulative impact of the post-crisis reforms. Second, it needs to rebuild its framework to make it more flexible and ensure stronger cooperation between national supervisors as the current framework was built with London as the dominant hub and the post-Brexit landscape of financial services in the EU will be more decentralised.

A new strategy: Any new legislation and regulation should be tested against a set of objectives and desired outcomes and be combined with non-legislative measures which nudge individuals and firms, particularly where barriers are cultural and behavioural, such as pensions and retail participation. In addition, the impact on attractiveness and competitiveness should be considered separately. Given the UK's post-Brexit desire to recalibrate its own regime, the EU will need a more flexible and nimble process for reviewing and reforming its existing rulebook if it wants to avoid the gap in competitiveness with the UK to widen.

Better supervision: A single supervisor will not magically create a capital markets union but ultimately a fully integrated market cannot exist without one. While there is a single EU rulebook, rules are applied slightly differently across the EU leading to complexity, inefficiency, less competition, and higher costs for businesses and citizens. Given the political sensitivities, the EU is rightly taking a gradual approach by focusing on convergence and enhancing the single rulebook. The next step should be to strengthen ESMA and EIOPA by reforming their governance, increasing their power and resources, and simplifying the framework by turning directives to regulations. Then, discussions should start on which sectors, firms, or activities need to be supervised at an EU level and which at a national level.

Effective monitoring & accountability: Mechanisms that effectively monitor progress against objectives and promote accountability are key. So far, the volume of legislation and regulations has been used to benchmark progress. While the set of indicators published recently by the DG FISMA to track progress on CMU is a step in the right direction and is based on outcomes rather than number of regulations, a more comprehensive effort is needed. More formal monitoring mechanisms could be set up measuring progress and ensuring accountability at both an EU and national level. Ecofin or another group could regularly monitor a clearer and shorter set of targets with defined milestones and deadlines, and the EU could work with member states to benchmark them against their peers around the world.

Dynamic regulation: Since regulations are often put in place to address specific challenges at a given point in time and take years to be implemented, they can quickly become outdated and subsequent well-intended fixes and overlays are inevitably temporary, resulting in a more unwieldly rulebook. The EU should follow a more dynamic and proactive approach to regulation and reform by establishing an ongoing review and accountability mechanism, and streamlining the process of reforms.

Rethinking the point of regulation: The EU needs to change its overall regulatory approach. Regulation is not an end in itself, not all problems are regulatory in nature or can be solved only by regulation. For example, simplifying the prospectus regime for smaller companies makes sense, but it assumes that the current rules are the main barrier to those companies to access capital markets. Also, complex markets may need complex regulation, but focusing too much on the detail can miss the bigger picture. Diving into the details of a product, market or sector, may miss the potential impact of the wider ecosystem. For example, the recent UK initiatives to get more infrastructure and long-term investment ignores the fact that the relative lack of investment in those assets is a feature of the system, not a bug.

2) Building deeper pools of long-term capital

A revised approach: Too much of pensions and insurance assets in the EU are tied up in non-productive assets, retail investment is relatively low, and the engagement of EU citizens with financial matters is sporadic. To address these issues, there needs to be a change in the overall regulatory and supervisory approach both at the EU level and the national level. For example, regulators and supervisors should strike the right balance between consumer protection and access to markets. While ensuring consumer protection is and should be at the core of regulations and policies, excessive protection might lead to exclusion of individuals from markets.

A shift in focus: While the new retail action plan is right to focus on assessing disclosures on financial products and inducements, reducing the administrative burden for more sophisticated investors and rising standards for financial advisors, the EU should focus more on the pensions and insurance market, assess market competition and costs to investors, and ensure the availability of clear and comparable information. Creating a pan European online platform where citizens can compare the different products and providers will be a massive step forward.

A focus on pensions: While the idea of a pensions dashboard is welcome, the EU needs a more rigorous approach to the sustainability of pensions systems across all three pillars (state, workplace, and private). This could include requirements for governments and companies to report annually pensions assets and liabilities in the same way, and fiscal incentives: if a country falls below a threshold, it would be asked to take measures. The EU and member states should also go beyond the recent study of auto-enrolment best practices and launch mandatory workplace pension schemes with initially-low but rising contributions for employers and employees, and tax incentives. Finally, it is vital to review the tax treatment of pensions (there are six different systems for taxing contributions, returns, and income).

Accessing illiquidity: The Solvency II review aims to make it easier for insurers to invest more in long-term capital by removing disincentives on equity investments. We think it should focus on a wider variety of instruments in order to be effective in shifting investment from non-productive assets to infrastructure, social, and environmental projects, and private or public companies with long-term growth potential and boosting sustainable economic growth. The revised rules should also look at stirring up investment in both equity and debt of unlisted scale-up companies and widening access to private capital and illiquid assets for individuals and smaller schemes by creating the right vehicles. Returns from those assets can be as much as 5% a year higher than public markets but they are off limits to most individuals.

A broader scope: The EU is right to target financial education in the new action plan but it will not alone address the lack of trust in in banking and finance, the lack of understanding in how they work or how they impact people's everyday lives and the low levels of retail participation. A combination of financial education programs, utilisation of technology and incentives, more transparency and information around costs and fees, and a change in how the industry talks about what it does would be more efficient.

Better engagement: Focusing more on engagement rather than education alone such as introducing 'financial health checks', simpler pensions dashboards and apps, and including simple and accessible information on people's future pension income in their payslips would also help. Renaming pensions as 'retirement savings' and adopting the Australian system which uses cultural references rather than hard numbers to express pensions in terms of the likely impact on people's lifestyle in retirement will make pensions more tangible to people.

3) Simplifying market infrastructure

A comprehensive audit: EU capital markets are small and fragmented. A more integrated market infrastructure with more transparency and competition would increase efficiency, liquidity, economies of scale, and lower costs for companies, investors, and market participants. The EU should work together with member states to conduct a comprehensive audit of the inefficiencies and barriers to competition in different markets at both a national and cross-border level.

Consolidation & competition: For as long as there are 22 different stock exchange groups in Europe operating 35 different exchanges for listings, 41 exchanges for trading, and nearly 40 different CCPs and CSDs, CMU is little more than a pipedream (see our recent report for more details). There is not enough competition in the right places, and between exchanges it is mainly restricted to trading volumes in the largest stocks. A small number of exchange blocs each having an umbrella operator with a series of 'local' markets like Nasdaq or Euronext and a system of cooperation like airline code-sharing would boost efficiency and competition for listings, trading, data and clearing. At the same time, policymakers should lift any barriers to competition and harmonize the rules between and within each block.

A single information hub: The key to well-functioning markets is consistent and timely information and there is plenty of room to improve, centralize, standardise, and simplify information. The proposed consolidated tape and the 'European single access point' are a big step forward but the EU needs to ensure they don't get watered down. Ultimately, the EU needs a single pan-European platform for filing and distributing comparable information on issuers including credit data on SMEs and growth companies. Over time, this platform could be expanded to a central portal for corporate governance and shareholder voting, reducing the bureaucracy and costs of cross-border investing.

A single platform: setting up a single pan-EU information hub for funds and other financial services such as crowdfunding or insurance would increase transparency, efficiency, competition, cross-border activity, 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. The EU should also push forward with an EU wide shareholder definition and utilise technology for exercising voting rights.

The wider ecosystem: The EU and member states should also focus on improving the ecosystem surrounding the different markets by working more closely with existing providers. Targeted public co-investment, perhaps in the form of a pan-European pre-IPO / IPO fund or the proposed European Pandemic Equity Fund under the umbrella of the EU's coronavirus recovery fund, would add critical mass to the smaller end of equity markets and help recapitalise companies in the wake of Covid. In the meantime, developing a new regime for direct listings and exploring the concept of 'hybrid markets' would provide companies with a wider range of options.

4) Embedding political support across the EU

A thorough plan: The long-term commitment of members states is key for progress as a deep integrated capital market takes time and requires deep national markets. For most politicians CMU is not a priority or raises too many domestic political challenges, and while they express their support in Brussels, they often seem to change their minds once they get back home. There is also a widespread public suspicion of capital markets and 'Anglo-Saxon capitalism' across the EU. Moving the dial requires concrete proposals, clear deadlines, monitoring and enforcement mechanisms, and collaboration with national governments, regulators, and other stakeholders. The heads of states should clearly endorse any agreed measures, commit to implement them, and pursue additional measures.

Making a better case: CMU supporters should explain at a national level the concrete benefits of bigger and deeper capital markets to businesses and citizens by framing them in practical terms (ie. what it means for jobs, investment and growth in each country). Over the past few years the debate has been conducted mostly at a technical level without a clear economic dimension or showing that capital markets are a public good serving the real economy. One positive from the Covid crisis is that it showed that for the first time in decades the industry can be part of the solution. The industry needs to redouble its efforts to show how it can help fuel economic recovery and the green transition, and that it is focused as much on the interests of companies and consumers as it is on its own interests.

A different approach: the EU needs to change the way it does policy and takes decisions. For many years this has involved very technical and specialist work isolated from the political reality in member states and the day-to-day priorities and policies of national governments leading to unintended consequences and contradicting outcomes. The EU should do better in identifying what is realistically and politically achievable in each country and within which timeframe, what are the concerns of different member states and how EU policies in in banking and finance fit with other policy areas at the EU and national level and with the priorities of national governments.

Building capital markets from the bottom-up: many of the big levers to drive growth in capital markets across the EU can only be pulled at a national and not an EU level. These areas include pensions, taxation, and addressing the debt / equity bias. The EU should work with member states in those areas that are beyond its remit by helping them to identify challenges and inefficiencies, providing technical support and resources as well as by nudging them into taking measures. Here is a series of questions that we drew up a few years ago for national governments to help understand their resistance to embrace CMU.

5) International competitiveness & attractiveness

Striking the right balance: in a new global reality of deglobalisation and rising geopolitical risks, the EU needs to protect its interests as much as any other bloc, but in doing so it needs to ensure a delicate balance. A strong internal capital market and capital markets that are open to the world are not mutually exclusive. The EU needs to strike the right balance between remaining open to international investment and capital flows and ensuring a level playing field for its companies and markets. It should not create more barriers to much-needed external investment that would send the wrong message to global investors and undermine the international role of the euro.

A new world order: while post-Brexit in aggregate EU banking, finance, and capital markets punch below their weight on the global stage, the EU remains one of the three global economic superpowers along with the US and China and in a number of areas the EU is a global leader. The EU should build on its existing strengths (eg. sustainable finance, investment funds, and insurance) and strengthen cooperation with other countries where it has less capacity. While much of the focus of EU policy has been internal over the past few decades, Brexit is a good occasion to reconsider the relative competitiveness of its banking, finance, and capital markets.

The wider world: the world is a lot bigger than Brexit. The EU should continue to cooperate and strengthen its relationship with other developed markets such as the US, Japan, and Canada; rebuild its relationship with Switzerland; and increase its financial, trade, and economic diplomacy and 'soft power' offensive with faster growing markets like China and India. The EU should resurrect its work on reforming equivalence to develop a more consistent, predictable, and sustainable global framework. It could include more formal working groups bringing together supervisors, regulators, and industry representatives and manage potential divergence over time by focusing on outcomes and more on economics rather than politics.

A post-Brexit relationship: the future relationship between the UK and EU will dominate the debate for years to come. The crucial question is how we move beyond a relationship that is dominated by mistrust and antagonism towards a more constructive relationship based on healthy competition and cooperation. Inevitably there will be divergence over time, but both sides should focus on where they have common interests such as sustainable finance, money-laundering, digitisation, data, and cyber security.

NEWFINANCIAL
Rethinking capital markets

About New Financial

New Financial is a think tank that believes Europe needs bigger and better capital markets to help drive growth and prosperity.

We think this presents a huge opportunity for the industry and its customers to embrace change and rethink how capital markets work. We work with market participants and policymakers to help make a more positive and constructive case for capital markets around four main themes: unlocking capital markets; rebuilding trust; driving diversity; and the impact of Brexit.

We are a social enterprise funded by institutional membership from different sectors of the capital markets industry. For more information on our work, please contact us:

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Our research on capital markets:
Here is a selection of some of our recent reports on capital markets:

- *Benchmarking ESG in banking & finance*
- *The future of EU capital markets*
- *Covid & capital markets: Part of the solution?*
- *Driving growth: the New Financial Global Financial Centres Index*
- *Brexit & The City: The Impact So Far*
- *The problem with European stock markets*
- *What do EU capital markets look like on the other side of Brexit*
- *A reality check on Capital Markets Union*

APPENDIX I – METHODOLOGY

Our sample:

We analysed the size and depth of capital markets in the following 24 different sectors of activity in all 27 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, 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 2020 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 EU28 average, which we again rebased to the EU27 average (to allow for comparisons to previous reports where we used the EU28 average). For example, the value of stock markets in the EU27 in the three years to 2020 is 64% of the EU27 GDP. We rebased this to 100, meaning that a country with a score of 50 has a stock market that is half as deep relative to GDP as the EU27 average, 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 outlying metrics at all.

Measuring growth potential:
In each sector and country we estimated the growth potential in terms of the number of additional companies that could get funding, how much they could raise, and as a percentage increase on the current level of activity. Given the disruption to the European economy from the Covid crisis, we have simplified our methodology for growth potential. In each sector we ranked each member state by the value of activity as a percentage of GDP, and divided them into quartiles.

> 2030: what might capital markets in the EU look like in 10 years' time?
For each country we estimated the growth in selected sectors of capital markets over the next 10 years based on a combination of the historical annual growth rate in real GDP over the past 20 years, and the historical annual change in the depth of capital markets relative to GDP over the past 15 years (depending on data availability).

> What if…?: what could capital markets look like if each country moved to the quartile above?
We estimated the growth potential in selected sectors of capital markets by assuming that in each sector activity increased in depth to the average level of the quartile above. For countries already in the top quartile, we assumed that activity can grow at half the weighted average rate of less developed markets. So, if a country was in the third quartile for IPOs, what would its IPO market look like if it were as a deep as the average of countries in the second quartile? We then translated this growth into the potential number of additional IPOs a year based on the average value of IPOs across the EU27 in the past.

There is no perfect way to measure the growth potential in capital markets and our approach has limitations. However, we think it creates a simple, realistic and achievable benchmark for potential growth: there is, after all no reason why a country shouldn't be able to move up into the quartile above in a particular sector. In most cases, our revised measure of growth potential falls between our 'business as usual' and more ambitious 'what if…?' figures from previous reports. We also think that this methodology may underestimate the growth potential for countries that are towards the top of their quartile, and may overstate the growth potential for countries towards the bottom of each quartile. In any case, we would stress that these numbers are not a growth forecast but a directional and realistic indicator of what could be achieved.

APPENDIX II – A SUMMARY OF THE GROWTH POTENTIAL

Fig.14 The growth opportunity for EU27 capital markets

This chart shows the projected and potential growth in the number of companies using capital markets and how much money they could raise each year in a selection of sectors in the EU27.

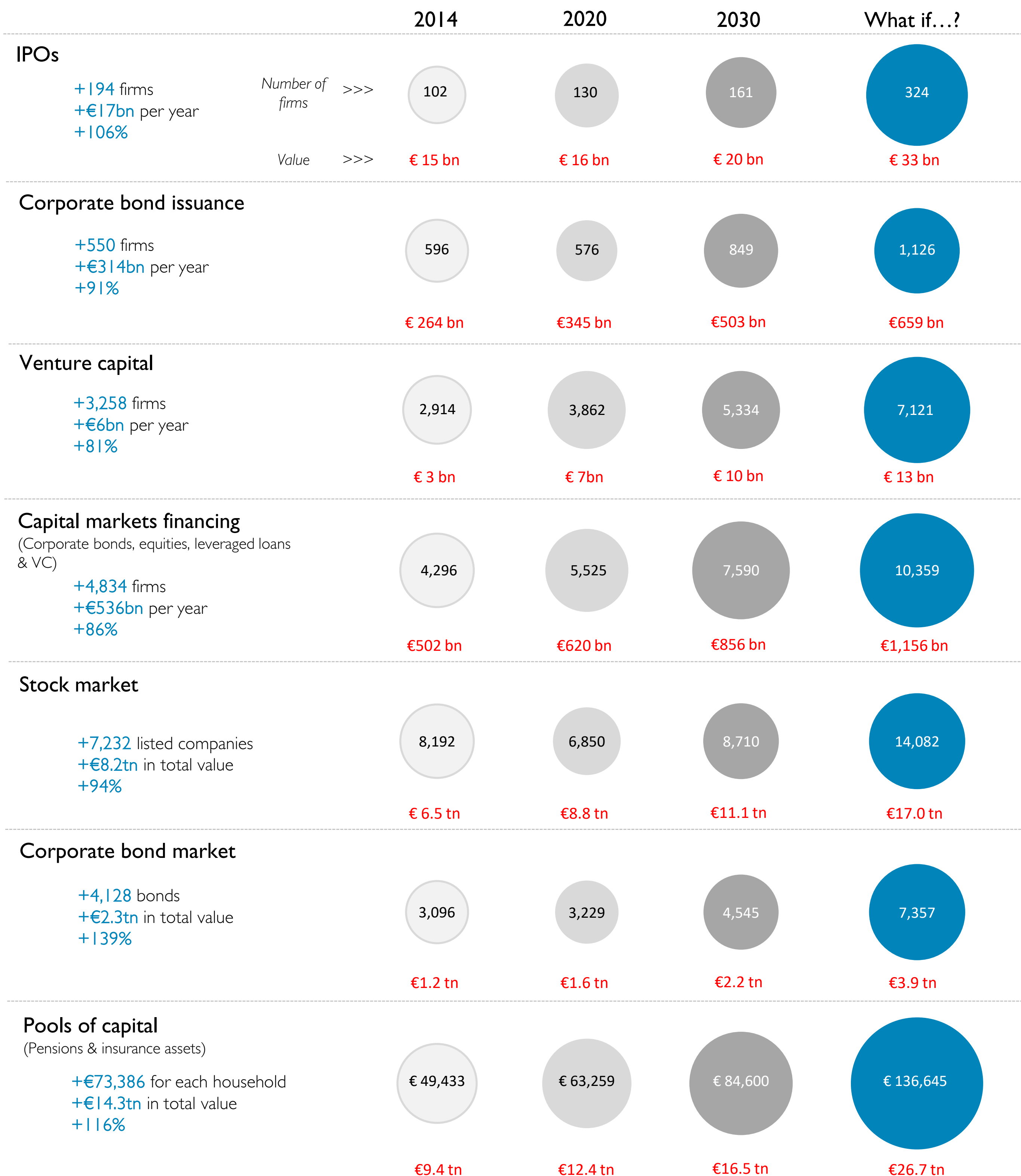

Fig.15 The growth opportunity in pools of capital

The growth potential in pools of long-term capital by country (pensions and insurance assets)

	2014		2020		2030			What if…?		
Country	€bn	Assets per household (€)	€bn	Assets per household (€)	Growth (€bn)	Growth (%)	Additional assets per household (€)	Growth (€bn)	Growth (%)	Additional assets per household (€)
Austria	103	26,932	135	33,810	39	29%	9,824	223	166%	56,018
Belgium	306	65,118	367	75,167	123	34%	25,285	236	64%	48,333
Bulgaria	5	1,631	10	3,603	9	90%	3,258	81	828%	29,846
Croatia	12	8,038	21	14,337	12	59%	8,502	32	154%	22,046
Cyprus	4	13,064	7	19,679	3	41%	8,068	31	472%	92,874
Czech Rep.	26	5,620	35	7,330	20	56%	4,131	42	119%	8,759
Denmark	757	318,903	977	404,886	353	36%	146,305	889	91%	368,415
Estonia	3	5,928	7	11,033	6	93%	10,316	35	508%	55,995
Finland	275	104,682	349	126,885	97	28%	35,344	271	78%	98,687
France	2,169	74,877	2,905	95,856	950	33%	31,338	4,217	145%	139,162
Germany	1,944	48,297	2,350	57,936	670	29%	16,532	1,560	66%	38,460
Greece	13	2,900	17	3,966	5	26%	1,043	70	400%	15,864
Hungary	11	2,691	14	3,381	5	33%	1,106	25	182%	6,168
Ireland	191	110,398	245	130,560	108	44%	57,251	304	124%	162,021
Italy	736	28,557	1,079	41,368	344	32%	13,175	669	62%	25,654
Latvia	1	850	1	1,548	1	76%	1,169	7	530%	8,199
Lithuania	25	18,990	31	23,039	24	76%	17,472	17	54%	12,545
Luxembourg	132	576,745	228	874,664	151	66%	578,707	140	61%	534,588
Malta	5	29,210	8	38,340	5	65%	24,828	7	85%	32,578
Netherlands	1,424	186,841	1,920	241,943	693	36%	87,357	1,869	97%	235,469
Poland	97	6,903	80	5,400	28	36%	1,919	216	271%	14,649
Portugal	69	16,995	105	25,729	30	29%	7,341	347	331%	85,175
Romania	4	588	14	1,882	10	73%	1,371	47	330%	6,207
Slovakia	13	7,207	18	9,462	12	69%	6,497	122	672%	63,596
Slovenia	7	8,058	9	9,771	4	39%	3,830	16	181%	17,711
Spain	410	22,290	484	25,772	165	34%	8,802	2,106	435%	112,034
Sweden	688	134,831	949	170,539	304	32%	54,598	766	81%	137,614
EU27	9,430	49,433	12,364	63,259	4,171	34%	21,341	14,344	116%	73,385
Developed EU	9,212	63,041	12,107	80,703	4,035	33%	26,899	13,634	113%	90,880
Emerging EU	218	4,890	258	5,668	136	53%	2,991	710	276%	15,625
Eurozone	7,830	52,730	10,265	67,491	3,430	33%	22,553	12,246	119%	80,515

APPENDIX III - CAPITAL MARKETS FINANCING

Fig.16 The growth opportunity in capital markets financing

The growth potential in capital markets financing by country (corporate bonds, equities, leveraged loans and venture capital)

	2014		2020		2030			What if…?		
Country	€bn	Number of firms	€bn	Number of firms	Growth (€bn)	Growth (%)	Additional firms	Growth (€bn)	Growth (%)	Additional firms
Austria	6	121	8	75	3	39%	25	15	192%	122
Belgium	17	146	25	233	12	46%	75	23	90%	189
Bulgaria	1	6	1	20	0	57%	11	1	194%	49
Croatia	1	9	1	12	1	63%	5	1	80%	15
Cyprus	0	6	0	11	0	43%	3	0	239%	13
Czech Rep.	5	19	10	34	8	80%	26	7	68%	31
Denmark	11	87	13	129	4	28%	31	13	103%	114
Estonia	0	11	0	24	0	77%	22	1	309%	31
Finland	8	203	11	210	4	41%	79	9	86%	160
France	118	693	141	1,022	52	37%	359	124	88%	838
Germany	127	1,044	159	945	56	35%	258	113	71%	549
Greece	8	48	5	47	2	30%	15	4	85%	84
Hungary	2	63	2	204	1	44%	150	3	152%	157
Ireland	11	112	13	335	9	64%	205	12	89%	258
Italy	53	220	55	268	13	24%	65	74	133%	553
Latvia	0	11	0	6	0	84%	3	1	651%	23
Lithuania	0	36	1	15	1	99%	9	1	142%	22
Luxembourg	9	21	11	30	6	57%	15	7	66%	23
Malta	0	3	1	9	1	85%	6	0	65%	7
Netherlands	35	262	61	396	22	36%	144	36	58%	285
Poland	8	113	7	91	5	68%	51	14	182%	204
Portugal	11	104	4	81	1	28%	17	7	158%	185
Romania	2	23	2	39	3	104%	28	5	187%	82
Slovakia	2	9	0	12	0	58%	5	2	739%	17
Slovenia	0	6	0	7	0	71%	2	1	380%	17
Spain	46	392	57	609	20	35%	243	41	71%	357
Sweden	20	528	30	658	13	42%	214	22	74%	451
EU27	502	4,296	620	5,525	240	39%	2,065	536	86%	4,834
Developed EU	473	3,942	589	5,013	216	37%	1,738	496	84%	4,103
Emerging EU	30	354	31	512	21	69%	327	40	131%	731
Eurozone	453	3,447	554	4,337	206	37%	1,549	470	85%	3,732