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Emerging Europe and the capital markets union

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Executive summary

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- **THE EUROPEAN UNION'S** capital markets union (CMU) plan is in urgent need of a revamp. Because of Brexit, EU capital markets and supervision need to become more integrated. The ongoing deep recession increases the need for equity finance mobilised by capital markets.

- **THE ELEVEN EU** countries in central and south-eastern Europe which joined the EU in 2004 and after (EU11) are particularly affected by the ongoing consolidation of exchanges, which has diminished liquidity in smaller markets and in the traded securities of mid-sized companies.

- **CORPORATE FUNDING REMAINS** even more bank-dependent in the EU11 than in the rest of the EU. Equity capital, whether in the form of listed shares or directly supplied by investment funds, is particularly underdeveloped. Even though the sustained and superior growth record in the region compared to the rest of the EU should be a magnet for investors, cross-border exposure to traded equity in the region remains very limited.

- **TO GAIN BROADER ACCEPTANCE** in all EU countries, CMU will need to support more forcefully funding for small and medium enterprises (SMEs), and foster market integration throughout the single market, including outside the euro area.

- **THE IMMEDIATE PRIORITIES** for the EU should be to revise market regulation and facilitate capital market access by smaller firms. Lighter standards in dedicated SME markets should be widened for newly-listed companies, but should not be available to more mature listed companies. In this way, high standards of transparency and integrity, which have been bolstered by post-financial crisis regulation, will be preserved.

- **THE EU11 COUNTRIES** need to embrace corporate governance rules and greater transparency of company financial data, which would facilitate equity finance. They must also attract investors who will seek disclosure of environmental, social and governance performance of issuers. Much could be done to foster liquidity on national exchanges, including by embracing the inevitable further consolidation of exchanges and other infrastructure.

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1 Introduction

The European Union's 2015 plan for a capital markets union (CMU) had two main goals: to improve access for companies to non-bank finance, thereby diversifying sources of corporate funding and making them more resilient in crises; and to make markets more efficient and more integrated across the EU. By the spring of 2019, ten legislative proposals from this original programme had been agreed or adopted, even though actual outcomes in terms of financing patterns and market fragmentation were little changed. Despite this progress, a somewhat technical agenda had failed to capture the public imagination.

A new phase of the capital markets union is about to start; Europe's Green Deal will require greater mobilisation of long-term and sustainable finance, sources of which within the EU are still scarce

A new phase of the CMU is about to start, and might well resonate more strongly within EU countries. Regulation of the London capital markets will soon diverge from that of the EU. This will likely underline the United Kingdom's deep integration with the EU in all areas of non-bank finance, including the fintech sector. Moreover, Europe's Green Deal will require greater mobilisation of long-term and sustainable finance, sources of which within the EU are still scarce. Also, in the wake of the 2020 recession there will be a much greater need to replenish corporate equity, addressing the imminent solvency crisis of companies in several EU countries. As financial instruments benefiting companies have been heavily cut back in the EU budget covering the period up to 2027, such finance will need to rely on private sources to a greater extent than previously anticipated.

In the 11 EU members of central and south-eastern Europe (EU11), which joined the EU in 2004 and after, financial systems have been built from scratch over the past thirty years. Banking networks are well-established but when adjusted for GDP, the size of capital markets in these countries is still only about one third of the pre-Brexit EU average.

To date these countries have remained on the side lines of the debate about further development and integration of EU capital markets, though their interests should be reflected. Their corporate sectors are predominantly composed of SMEs, leading to different priorities for non-bank finance. Also, their stock markets have continued their structural declines, listing fewer and only the largest companies. In future, cross-border investment flows and market liquidity will need to take on a greater priority relative to the objective of preserving local market infrastructures.

Governments in the region are in principle committed to further capital market development. Bulgaria, Hungary, Poland and Lithuania, among others, have agreed specific plans with market participants to this end. Capital market funding, including venture capital and equity finance for SMEs, is seen as a source of risk-oriented, long-term capital that is crucial to productivity growth. A number of countries in the region seek to develop 'green' financial instruments, and the governments of Poland and Hungary have issued sizable green bonds on international debt markets.

From the standpoint of the rest of the EU, the EU11 countries are an important destination for banking assets and foreign direct investment (FDI). Diversifying financial markets within these countries will bolster financial stability and help the corporate sector rely less on bank finance. Moreover, six of the 11 countries remain outside the euro area and do not benefit from the mechanisms for risk sharing and common standards in bank supervision developed within the banking union.

This Policy Contribution takes stock of the development of capital markets in the EU11, and proposes priorities for local market development and EU-level regulatory reform. We also propose an approach that could shape the next phase of CMU and foster market development and EU integration that involves these countries more fully than so far.

2 An ambition for more diverse financial markets

Capital market development became a policy priority for the EU11 countries only recently. Until the 2008 financial crisis, the expansion in domestic financial assets in those countries was almost entirely down to the rapid expansion of banks, based on the deepening engagement of European cross-border banks. In the early years of economic transition a bank-based financial system served countries in the region well, as capacity in local banks was minimal, and as the largely unbanked population required a widely dispersed branch network offering simple retail banking services[1].

The immediate post-crisis period then saw a sudden reassessment of this financial openness. Rapid expansion of banking assets and the risky lending practices of foreign-owned bank subsidiaries had resulted in a number of system-wide risks. For example, foreign currency-denominated lending to households led to several restructurings of mortgage liabilities imposed by governments. Between 2008 and about 2016 a protracted deleveraging of foreign bank exposures set in, which was much sharper than in any other emerging market region. Local regulators became much more sceptical about the financial stability implications of foreign-owned banks. Countries including Hungary and Poland adopted explicit policies to raise domestic ownership in the sector, including by state-owned banks. Ring-fencing of liquidity, and restrictions on dividend repatriations complicated the free flow of capital within banking networks, and this was likely further motivated by the need to design local bank resolution schemes with only national fiscal resources as the ultimate backstop (Lehmann, 2019).

Meanwhile, the role of local markets in stabilising funding for companies became more apparent[2]. The COVID-19 crisis may now have further reinforced interest in local capital market development. Early survey evidence indicated that with the onset of the 2020 crisis, banks expected to further step up deleveraging, which would widen gaps between credit demand and supply (EIB, 2020). Yet, as euro-area and US monetary policy eased, emerging markets, including in central Europe, have experienced a surprising inflow of portfolio capital into government and private bond markets. Companies with an equity listing found it easier to access investors than those which did not, underlining that capital markets provide an additional and stabilising financing option (AFME, 2020).

2.1 Funding diversification and market integration

The EU's CMU plan was in part intended to address the financial-sector vulnerabilities exposed by the 2010 crisis. However, the EU11 countries seem to have made barely any progress towards the dual goals of diversification of funding and integration of markets.

The external funding of companies remains overwhelmingly dependent on bank loans. Debt securities amount to only 2.4 percent of overall company balance sheets in the EU11, while loans and trade credit amount to over 70 percent (2017 data, Eurostat). In Poland, the region's most developed equity market, corporate equity issuance amounted to no more than 0.3 percent of GDP on average over the seven years to 2016, a period during which the ratio of private credit to GDP rose by ten percentage points. Surveys of enterprise funding preferences suggest that these very limited liability positions are matched by scant appetite for non-bank finance, in particular external equity which would realign ownership rights.

An International Monetary Fund index of access to market finance provides a broad

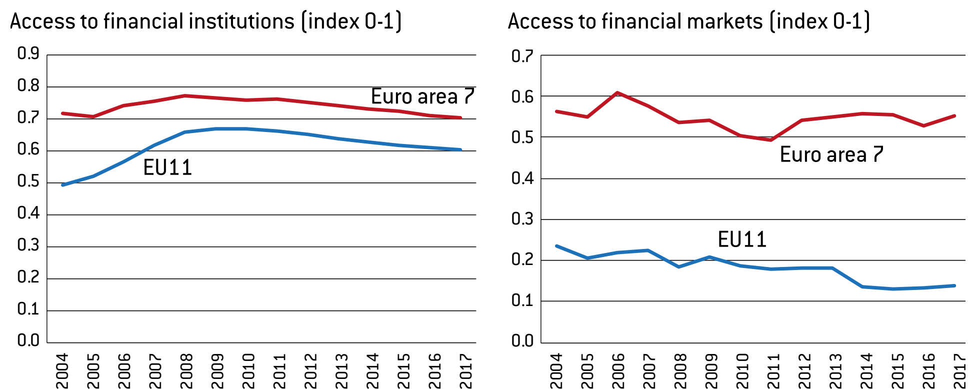
1 A number of studies have underlined the benefits to the region of integration with foreign banking networks for both financial stability, and overall growth; see EBRD (2009).

2 See European Commission (2017), which confirms the that corporate bond issuance substituted for the decline in bank lending following the 2010 financial crisis.

measure of the capitalisation of mid-sized firms (other than the largest listings) and shows that for the region as a whole, capital markets have in fact become *less* relevant (Svirydzenka, 2016). This development is in stark contrast to the financial deepening brought about by the greater use of banking services, on which the EU11 have nearly converged to western European levels (Figure 1).

This continued market underdevelopment, coupled with the dependence on bank finance, results in higher financing costs. It also exposes younger and more innovative firms to restricted and uncertain funding because such firms are, because of the lack of collateral, more constrained in accessing bank funding.

Figure 1: Access to financial institution and market funding, EU11 and seven other euro-area countries



Source: IMF. Note: Financial access is measured as an index between 0 (lowest development) and 1 (highest) of private sector credit and other assets; the index for financial institutions reflects availability of banking services; financial market access reflects smaller companies' capitalisation and number of issuers. Unweighted averages within each country grouping. The euro-area group includes Germany, France, Spain, Italy, Belgium, Austria and the Netherlands.

Progress towards the CMU goal of financial integration has also been limited. The cross-border liability positions of banking groups, and the provision of services through local subsidiaries, remain substantial. Following a sustained period of deleveraging between 2009 and 2016 external liabilities to non-resident banks stabilized, and remained at roughly $350 billion for the entire region at end-2019.

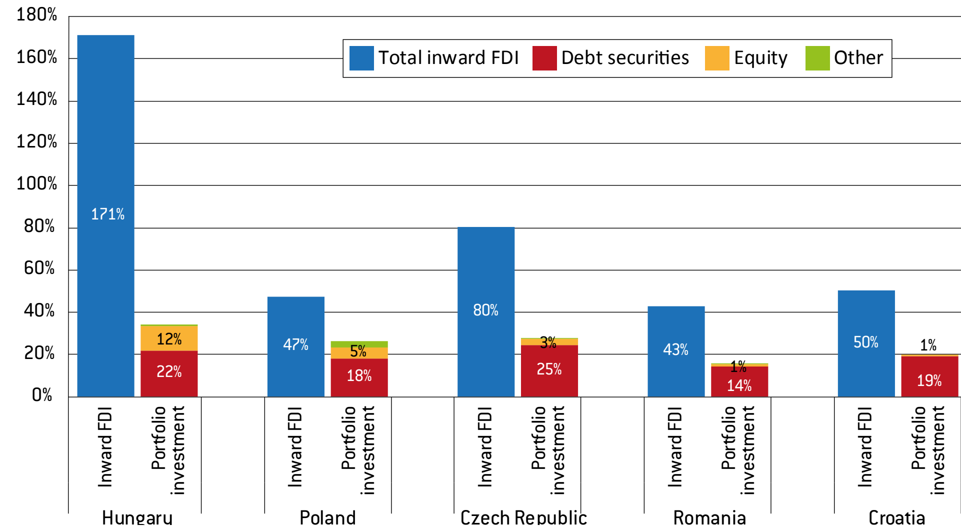
Cross-border exposures are substantial in terms of FDI, but non-resident investors have relatively limited positions in local debt and equity markets (Figure 2). Foreign investors have steadily built up positions on local bond markets (where foreign investors' share of government bond markets is substantial) (Figure 3). In tradeable equity, this integration has been much more limited, and the share of the advanced EU countries in inward investment is much lower than it is in bond markets[3]. This is surprising given that the sustained high growth rates in the region up to early 2020 should have attracted much greater flows into the listed shares of EU11 countries.

Integration through capital markets could be particularly attractive for the EU11 countries because non-resident investors would offer a greater variety of investment products and supporting services, which are often not present in central and south-eastern Europe. Cross-border equity ownership would temper country-specific income shocks. This could be particularly important for the six EU11 countries in the euro area – which lack the independent shock absorption of their own currency – and for Croatia and Bulgaria, given their rigid exchange rate regimes.

3 Figures for net inflows into dedicated emerging market funds even show outflows of portfolio equity (EBCI, 2020). The IMF Coordinated Portfolio Investment survey suggests that advanced EU countries account for 72 percent of the liability position in portfolio debt, though only for 24 percent in equity.

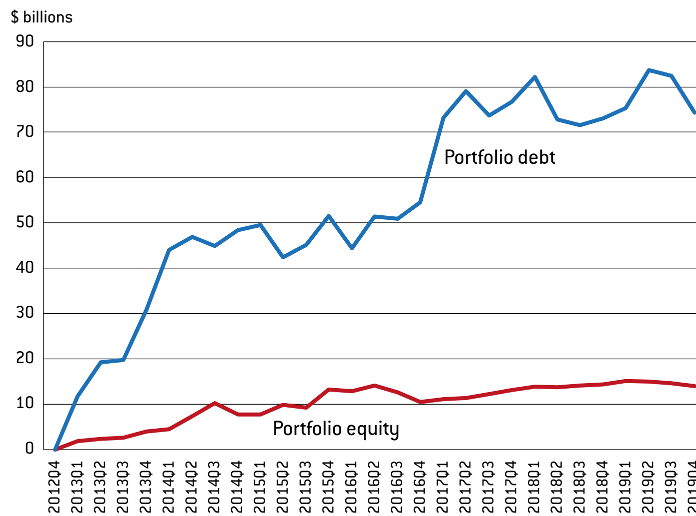
Many factors explain this continued fragmentation, including the lack of transparency of listed and unlisted firms, withholding taxes, corporate governance practices and insolvency procedures that discourage cross-border ownership (IMF, 2019). An already limited local investor base has been further diminished as private pension funds have been curtailed throughout the region.

Figure 2: Liability position with the rest of the world, 2019, % of GDP



Source: Eurostat.

Figure 3: Cumulative flows of portfolio investment into the EU11, $ billions, beginning 2013



Source: Bruegel based on IMF Balance of Payments Statistics.

3 Priorities for local capital market development

The next phase of CMU will coincide with the recovery from the current deep recession, which has already undermined company solvency, especially that of SMEs. The EU11 countries on the whole show modest corporate leverage ratios and lower corporate debt than in western Europe. Companies are therefore well positioned to withstand the deep but temporary demand contraction (Table 1). Poland, for instance, has previously not experienced a recession in almost thirty years and corporate working capital and liquidity positions have been bolstered by export-led earnings. Even after the end of the lockdowns of the first half of 2020, periodic restrictions on economic activity, travel and labour mobility, and on retail spending, may continue to diminish these buffers. Alongside other objectives, equity finance will therefore need to be a priority in capital market development, in particular for SMEs.

Table 1: Debt of EU non-financial corporations

	Debt/GDP (%)		Debt/equity (%)	
	2010	2018	2010	2018
EU11				
Bulgaria	117	83	96	60
Czechia	44	47	43	57
Estonia	95	73	63	43
Hungary	88	66	72	47
Poland	39	46	49	62
Romania	53	33	88	63
Slovakia	44	55	59	92
Other euro area				
Austria	93	92	102	86
Belgium	138	153	61	73
Finland	108	116	72	70
France	112	153	56	50
Germany	56	57	71	71
Greece	67	59	221	100
Italy	82	69	93	69
Netherlands	146	166	68	64
Portugal	127	101	93	71
Spain	140	96	89	47
Euro area	98	103	72	59
EU 27	96	100	70	58

Source: Eurostat.

3.1 Opening to private equity participations

Even though liquid equity markets are the ultimate aim, *private* equity investment may need to be developed to prepare companies to meet public listing requirements. In many emerging markets, the development of private equity has proven to be a catalytic intermediary stage in developing risk capital. This is because the efficiency and governance changes brought about by the involvement of private equity investors are essential for the few companies that

ultimately manage a listing on public equity markets.

Private equity is of course controversial because of the deep governance and operational changes it brings to investee companies. Established owners may be marginalised, and managers replaced or subjected to tougher performance criteria. There are also concerns about excessive leverage (ECB, 2020). At the same time, by the time the private equity investor exits, investee companies have generally established a successful track record, and have reformed governance and financial reporting in a way that will make these companies attractive for public markets. Evidence from the wider emerging Europe region shows that companies with such private investors perform significantly better in terms of employment and productivity growth (EBRD, 2015).

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That said, emerging Europe remains a backwater for private equity funds. Within this broadly defined region, private equity funds raised only €1.4 billion in 2019, or roughly 1.3 percent of the European total, and actual investment activity accounted for roughly three percent of the European total (which itself is relatively modest compared to European GDP). Investments represented barely a tenth of a percent of GDP in the region on average, which is a fifth of the same ratio in the leading EU markets such as France and the Netherlands[4].

Private equity investors typically operate from local offices within each market, performing extensive due diligence on potential investee firms. The scarcity of potential targets, and hence of investors, in central Europe is explained by poor corporate disclosure and corporate governance practices, and by the resistance of established owners to outside equity.

A local investor base can only emerge gradually, and only based on significant reforms of the pensions and insurance sectors. Problems related to corporate governance regimes (specifically investor protection), the transparency of company financial information and contract enforcement should be addressed. Furthermore, national development banks should tighten their equity programmes to ensure that their often generous investments are additional and do not displace private fund managers.

3.2 Promoting public equity listings on viable exchanges

Capital market reform in central and south-eastern Europe crucially requires defining a future for local stock exchanges. All countries in the region have a local exchange, though several are essentially dormant, registering barely any trades.

On the bond market, issuance and trading is significant for government bonds and, more recently, bonds of banks and municipalities, while corporate bond capitalisation as a share of GDP remains in the single digits in all countries (European Commission Expert Group on Corporate Bonds, 2017).

On local equity markets, issuance volumes and trading have generally declined, and have become more concentrated in the key exchanges of Warsaw, Prague and Budapest. While many exchanges listed initially a large number of firms, often stemming from the early waves of market-based privatisation, many firms have since de-listed, or are not traded. Only Poland, Hungary and the Czech Republic show meaningful share turnover ratios, though trading is concentrated in a small number of companies that constitute the main indices (Table 2). Low liquidity is a serious obstacle in attracting new issuers and institutional investors, as the inability to trade without sparking large price swings results in discounts for the primary issuer, and higher cost of equity funding.

With the exception of the Warsaw and Budapest exchanges, stock exchanges in the region have not become a meaningful source of equity capital for local companies. In total, €400 million in new equity was raised between 2017 and 2019 from 83 listings (though nearly half of that volume was down to one listing in Estonia). This is of course insignificant relative to total GDP in the region (almost €1,500 billion in 2019). Moreover, there is an ongoing trend of de-listings and share-buybacks. Warsaw, the largest exchange in the region, listed an

4 Figures from Invest Europe (2020).

additional 65 companies between 2017 and 2019, of which all but 16 were on the junior SME market. Over the same period, 131 companies withdrew their listings (Table 3). New business has been declining, with Polish pension fund reform significantly curtailing the institutional investor base. Foreign investors account for about 60 percent of trading on the main market, though only a minor share of trading on the SME-oriented New Connect market.

Table 2: Equity market capitalisation, liquidity and turnover in the EU11

	Market capitalisation (%GDP)		Market liquidity, value of shares traded (%GDP)		Turnover ratio, value of shares traded, % of market cap.		No. listed domestic companies	
	2010	**2019**	**2010**	**2019**	**2010**	**2019**	**2010**	**2019**
Poland	39.8	25.6	14.5	8.5	36.4	33.2	570	798
Hungary	21.1	20.4	20.2	5.4	95.5	26.4	48	44
Czech Republic	17.4	..	10.6	..	78.9	14.6	16	..
Slovak Republic	4.6	..	0.3	..	7.4	..	90	..
Bulgaria	14.6	..	0.7	0.3	5.1	1.1	390	262
Croatia	42.8	37.2	1.8	0.5	4.1	1.5	240	119
Romania	8.5	10.4	1	0.8	11.8	7.8	73	81
Slovenia	19.6	14.7	1	0.3	5.1	1.9	72	29

Source: World Bank, based on FESE.

Table 3: IPOs by volume and number of listings and de-listings, 2017-19

	Number of listings		IPO amounts raised (€m)		De-listings
	Total	Of which SME market	Total	Of which SME market	
Budapest	4	4	84	4.5	5
Warsaw	65	49	81	2.5	131
Prague	6	6	16,3	16.3	7
Nasdaq Tallin	3	0	191	0	1
Nasdaq Riga	2	1	3.3	3.3	8
Nasdaq Vilnius	3	1	25.7	3.6	2

Source: FESE.

The long-term success of an exchange seems crucially to be determined by its early growth (Albuquerque de Sousa *et al*, 2017). Without a minimum number of listings and turnover early on, exchanges fail to attract further capital and quickly become dormant. Banking sector development and availability of a national savings pool appear to be important determinants. The banking sector development factor will favour the EU11; the lack of household savings, and of institutional investors that manage such savings, less so. The poor record of stock exchanges in central Europe therefore is in line with these findings from emerging markets. Issuance and trading appears increasingly concentrated in a small number of larger exchanges and in larger companies (OECD, 2016).

Most stock exchanges in emerging markets have become part of an international group structure, or pool their trading. Central Europe has been no exception. All three exchanges in the Baltics are owned by the international operator Nasdaq, and the Prague exchange belongs to the same group as its peer in Vienna. The small exchanges in the western Balkans now cooperate on key aspects of their operations, facilitating more liquid and integrated

trading, including with the smaller markets in non-EU candidate and accession countries[5]. Bucking this trend, the two largest exchanges in the region, Budapest and Warsaw, remain independent and in government ownership.

Central European markets, and listed entities within these markets, are highly illiquid. This is a particular problem for SMEs, which by nature trade in small amounts, and whose owners might well be deterred from listing if illiquidity results in large discounts at the point of primary issuance. The trades that take place should be pooled in a single location, and be made available to as many investors as possible. The consolidation of stock exchanges is therefore sensible and could be complemented by the cross-border branching of exchanges, as proposed by the High Level Forum (2020).

3.3 Infrastructure that fosters market integration

In addition to increasing market liquidity, it is crucial to strengthen the market infrastructure in EU11 countries, making it more resilient to local risks, while overcoming fragmentation and reducing trading costs for international investors.

The systems that govern clearing, payment and settlement are key components of financial market infrastructure. In the EU11, this infrastructure is fragmented, with every exchange having a central securities depository attached, though these depositories are largely limited to their national markets and settlement in foreign currency is often difficult.

Another key infrastructure component is central counterparties (CCPs). CCPs replace bilateral exposures between sellers and buyers with concentrated exposures to a single intermediary entity. This ensures the performance of open contracts, and significantly reduces counterparty risk. Clearly, this requires a capital cushion within the CCP and procedures for handling the possible default of a trading member.

International consolidation is accelerating and most of the 16 CCPs licensed in the EU function as multinational entities, covering multiple markets across the region. For instance, exchange operator Nasdaq owns the three exchanges in the Baltic countries, and also services these with a single clearing house.

The two independent CCPs in the EU11 in Warsaw and Budapest are among the smallest in the EU[6]. A single regional CCP would economise on capital requirements and reduce risks by combining trading members from various jurisdictions. International investors would have a single entry point to markets in the region. This would require building better linkages between the individual national exchanges and the CCPs in in Budapest and Warsaw.

3.4 A framework for green capital markets

If EU11 capital markets are to become more open and vibrant, they must adapt to the much greater scrutiny of environmental, social and governance (ESG) issues by international institutional investors. The United Nations-sponsored Principles for Responsible Investment, for instance, now count all major asset managers as members, and many have established ESG-oriented investment vehicles. The fiduciary duty of fund trustees towards asset owners is now commonly understood to include a review of invested assets against ESG principles (UNEP FI, 2019).

While EU11 governments have been resistant to ambitious EU climate targets, financial regulators appear to be increasingly engaged in the EU's sustainable finance agenda. Lithuania and Hungary are in the process of developing sustainable finance frameworks,

5 SEE Link is a project started by Bulgaria, Croatia and Macedonia and subsequently expanded to include the Ljubljana and Belgrade stock exchanges and two exchanges in Bosnia-Herzegovina. Local markets are integrate their IT systems, though without cross-ownership between the exchanges. This will ultimately allow investors easier access to regional markets through brokers in their home country.

6 The CCP at the Budapest exchange cleared only about one tenth of the equity transactions registered in Warsaw (EBRD and Oliver Wyman, 2015), though it also clears electricity contracts across Europe, and appears to be more open to international trades. Two thirds of its clients were from outside Hungary, and it has recently established a partnership with the CCP in Kazakhstan.

expecting to attract issuance also from other countries in the region. Poland and Hungary have been among the few governments to have issued sovereign green bonds, on the basis of new frameworks for monitoring and verifying the use of proceeds.

The EU sustainable finance strategy of 2018 had led to greater transparency. The disclosure regulation (EU 209/2088), relating to sustainability issues, will from 2021 apply to investment funds and financial advisers. But the main obstacle to attracting ESG-oriented investors to the EU11 region will lie in generating suitable projects and financing opportunities. Better disclosure by issuers is an important precondition. The EU non-financial reporting directive (2014/95/EU) will require the largest companies to apply the recommendations of the G20 Task Force on Climate Related Financial Disclosures. EU guidelines already call for such companies to disclose their carbon footprints (including those of their clients), and to set targets for reduction of greenhouse gas emissions (European Commission, 2019). Capital market instruments that appeal to specialist investors, such as green bonds, will also need to target activities listed in the new EU taxonomy, which will become binding from 2021 (EU Technical Expert Group on Sustainable Finance, 2020). The EU green bond framework is at time of writing still under discussion but is likely to set higher standards for verification of the use of funds raised, and will seek to contain risks of greenwashing.

Even in the main EU markets, green bonds amount to only a small share of climate-related investment. As with other funding of investment, the bulk of financing is generated by banks. Once activities of bank borrowers are transparent, and loans are aligned with activities prescribed under the EU taxonomy, banks may be able to issue asset-backed securities, which would considerably expand banks' refinancing options while generating assets that are more liquid than the bonds of individual issuers.

The exchanges in Paris, Dublin and Luxembourg have attracted issuers and investors in green assets from across Europe. There is clearly a role for the exchanges in the central Europe region to cater to local investors and issuers. The exchange operators will need to promote standards for green products, services and benchmarks, and educate market participants.

4 Central Europe's stake in the future CMU

The second phase of the CMU plan is underway[7]. To address the pressures on short-term funding in the ongoing recession, the European Commission in July 2020 proposed amendments to rules on listing prospectuses, to the Markets in Financial Instruments Directive (MiFID II, 2014/65/EU) and to securitisation rules, seeking to ease capital market access.

For the EU11, adapting future capital market legislation to the requirements of smaller companies and their more illiquid investor bases is particularly relevant. The high fixed costs of listing, disclosure and complying with market conduct rules are particularly burdensome for smaller companies and justify simplified requirements. Compared to western Europe, the firm-size distribution in the EU11 is skewed towards smaller firms, with few potential candidates among mid-sized firms, of up to 500 employees.

Capital markets legislation in the immediate aftermath of the financial crisis had the overriding ambition of bolstering transparency and market integrity. As yet, the resulting extensive EU regulation of exchanges does not accommodate well the financing needs of SMEs.

There have been some attempts to address these obstacles. More recent regulations and directives, and amendments to earlier provisions, have sought to foster market access

7 ECMI (2019) and High Level Forum (2020), which made 17 proposals emphasising retail investment, and tackling some of the barriers outside the narrow field of capital market regulation, such as insolvency reform and taxation.

and market liquidity. MiFID II has already created the so-called SME growth markets as a category of exchanges distinct from the higher-standard regulated markets, aiming to address the palpable market failures in the access of SMEs to capital markets (Thomadakis, 2017). The idea of easing regulation on a segment of an exchange for smaller companies as an alternative, or a precursor, to the main exchange listing is common in young capital markets.

By mid-2020, 20 exchanges in the EU and the UK had been given this status, listing about 1,700 companies (a further 14 exchanges also primarily target SMEs). London's junior market AIM alone lists 40 percent of the total number of firms, and attracted numerous SME listings from across Europe. SME equity could therefore become quite shallow within the EU (SME bonds are in any case negligible, accounting for no more than single digit percentages of total corporate funding).

Within the EU11, Warsaw's New Connect is the largest such market, and companies in the Baltics access the integrated market based in Sweden. The Budapest Stock Exchange, through its SME market, also supports capacity building in young companies ahead of a listing. The state covers listing costs and provides liquidity for trading in these shares.

Subsequent EU legislation has built on the concept of SME exchanges and further reduced barriers for SMEs accessing capital markets. One such measure concerned the disclosure by listed SMEs of corporate officers with insider information under the market abuse regulation (EU 596/2014); another was the simplified requirements for the publication by smaller companies of listing prospectuses (Prospectus Regulation, 2017/1129).

For potential issuers, a dedicated SME market offers a listing process and access to bond and equity finance at reduced costs and with reduced compliance requirements. Emerging markets have had mixed success with SME-focused exchanges. Only a small number of listings were done on the Asian SME exchanges. This may be because institutional investors seek primarily large and liquid listings. In the absence of an investor base, neither the junior nor the main segment of the market seems to prosper (Abraham and Schmukler, 2017). The record in the EU11 is sobering. After three years, the Zagreb trading platform for SMEs, which also covers Slovenia, and the junior market in Budapest only list a handful of SMEs each.

The record in the EU11 in SMEs is sobering. The Zagreb trading platform for SMEs, which also covers Slovenia, and the junior market in Budapest only list a handful of SMEs each

A key question now is whether SME 'growth markets' should be further expanded. In an attempt to create liquidity, MiFID II allowed admission of regular larger companies into SME markets that benefit from streamlined requirements. But frequent corporate governance problems crop up with listed SMEs, which risk undermining investor confidence in the larger companies listed on regular exchanges. Liquidity should be fostered by the cross-border integration of markets (ECMI, 2019).

Addressing illiquidity also entails addressing SMEs' resistance to new owners. To that end, exchanges could allow the issuance of dual-class shares, which would protect established owners (see High Level Forum, 2020). However, these instruments do not offer the benefits provided by the ownership and stewardship of new investors.

Finally, SME securities should be exempt from the requirement that fees for the execution of trades and the provision of research must be unbundled. Until MiFID II came into effect in 2018, brokers applied a single charge to asset managers for both the execution of trades and the provision of research. A concern with such 'soft commissions' was that opaque pricing for research would become an inducement for brokerage services. The unbundling of research from brokerage services under MiFID II was meant to address such market failures. However, the ambition for market efficiency seems to have come at the cost of access to non-bank finance. There is clear evidence that access to capital market funding and liquidity in equities is closely related to research coverage, and that the scarcity of such research, which is typically provided by local brokers, can be a barrier to SME listings. Yet the unbundling seems to have led to a sharp decline in the research coverage of smaller and less frequently traded companies. Exempting SME securities from the unbundling requirement would foster access to equity finance, albeit at the cost of reintroducing some market distortions.

4.1 Bank equity holdings

More complex EU regulation has clearly held back primary issuance and reduced liquidity in the EU11 capital markets. Many other obstacles are home-made. The absence of large domestic institutional investors, such as insurers and pension funds, remains a key constraint. For some time now, central European countries have curtailed the private pension funds which were set up in the 1990s, in particular with the full nationalisation of pension assets in Hungary in 2010, and limitations on the investment activities of Polish pension funds from 2015.

This aggravates an already low level of household financial assets, estimated at roughly 100 percent of GDP in the EU11, compared to over twice that ratio in the rest of the EU (AFME, 2016). Private pension assets cannot be generated in the short term, and pension policy should not become an instrument of capital market development. Nevertheless, there are sensible suggestions about how supplementary occupational pensions could be offered in all member states (eg High Level Forum, 2020). EU countries that are furthest advanced in establishing funded pension schemes, such as Sweden and the Netherlands, also have some of the most liquid local capital markets.

In the absence of other large investors, banks play a significant role in supporting liquidity in local equity markets. They do this by making buy and sell offers ('making a market') in equities, which would otherwise be highly illiquid. But also they often become holders of the equity of their clients, for instance after a debt restructuring.

Equity holdings should not be a core part of banks' business models, and for this reason justify stringent capital adequacy requirements. Under the Basel III framework, risk weights based on bank-internal models are to be abolished, and replaced by a standard risk weight that could be up to 400 percent for short-term holdings. This would make bank equity investments uneconomical and discourage the participation of banks in private equity and state-led equity funds. As the Basel III text offers considerable leeway in how equity holdings are treated, the European Commission may still have scope to introduce a less-stringent interpretation.

5 Priorities at national and EU level

The ongoing structural changes in international capital markets have favoured larger companies, which are suitable for index-based passive investing, and investment on larger and more liquid exchanges. Illiquidity in markets, and the lack of a private sector market 'ecosystem', might now be aggravated as the UK leaves the EU single market. Past trends have disadvantaged smaller EU capital markets, including in the EU11 region, and have reinforced the ongoing de-listing of enterprises. EU11 markets are also poorly prepared for the growing investor appetite for ESG-based and green investment which will require strong disclosure, alignment with the EU environmental taxonomy and high corporate governance standards.

Governments in central and south-eastern Europe have long called for more risk capital to support young and innovative companies. Yet, the dominance of bank funding is undiminished. Corporate insolvency looms in the wake of the COVID-19-induced crisis and equity capital, whether in listed shares or provided directly by investment funds, is needed more than ever.

This context calls for governments and regulators in central Europe to engage proactively in shaping the next phase of CMU. They should seek revisions in capital market legislation to better account for the needs of SMEs (especially in the MiFID II review, which is ongoing at time of writing).

Specific regulatory provisions aimed at SMEs, such as the SME growth markets under MiFID II, may need to be expanded, without compromising the transparency and integrity

of the regular markets. Investors are clear that smaller and younger companies bring with them greater financial and corporate governance risks. In the 'light-touch' SME markets they should only find such enterprises, not more mature companies that have been mixed in to support liquidity. In this way regulation would offer a stepping stone towards fully-fledged capital market listing. Entry into SME markets and transition into the more mature markets may need to be supported. Financial support from public sources, whether from national public banks, or through the SME IPO fund that was proposed by the EU Commission, should be focused only on market failures.

There is also a critical domestic agenda which includes revising corporate governance practices to encourage more outside investment and preparing enterprises for life as public companies (for instance through the numerous equity support programmes offered by national development banks). Many countries have rightly embraced consolidation of exchanges and other infrastructure and thereby eased access to institutional investors. The two largest exchanges in the EU11 remain independent and should seek alliances that similarly foster market access and liquidity.

The rest of the EU would be well advised to foster capital market integration with central and south-eastern Europe, so that its investors can participate in sustained high growth in the region, and offer a plan that promotes risk sharing beyond the common currency area.

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