Europe's position in global capital markets

by Rainer Riess, Federation of European Securities Exchanges (FESE)

RECENT EMPIRICAL EVIDENCE[1] SHOWS THAT EUROPEAN CAPITAL MARKETS ARE NOT FULFILLING THEIR POTENTIAL AND CURRENTLY LAG BEHIND THEIR COUNTERPARTS IN THE US AND ASIA IN MANY REGARDS, FOR EXAMPLE, THE USE OF EQUITY FINANCE FIRMS, THE PREVALENCE OF VENTURE CAPITAL, AND THE RELATIVE SHARE OF IPOS. THERE IS SIGNIFICANT ROOM FOR DEVELOPMENT AND EUROPE STANDS TO GREATLY BENEFIT FROM INCREASING LIQUID, TRANSPARENT AND EFFICIENT CAPITAL MARKETS.

The European Commission has rightly recognised that capital markets play a beneficial role in the economy and have taken initial steps to overcome regional barriers and promote capital markets integration, such as the Capital Markets Union project.

Important challenges remain, however. FESE recognises that further development of Europe's capital market is necessary if it is to support the real economy to the best of its ability.

The current state of European capital markets

In comparison with its counterparts in the US and Asia, European markets' ranking is not favourable particularly in its ability to provide funding for the real economy and in comparison, European secondary markets are not as liquid.

When capital markets perform their core functions (funding, secondary trading, risk management) successfully, they contribute to stability and economic growth in their respective region.

Underperformance of public market funding

Capital markets enable funding thus allowing firms to raise long-term capital and provides investors with a return on their savings. European capital markets struggle to fulfil this function and as a result do not provide optimal funding for the real economy.

At 300% of GDP, the overall level of corporate funding is comparable across all regions. The proportion of these

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funds raised in capital markets varies significantly. European corporate funding relies heavily on bank loans and, as a result,the equity proportion of total funding is especially low. Equity funding is only 73% of GDP in Europe, while it is 147% in the US and 98% in Asia. This is problematic since over-reliance on bank lending is commonly believed to impede economic growth and increases levels of systemic risk.

Bank and capital markets based financing can complement each other by increasing the options available to companies seeking capital. We firmly believe that European firms suffer from this over-reliance on bank lending which unnecessarily limits their financing options. Europe needs a more optimal equity/debt ratio if it wants a resilient and flourishing economy.

Asia has had the largest share of IPOs with 638 companies listed in 2016. It is common knowledge that the vast majority of IPOs take place in the corporation's home region. In 2016, only 18 corporations engaged in cross-national IPOs. The overwhelming majority of these took place on US exchanges. European exchanges attracted no more than four cross-regional IPOs. This low rate of foreign company listings in Europe is not due to regional variation in IPO costs. Issuers simply expect better financial outcomes from listing in the US.

On a positive note, in recent years IPOs of small and medium-sized enterprises (SMEs) in Europe are increasingly well supported by dedicated SME markets set up by exchanges. European exchanges strive to offer an alternative to main listing boards on national stock exchanges and provide SMEs with the opportunity to IPO once they are sufficiently well established to take a larger number of equity investors on board.

These markets are characterised by more relaxed listing requirements and lower costs than the main boards. Several such markets – such as AIM (LSE), Alternext (Euronext), First North (Nasdaq), MAB (BME), New Connect (Warsaw SE), and Scale (Deutsche Börse) – have proven successful in Europe. Over 2,000 companies are currently listed on these markets in Europe. Nevertheless, compared to their US counterparts, European SMEs remain reluctant to list and further opportunities remain in this space such as private placement or online financing.

European private placement is a source of financing for SMEs without the need for a credit rating and costly disclosure requirements. The German "*Schuldscheine*" and the French "Euro-PP" are the most significant private placement markets in Europe, while markets in other European countries remain small. Total issuance on European private placement markets in 2015 was roughly half the size of that of the US market. However, European private placements have recently gained momentum, growing at the expense of European issuance on US markets.

In the online alternative finance space (e.g. peer-to-peer lending and crowd-funding), 2015 market volumes in Europe were considerably below volumes in Asia and the Americas, and it is estimated that the UK alone represents roughly 80% of the European alternative finance market.

Lack of depth and liquidity

Through the secondary market, capital markets provide liquidity to investors by allowing them to enter and exit positions as needed. However, for these markets once again Europe's performance is somewhat lacking in comparison to US markets which surpass European markets in depth and liquidity.

The advent of Europe's primary markets regulation, MiFID I, resulted in fragmented European markets which diffused liquidity across a larger number of alternative trading venues. This fragmentation of the European trading venue landscape also resulted in lower levels of market transparency. The fact that the proportion of trading in major equity indices going through "lit venues" is much lower in Europe than in the US and Asia is cause for concern.

European equity and bond markets are comparatively illiquid compared to its neighbours. While equity turnover velocity in the US and Asia is around 150% and 130%, respectively, it is 90% in Europe. In the corporate bond markets, European liquidity is similar to Asian liquidity, but well below the US.

Liquidity in individual European equity markets varies, ranging from around 35% in Austria to around 140% in Italy. Although these liquidity measures consider only lit venues, and a large portion of European equity trading takes place on dark venues, this measurement skew does not fully account for the low levels of observed liquidity in Europe.

Europe can facilitate risk management

When it comes to risk management, European capital markets successfully give companies and investors access to clearing services and risk management products, such as derivatives. Indeed, the European capital market provides good access to risk management products and transacts a significant market share of the global FX business. Europe's position in global derivatives and FX, however, is concentrated primarily in the UK.

Prior to the financial crisis, a large portion of derivatives transactions were over-the-counter (OTC). Post-crisis, regulations have been designed to reduce that market opacity created by OTC derivatives by driving transactions onto exchanges, cleared through central counterparties.

FX and interest rate derivatives account for most derivatives trading in all regions, both on exchanges and over-the-counter (OTC). Aggregated European derivatives markets amount to approximately US$1,400 TN in notional value traded in 2016. The aggregated derivatives market of the EU27 countries is far smaller, on account of London's dominant position in the European market.

The European derivatives market is smaller than the US market both in absolute terms and relative to GDP. While its notional traded volume amounts to 78x GDP, the US market is 98x GDP. Asian derivatives markets remain less developed at 23x GDP.

In 2013 the aggregated European derivatives market was larger than the US market. A significant decline in interest rate derivative volumes in Europe from 2013 to 2016, caused by an exceptionally low interest rate environment, means this is no longer true.

The current regulatory environment

Europe and the US have often faced similar challenges when regulating financial markets. While similar approaches have been taken in many cases, divergent approaches have both reflected and contributed to the development of their respective capital markets.

In 1986 the UK took dramatic steps to liberalise its financial markets. Some key measures included the abolition of fixed commission charges, the shift from open outcry trading to electronic trading as well as changes to the broker landscape. These changes where echoed in the US and Europe and marked a shift toward the types of capital markets we see today.

MiFID I defined the regulatory landscape for equities' trading in Europe. Through MiFID I, policymakers hoped to increase investor choice and competition between trading venues. Regrettably this legislation brought about some unfortunate consequences such as the proliferation of opaque trading venues, liquidity fragmentation and increased "dark trading" (i.e. OTC BCNs and platforms operating under pre-trade transparency waivers).

The US has also seen increased competition in trading venues although the shift toward dark trading has been significantly less dramatic. US regulations have instead given rise to new low latency trading and execution algorithms. As a result, these activities are more prevalent in the US than in Europe.

The global financial crisis led to global consensus about the need for regulatory reform. The 2009 G20 Pittsburgh Summit proposed a number of measures to increase resiliency, transparency and investor protection for financial markets. Europe and the US have followed the same broad G20 objectives, with the Dodd Frank Act in the US and MiFID II/MiFIR and EMIR reforms in the EU. MiFID II will be applicable from January 2018.

Despite the progress made there are still concerns that any further reduction of market transparency could affect price formation and hurt the fair and objective valuation of European securities trading. That said, the regulated European regulatory regime has demonstrated resilience in the face of post-crisis volatility and sovereign debt crises. In fact, Europe now has higher levels of bank capitalisation and deeper "default waterfall" prevention measures than the US.

European policymakers have moved to implement new rules via Regulations rather than Directives, and made significant changes to the European Supervisory Authorities. Both moves are aimed at avoiding regulatory fragmentation and providing financial stability in Europe.

Looking to the future

European capital markets show significant room for development and foster economic growth by supplying investment, financing and risk management services. It is vital that our markets enable access to non-traditional financing methods for young companies, encourage the use of technological innovation and avoid additional transaction of financing costs as a result of unintended regulatory consequences.

Furthermore, we must strive for a European capital market that is open to all participants, regardless of their location or national boundaries and continue to push for harmonisation and review potential barriers to cross-border transactions. If Europe's position in global capital markets is to improve, its capital markets must be able to compete effectively for global flows. In order to do so, aligning capital market regulation with global standards, particularly for derivatives, is paramount. Additionally, regular assessments of the impact of regulation should be conducted to ensure that strengthening Europe's position in global capital markets occurs in an up-to-date and supportive regulatory environment.

European capital markets need a level of transparency that facilitates price discovery and financial stability. With this in mind, it is crucial to establish pan-European information systems improving transparency. We also need to ensure that the mistakes through MiFiD I will not be repeated via loopholes in the MiFID II regulation, especially the systematic internaliser regime which might undermine market transparency and effectiveness and lead to an unlevel playing field to the detriment of investors and issuers.

The overall vision that FESE and its Members aspire to is that of a thriving capital market which is able to attract the inward investment needed for European competitiveness and growth. Greater market depth and further diversification of funding, trading, and risk management opportunities would benefit the real economy of Europe.

We encourage European policymakers to support Europe's capital market by adopting policies that make it more efficient, transparent and open. In doing so, we hope that policymakers will take the international dimension into account when producing regulation, promoting consistency with other parts of the world.

Note:

1 FESE/Oliver Wyman joint report 'Strengthening Europe's Position in Global Capital Markets'.

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