

Report of the 2018 **ECMI** Annual Conference

**Sustaining Growth
through Innovation in Capital Markets**

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Sustaining Growth through Innovation in Capital Markets

Final Report of the 2018 ECMI Annual Conference

Well-functioning, deeper and highly integrated European capital markets are expected to play a greater role in providing alternative corporate funding, better savings/investment opportunities and enhancing private risk-sharing mechanisms. This year's Annual Conference contributed to the public debate about the capacity of capital markets to enable long-term value creation in the real economy, namely supporting innovative companies and sustainable economic growth.

As the end of the five years of the Juncker mandate approaches, European capital markets are at a very important intersection. The Capital Markets Union (CMU) project should aim beyond the actions set for end-2019, towards a revamped strategy for EU-27. However, before setting priorities for the future, it was necessary to take a critical look backwards on what has been promised and what has been achieved. Despite the huge demand for capital, innovative companies and small enterprises are tending to prefer staying private longer or not going public at all. Although the Commission is committed to unlocking the full potential of sustainable finance, current ESG investment represents a very niche part of the total fund market. Last but not least, capital markets across Europe, and particular in the CEE region, remain significantly less developed, both in terms of size and liquidity.

For ECMI, pursuing a path traced 25 years ago, this means an even more active and vital role in steering the discussion and engaging in strategic thinking about Europe's capital markets.



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Disclaimer. This report includes the main conclusions from the 2018 ECMI Annual Conference. Its content should be attributed solely to the rapporteurs. The speakers participated in their personal capacity and their statements do not necessarily reflect the official position of the organisation with which they are affiliated. A detailed overview of the proceedings is available [here](#).

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Opening speech

John Berrigan

Deputy Director-General, DG FISMA, European Commission

In essence, CMU has a relatively straightforward objective. This is to boost economic growth and job creation across the EU. Moreover, integrated capital markets can also widen the opportunities for much needed private risk-sharing mechanisms. Many barriers to cross-border investment remain, fragmenting markets and impeding competition. Building CMU is also crucial to prepare the EU economy for a new era of innovation. Indeed, market-based funding is best-suited for high-risk/high-return projects, whose innovative nature can boost economic growth via enhanced productivity. In this context, it is worth noting that the US venture capital industry is 5 times larger than in the EU.

The Commission's Action Plan on Financing Sustainable Growth is a fundamental step towards mobilising the investments needed to finance the transition to a low-carbon and circular economy. The introduction of a taxonomy will provide a

basis for low-carbon benchmarks and defining investors' duties to integrate sustainability factors in decision-making and risk management.

The focus of CMU is not only market integration but also market development. Many Member States in Central and Eastern Europe do not have a level of domestic financial development sufficient to enable meaningful benefits from further integration. CMU must also cater for the needs of these Member States, helping them to walk before they run.

CMU has been a key priority of this Commission since the outset. It is likely to remain a priority in the future. The Council and Parliament and the private sector should play their part too. PEPP could provide a tangible improvement for the European citizens. But further actions relating to insolvency laws, taxation and supervision, must be at least on the table and not considered somehow taboo.



Financing innovation through capital markets

Europe's innovative firms are still facing tremendous bottlenecks in financing their growth. Traditional bank channels are not sufficiently accessible or simply not suitable for this type of companies. Alternative funding sources (IPOs, direct listings, private equity, venture capital and

crowdfunding) are unevenly available across Europe. Companies have very different experiences in raising capital on public or private markets, sometimes taking advantage of better opportunities on other continents. How can these markets be made more efficient?



Alexander Ljungqvist
Stockholm School of Economics



Gareth McCartney
UBS



Wilfrid Xoual
Moody's Investors Service



Stefano Corvo
GPI Group



Florencio Lopez de Silanes
SKEMA Business School

Despite the huge demand for equity and debt financing by small enterprises and innovative companies, they do not usually scale up, and those that do fail to reach the market.

Alexander Ljungqvist ([presentation](#)) indicated that most companies never get near the stock market, and only less than 1% go public. The decision comes down to comparing costs and benefits. With costs increasing (regulatory burdens, onerous requirements, short-termism) and benefits reducing (less trading liquidity for small-caps, increased competition from other sources of capital and trading venues),

companies are either staying private longer or not going public at all.

From an investors' perspective, **Gareth McCartney** ([presentation](#)) emphasised the transition of equity fund flows from actively towards more passively managed strategies (e.g. ETFs, index tracking). Moreover, regional concerns due to political instability in recent years, combined with a very strong domestic performance in the US, resulted in international investors disengaging with Europe. In terms of debt funding, **Wilfrid Xoual** ([presentation](#)) highlighted the large discrepancy between national markets in

Europe, due to strong competition from banks and local specificities. Alternative funding channels (e.g. private placement, mini-bonds, securitisation, crowdfunding etc.) are still in their infancy. Information asymmetry further limits the funding capabilities of alternative investors.

Representing an innovative company, **Stefano Corvo** ([presentation](#)) raised three important issues of going public. First, getting from a family- to a publicly-owned company involves acknowledging the fact

that rules will change, decision making processes will be different as well as transparency and information sharing. Second, it is very important to work with experienced consultants with specific knowledge in capital markets, i.e. how to interpret rules and access finance through them. Third, a Virtual Data Room, in which certain situations and procedures can be prepared, tested and examined, is a very powerful tool for spending much less time and money.



Building the framework for sustainable investment

Sustainable finance has a great potential to bring investors into sync with the long-term needs of the real economy. It can also provide powerful incentives for corporates to transform their operations and processes more swiftly and effectively. The incorporation of material Environmental, Social and

Governance (ESG) factors across their supply and investment chains would in turn enable compelling value propositions. Financial regulation should work alongside sectoral policies. How can sustainable finance be mainstreamed?



**Ana Maria
Martinez-Pina**
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Jan G. Loey
J.P. Morgan



Vicky Sins
ABN AMRO
Clearing



Erick Decker
AXA Group



Paulo Garcia
Unilever
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Sustainability was given a fresh political impetus with the Paris Agreement on climate change, the UN2030 agenda, and the Commission's Action Plan on financing sustainable growth. **Ana Maria Martinez-Pina** stressed the importance of taxonomy, benchmarks and transparency. The taxonomy will clarify what activities, products, projects can be considered sustainable, but it should not be ignored that is a complex and technical matter. ESG activities will have to comply with at least one out of six environmental objectives: 1) climate change mitigation; 2) climate change adaptation; 3) sustainable use and protection of water and marine resources; 4) transition to a circular economy, waste prevention and recycling; 5) pollution prevention and control; 6) protection of healthy ecosystems. Benchmarks will provide investors with the necessary information on

the carbon footprints for potential investments. Transparency will ensure that environmental and social considerations are actually taken into account in investment decision-making. **Jan Loey** ([presentation](#)) highlighted that even though sustainable finance is coming into the mainstream, it still represents less than 2% of the total fund market. Nevertheless, Europe is at the forefront of ESG investing and regulation, with US, Asia and other emerging markets lagging behind. Thus, Europe has a golden opportunity to either become a unique centre for sustainable capital markets or just add another brick to the wall of bureaucracy.

The financial sector, as **Vicky Sins** described, has a key role to play not only in providing safe and transparent markets by incorporating ESG metrics into risk parameters but also by helping to deliver the UN Sustainable

Development Goals (SDGs). Initiatives such as sustainable stock exchanges that require ESG disclosure requirements for listings need to be encouraged. Looking at the integration of ESG measures in security selection, **Erick Decker** expressed his concerns over how scores, targets and benchmarks will be used and compared internally, externally, or industry-wide. The main objective should be to finance the real economy and not to beat scores. In addition, further work is needed in order to

make ESG measures practical, with clear objectives, rather than simply reporting requirements. To this end, moving from short to long investment horizons is essential according to **Paulo Garcia** ([presentation](#)). While risk, uncertainty and volatility encourage short-termism for both industry and investors, long-term approaches can result in value-creation and enhance corporate returns.



Developing capital markets across in Europe

In Europe, capital markets have reached varying stages of development. In the CEE region, they are relatively small and lack sufficient liquidity and depth. Companies and households continue to rely heavily on the banking sector. A recent [report](#) finds that around €250bn in private capital could be

unlocked if necessary reforms were pursued. Most governments and market participants have already issued national strategies, and also intensified regional cooperation efforts. Moreover, the CMU project has received strong political support. But is it delivering on its promises?



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The capital markets ecosystem (issuers, investors, trading venues, and professionals) needs to develop further in the CEE region. According to **Daiga Auzina-Melalksne**, most SMEs are struggling to attract both retail and institutional investors, as their primary focus is on large-caps and blue-chips. Size really matters as costs can mount quickly. For example, a small company valued at €30m in market capitalisation seeking to raise €3m will incur costs and fees of around €300,000 (10%).

Ian Firla focused on financial literacy and stressed out that current educational barriers inhibit the development of capital markets across Europe. Failure in bringing down these barriers will cause major knowledge and material losses to the CEE region. Regulatory

changes are necessary. However, it remains uncertain if these will bring consolidation in the industry, or result in the risk concentration.

For **Zoltán Bakay** ([presentation](#)), capital markets development is about increasing prosperity. Diversification of capital sources is necessary in order to achieve convergence and economic growth. However, the CEE is currently dominated by foreign financial service providers that do not necessarily support local economies, in particular SMEs. Retail investors can certainly be part of the solution. Even though the savings rate in Europe is twice as high as in the US, the financial assets of US households far outperform their European equivalent; CEE is not an exception to this norm. The picture is

no different when looking at institutional investors, as highlighted by **Dimitris Zafeiris**. The regional assets of the insurance sector in CEE only account for 8% of GDP (compared to 70% of GDP in the euro area) and represent less than 1% of total EEA assets. Investment is heavily concentrated in fixed income securities, and particularly sovereign bonds. Even worse is the performance of the pension sector, with the assets held representing a mere 0.3% of total EEA assets.

For **Hannes Takacs** ([presentation](#)), exchanges have the potential to be converted into company financing hubs, covering the full financing needs of companies across their lifecycle (funding escalator). However, such developments should acknowledge that each market segment must be tailored for specific types of companies and investors. To this end, pre-listing support programmes – like the one recently launched in Slovenia – can help companies better understand what it takes to be listed and what are the requirements thereafter.



ECMI Best Paper Awards



“How do sovereign credit ratings help to financially develop low-developed countries”

Authors: **Rosanne Vanpee**, KU Leuven and **Prabesh Luitel**, KU Leuven

“Unconventional Monetary Policy and Credit Rating Dynamics”

Authors: **Nordine Abidi**, **Matteo Falagiarda**, **Ixart Miquel-Flores** (from ECB)

“International capital flows at the security level - evidence from the ECB’s asset purchase programme”

Authors: **Katharina Bergant**, **Michael Fidora**, **Martin Schmitz**

Academic Committee (Chair and Vice-Chair)

Andrei Kirilenko, Imperial College London and **Florencio López de Silanes**, SKEMA Business School

International capital flows at the security level - evidence from the ECB's asset purchase programme

What is the impact of ECB's APP on international capital flows and in particular on euro area investors' portfolio rebalancing? Using security-by-security data over the first two years of the PSPP period (2015Q1-2016Q4), the authors investigate euro area portfolio rebalancing at both country and sector level, incorporating domestic, euro area and global capital flows of euro area investors.

The findings can be summarised as follows: i) euro area investors rebalanced their portfolios from domestic and other euro area debt securities towards foreign debt; ii) euro area investors were net buyers of securities with longer maturities; iii) euro area investors in search of higher yields moved away from euro-denominated debt securities to euro-denominated equity (investment fund shares).

How do sovereign credit ratings help to financially develop low-developed countries?

Having a sovereign credit rating is essential for a country aiming to issue publicly-traded debt instruments. However, what is not so clear is the impact that sovereign credit ratings can have on the financial markets of low income countries. In an attempt to provide an answer, the authors investigate and compare the financial development of 32 rated and unrated developing countries. Results show that when

a less developed country receives its initial rating: i) banks change their assets portfolio and lending to the private sector increases; ii) foreign inward investments are fostered, both in terms of FDI and portfolio investments; iii) the issuance of foreign currency bonds is higher than in unrated countries; iv) less short-term debt and more long-term debt than a developed country is issued.

Unconventional Monetary Policy and Credit Rating Dynamics

Does the explicit reliance on credit rating agencies (CRAs) for monetary policy reduce incentives to assess credit risk carefully? Using a large dataset of around 1,500 bonds per month over a period of three years across 16-euro area countries, the authors examine the effect of the ECB's asset purchase programme (APP) on CRAs behaviour. Their analysis shows that after the launch of APP, CRAs gradually

inflated their final ratings thereby increasing the set of eligible bonds by around 3%. This is most noticeable for corporate bonds that were initially located below, but close to, the eligibility frontier. However, results suggest that these rating distortions are unlikely to have had adverse macroeconomic implications.

Closing speech

Antonio J. Zoido

BME Group



Even though one of the main priorities set out by the European Commission was to increase companies' access to regulated exchanges, the reality indicates that the CMU Action Plan failed to properly address this issue. The number of listed companies on both European and US exchanges has been declining over the last 10 years. Moreover, while the numbers

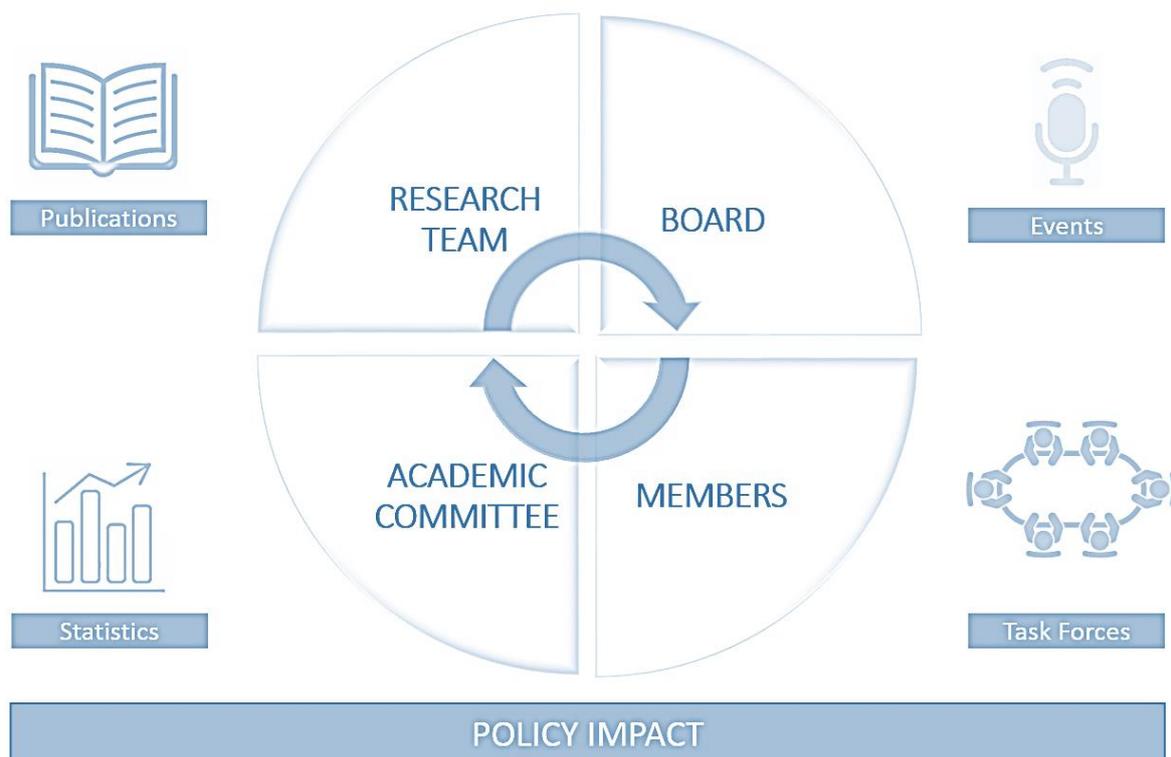
have gone down, average market capitalisation has risen, suggesting that a listing is more beneficial for bigger companies than for smaller companies. While many areas have been recognised as reasons for this phenomenon, no proper action has been taken. Excessive regulatory burdens, equal treatment of tangible and intangible assets, tax bias favouring debt over equity, wrong liquidity culture, and inadequate investment instruments structure, are only a few of the issues that should have been clarified and tackled in the first place, well before the deployment of CMU. In the wake of a new Commission mandate, it remains to be seen whether these issues will be prioritised. Otherwise, the CMU project risks being derailed. The presentation is available [here](#).



About the European Capital Markets Institute

Mission statement. ECMI conducts in-depth research aimed at informing the public debate and policy-making process on issues relevant to capital markets. Through its various activities, ECMI facilitates the interaction

among policymakers, market participants, and academics. ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels.



Core activities. The exchanges among various stakeholders are fuelled by the work done by its researchers, such as commentaries, policy briefs, research reports, working papers, statistics. In addition, ECMI organises seminars, workshops, conferences, task forces that offer multiple networking opportunities. ECMI also undertakes studies commissioned by the EU institutions and other organisations, and publishes contributions from high-profile external researchers.

Membership and governance. The membership is open to private companies/associations, regulatory authorities and academic institutions. The board members provide the strategic direction, supervise the management team and the financial soundness of the research institute. The research staff works on the basis of an independent policy and market oriented programme and are assisted by the members of the academic committee.

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