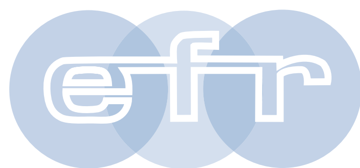

European Financial Services
Round Table

February 2025

EFR paper on Strengthening European competitiveness and growth through equity

The EFR welcomes the call by European leaders, as expressed in the Budapest Declaration of 8 November 2024, to improve the European capital market as part of the European competitiveness and growth agenda. The Eurogroup, Enrico Letta and Mario Draghi all point to public and private money invested side by side to increase European competitiveness.

Executive summary

Key recommendations that the EFR identifies to support the Mario Draghi report's call for more long-term equity finance to support European growth:

- **Real and lasting improvements in the European capital market can only be achieved by considering the European economic ecosystem as a whole as well as tangible steps to strengthen the market.** This includes looking at ways to increase levels of equity finance from both retail and large institutional investors, in both listed and unlisted segments of the market. To this end, European policy makers should address **both the primary and secondary securities markets in Europe with the aim of identifying key initiatives to further attract sustained investment**.
- **The EFR encourages the European Commission and ESMA to act as catalysts for the capital market by sharing successful Member States' practices, encouraging more cooperation between Supervisory Authorities and addressing the root causes as to why the European capital market is smaller and less liquid than the US market.** The approach should be holistic, looking at regulatory tools as well as other policy measures such as tax.
- **European companies should be incentivised to seek a higher proportion of their funding from equity markets.** The EFR welcomes ESMA's recommendations[1] (Building more effective and attractive capital markets in the EU) on improving company funding structure, equity finance and the European securities market and would encourage the European Commission to follow this up.
- **The EFR would encourage policy makers to take steps to broaden the investor base to promote more equity finance in Europe.** The EFR supports the initiatives to improve retail and sophisticated investor participation to ensure that the large reserves of current private savings are mobilised towards the European economy (cf. EFR Paper on "European Savings - Proposed Actions Concerning Long-Term Investments" of July 2024), while maintaining that there is a need to broaden the approach beyond cost considerations that structure the Retail Investment Strategy approach. Simultaneously, stronger participation by institutional investors is necessary and large long-term investors, including insurance companies and pension funds, should be allowed the scope to utilise more equity finance, e.g. in infrastructure.
- **Institutional investors are a key part of the investor base and must be central to the approach to promote more equity finance.** They drive the largest investments, and they trigger the involvement of smaller investors. They can be key drivers of a true and lasting change to the European economy and capital market, encouraging more equity funding in European companies. Asset managers, insurance companies and pension funds based in Europe should be considered key players and enablers facilitating the economic transition.
- **The green transition will require increased equity financing.** Regulatory reforms must be considered to facilitate investments in sustainable infrastructure projects and transition finance, ensuring a proper balance between investors' returns and long-term development project phases. Guarantee programs and other risk mitigating tools can encourage private investments, while tax incentives are equally critical. A solid capital base is key for entities and projects seeking to secure funding, whether through bond issuance or lending.
- **Liquidity in European equity capital markets should be improved/accessible to everyone.** A number of drivers are moving liquidity out of EU capital markets due to regulation and supervision not being coherent with the market reality and a growing inequality in access to liquidity. We are calling for more transparent markets, where market participants can operate on a level playing field. Liquidity should be accessible to everyone and on the same conditions.

[1] ESMA Position Paper 22 May 2024

Introduction

Europe must mobilise long term capital and institutional investors that can drive change at scale in the European economy. Europe needs to function better, with larger and more liquid equity and securities markets to improve its competitiveness and thereby strengthen the economic growth rates necessary to maintain economic welfare for all its citizens in the future. More equity finance requires an effective and efficient ecosystem for securities investments. A vibrant capital market, both unlisted and listed, with well-functioning primary and secondary securities markets, will help to attract more investments to Europe, drive companies to seek more equity finance and increase the ability to scale European companies into global leaders.

Europe's equity markets are fragmented across the Union, both at the level of infrastructure, with numerous stock exchanges and trading venues, clearing houses and central security depositaries spread across Member States[2], and at the level of economic, tax and legal structures. Both levels must be improved in order to strengthen the system as a whole. At the national level, Member States have different degrees of incentivisation for equity saving, tradable corporate funding and strong capital markets. Public incentives through tax, pension schemes, financial education and overall industrial policies all impact the development of the capital market in each Member State, which in turn impacts the European capital market. The EFR encourages European policymakers to consider the entire ecosystem with the aim of generating real and lasting progress aimed at making the EU capital market more competitive on a global scale. Stable, recognisable and predictable policymaking is key to attracting investments.

A new geopolitical context

As pointed out across the reports prepared with a view to strengthening Europe's competitiveness and growth ability, Europe needs to lower its dependency on other regions for various value chains. This includes strengthening the European financial sector. A strong European financial sector and capital market is required to underpin European security, competitiveness, growth potential and resilience. The global market cap of the European banks has shrunk considerably since the 2008 financial crisis for various reasons including the uncertainties regarding the level of capital targeted by EU Authorities. Europe needs to increase its ability to scale European companies into global leaders. More equity finance plus a stronger European capital market and EU market participants form a key tool for achieving this throughout the entire market vertical (exchanges, listing, trading, clearing and settlement).

Recommendations for driving more equity finance in Europe

1) *Boost institutional investor participation*

Incentivising stronger participation on the part of institutional investors will play a crucial role in deepening the investor base and demand side of the European market, thereby improving the liquidity and depth of equity markets. Measures should be aimed at facilitating investment firms, pension funds and insurance companies to allocate higher levels of capital to equities. Key reforms could include a review of the prudential treatment of long-term equity investments as well as alignment with and targeted adjustments to the taxation of long-term equity holdings for institutional investors across Member States[3]. In addition, as outlined by ESMA in its position paper on building more effective and attractive capital markets in the EU, it will be important to assess "the potential for further mobilising and scaling institutional and retail equity capital through dedicated funds, including public private partnerships, to better support the growth of critical business sectors in the EU and the objective of strategic autonomy".

2) *Unlock sophisticated investor participation*

Whilst investor and consumer protection rules ensure trust in the market, excessive risk aversion is limiting attempts to broaden Europe's investor base. Restraints imposed by MiFID II/MiFIR[4] on sophisticated investors with capital markets expertise opting to be treated as professional investors across their investment portfolios are making it difficult for financial services firms to support these investors. Reform could unlock the potential from these investors and, at the same time, provide them with access to better financial advice and more varied portfolios.

The EU Retail Investment Strategy could be an instrument for simplifying the existing MiFID II 'client categorisation' rules for a targeted cohort of sophisticated investors. The aim would be to allow these investors access to a larger product universe including AIFs[5] such as private equity, European Long Term Infrastructure Funds and ESG[6] funds, thereby broadening both the investor base of Europe - while in parallel securing these investors access to broader range of financial products and advice. Unfortunately, at present the text of the Commission does not go that direction with new compulsory tests and the focus on cost considerations only.

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[2] There are currently about 30 CSDs operating across Europe. There are around 17 CCPs operating in Europe, authorised by EMIR. Europe has approximately 20-30 major stock exchanges. Europe has over 100 MTFs and trading venues

[3] For insurers, a review of long-term equity is already part of the SII review

[4] Markets in Financial Instruments Directive/ Markets in Financial Instruments Regulation

[5] Alternative Investment Funds

[6] Environmental, Social & Governance

3) *Higher ratio of equity and transferable securities in European companies' funding structures.*

European companies must be incentivised to seek a funding structure that includes higher levels of equity funding and transferable securities. Policy makers must allow private markets to develop efficient market solutions. Fragmentation of the European capital markets imposes constraints both at trade and post-trade level. An overall high regulatory burden is also a costly impediment. Taxation structures are another part of the discussion. Going forward, European policy making must address these high-level issues with equal importance attached to the more detailed obstacles, such as constraints in MiFID II/MiFIR.

4) *Assess how the relationship between primary and secondary capital markets affects the overall attractiveness of equity markets*

Given the close connection between strong primary markets and effective secondary markets, an assessment on how this interplay impacts the overall functioning and attractiveness of equity markets needs to be considered. ESMA can play a catalyst role through analysing and gathering the best practices across Europe. Elements of a company's life cycle before and after becoming publicly listed could be assessed including: valuation and presence of a comparable pool of peers, sell-side expertise and research availability, institutional investors' activity compared with other jurisdictions, taxation and corporate law, disclosure and conduct requirements, market infrastructure fragmentation and impact on financing costs / liquidity constraints. The EFR encourages the European Commission to commission a study to identify regulatory hurdles preventing the development of an environment that encourages companies to consider listing in the EU and committing to greater institutional investor engagement in equity markets.

5) *Simplify and recalibrate key pieces of EU legislation to allow more risk capital*

The EU must rethink its regulations in order to encourage risk-taking and individual choice, which is needed to drive growth and scalability for European companies. Priorities should be: i) ensuring that the SFDR[7] review adopts practical standards that support sustainable investing; ii) simplifying the CSRD[8] to ease compliance for businesses; iii) avoiding AI rules that restrict EU market growth compared to the US; and iv) aligning the Retail Investment Strategy to focus on high-value products, instead of cheapest price (including costlier alternatives like PE[9], long-term infra etc.)

6) *Boost the venture capital sector*

A vibrant venture capital sector is key not only to driving innovation and risk taking by entrepreneurs, but also to feeding the pipeline of companies wanting to raise equity capital on European markets. Although listing reforms and introducing measures to boost the availability of investment research are steps in the right direction, more needs to be done in this respect.

As underlined by Christine Lagarde[10], "Fixing the demand side is key. There are too many barriers and bureaucratic hurdles for entrepreneurs in our Single Market, which means there are fewer high-growth companies that VCs[11] want to finance. The recommendations in the Letta and Draghi reports on completing the Single Market are critical for VC to play a greater role.

But we also need to work on the supply side". "We need to use all the flexibility we have within the European financial system to unlock funding for innovation".

7) *Sustainable investments*

The EU's sustainability goals present significant economic opportunities for investors and businesses alike, and can act as a catalyst for more equity finance. However, reporting burdens and disclosure requirements should be simplified as they impose high costs and regulatory complexity on European firms. Standardising labels can make it easier for investors to comprehend, reducing complexity and enhancing clarity for the industry.

Equity investments in infrastructure should be encouraged to drive the transition. Infrastructure, especially in initial technological phases, is more suited to equity than debt finance. Infrastructure has several characteristics that make the asset class attractive as an investment for institutional investors, such as good long-term returns and stable cash flow. In most cases, the cash flow is also inflation-protected through regulation and stipulated contracts and/or concessions. Infrastructure investments also have a low correlation with other

[7] Sustainable Finance Disclosure Regulation

[8] Corporate Sustainability Reporting Directive

[9] Private Equity

[10] https://www.ecb.europa.eu/press/key/date/2024/html/ecb.sp241122~fb84170883.en.html

[11] Venture Capital firms

asset classes, which helps to deliver good diversification. There are, however, some characteristics that create uncertainty among institutional investors, such as political and regulatory risk, capital intensity, cost overruns and delays, refinancing risk due to its illiquid nature, limited access to ongoing information related to valuation and transparency around this type of investment. These are concerns that can be addressed at an aggregate level to attract more equity finance to infrastructure projects.

8) *Accounting standards*

Under the current IFRS[12] framework, investment in equity, long-term equity and equity-type instruments is penalised. In the case of equity instruments that are held directly, the current IFRS model based on fair value through other comprehensive income ('FVOCI'[13]) does not allow the recycling of gains or losses on realisation of equity instruments measured at FVOCI. With reference to the insurance industry, EFR notes that the need for recycling gains or losses on realisation of equity instruments measured at FVOCI is critical for promoting long-term equity investments in Europe, given that shadow accounting is no longer permitted for account insurance liabilities, meaning that the lack of recycling will therefore increase accounting mismatches for those insurance companies that have profit-sharing features in their insurance liabilities.

In the case of equity instruments that are held indirectly (equity-type instruments), IFRS models based on FVOCI are no longer allowed. Compulsory measurement of equity-type instruments at FVTPL[14] distorts financial performance and would not appropriately reflect the management strategy of certain funds and long-term business models. In this sense, investment funds in variable or fixed income should be accounted at FVOCI category and not FVTPL, otherwise volatility will lead to less investment in these products.

9) *Liquidity in equity capital markets.*

A number of drivers are moving liquidity out of EU capital markets. Among them: the EU market structure has become too complex and costly; excessive regulation and supervision, which are not coherent with market reality; and a growing inequality in access to liquidity both within regulated markets and MTFs[15]. We are calling for more transparent markets, where market participants can operate on a level playing field. Liquidity should be accessible to everyone and on the same conditions. We encourage authorities, post MiFIR Review, to closely monitor the quality and availability of liquidity in EU shares, so as to make sure that future development of the regulatory framework is based on a deep understanding of market mechanisms. Whilst addressing tools to improve liquidity and the overall efficiency of the EU capital markets, digitalisation can be an enabler which should be assessed.

[12] International Financial Reporting Standards
[13] Fair Value Through Other Comprehensive Income
[14] Fair Value Through Profit or Loss
[15] Multilateral Trading Facilities

The European Financial Services Round Table (EFR) was formed in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with headquarters in Europe. EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

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ANNEX

Annex A:
Why is the European capital market smaller and less liquid than the US market?

Numerous reports demonstrate how the EU's capital markets lag behind the US in terms of the depth of its capital markets.

- Between 2016 and 2022, Europe's equity capital market capitalisation (as a share of GDP) rose from 48% to 66%, whereas in the US it increased from 104% to 157%[16].
- Liquidity of equity markets (as measured by turnover velocity) decreased from 68% to 52% in Europe, whilst it stayed at 145% in the US over the same timeframe[17].
- Looking at the availability of risk capital shows us that the EU pool is ten times lower than it is in the United States (0.044% of GDP versus 0.633% of GDP)[18].

So why is Europe struggling to improve its capital markets? At its core, Europe unsurprisingly suffers from highly fragmented capital markets. This impacts market structure, with lower levels of capital access and investor participation, liquidity and products.

Market structure:

- The US is a unified market with a handful of dominant exchanges including NYSE and NASDAQ. The EU on the other hand is heavily fragmented with over thirty-five national exchanges[19]. As such, there is no single point of entry for listing as a truly 'European' entity. Smaller exchanges unsurprisingly mean smaller pools of liquidity, with most stocks trading equally across multiple venues.

Capital access and investor participation:

- US capital markets enjoy much greater participation on the part of institutional and retail investors. This means greater diversity of risk tolerance, investment strategies and cultural preferences towards savings, for example.
- For corporates, the EU proportion of market-based financing has not visibly changed over the last five years, standing at 14% in 2024, below the US (36%), UK (35%), and China, Japan and Australia (each at 20%)[20].
- The US has a higher proportion of retail assets invested in equites compared to Europe. The average EU adult holds €42,000 in market-based instruments, significantly less than their American (€190,000), British (€80,000), or Japanese (€50,000) counterparts, even after adjustment for differences in the cost of living[21].

Liquidity:

- US markets demonstrate significantly higher turnover (direct function of liquidity) compared to European markets. Interestingly, a large part of this turnover is a function of the impact of the 'Magnificent 7' tech stocks. The lower turnover in Europe is driven by the types of companies (traditional industrial/ energy sectors compared to high-growth tech sectors) and associated valuations[22].
- Fragmented clearing and settlement systems, along with concentrated trading activity during certain hours, further contribute to low liquidity and turnover, which impedes market growth and efficiency in Europe.

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[16] A Comprehensive Analysis Of Europe's Capital Markets

[17] Ibid

[18] PC-CMU.pdf

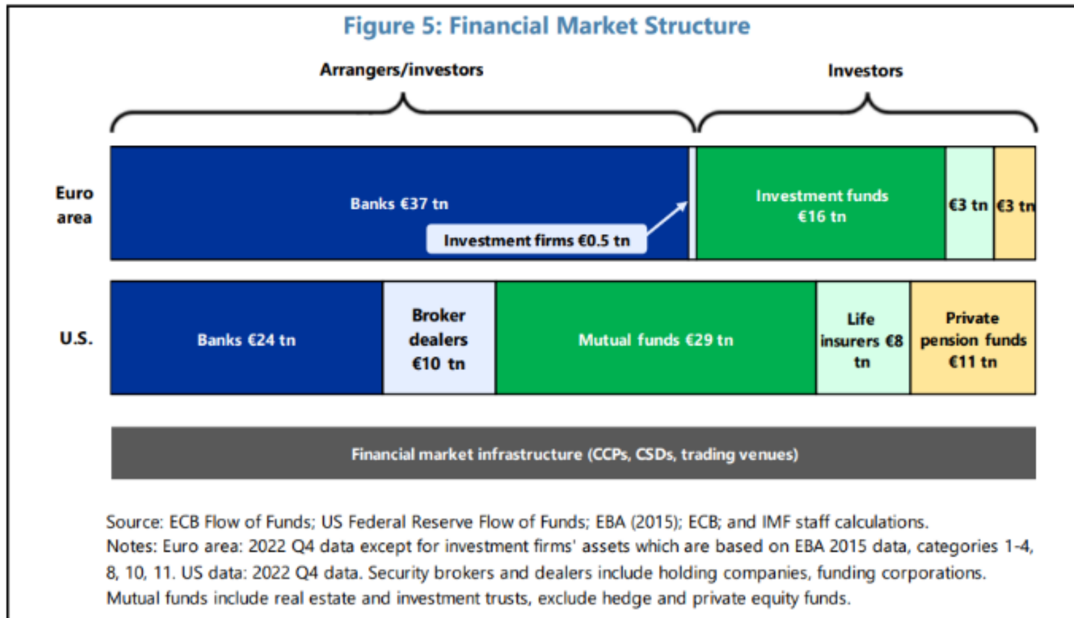
[19] The problem with European stock markets

[20] AFME CMU KPI November 2024

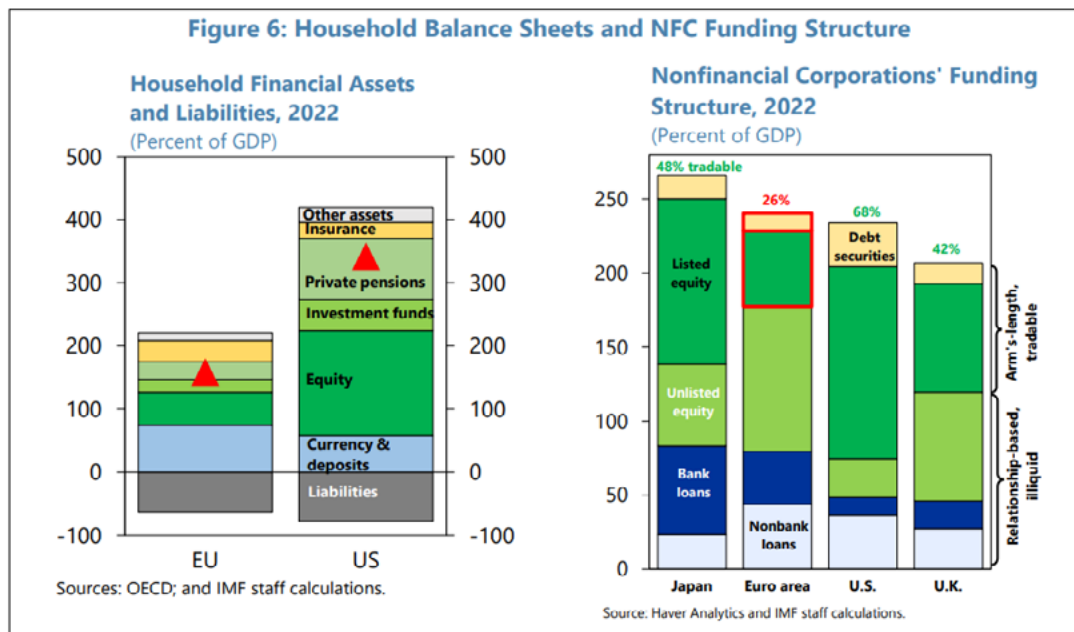
[21] AFME CMU KPI November 2024

[22] Mario Draghi: *'The core problem in Europe is that new companies with new technologies are not rising in our economy. In fact, there is no EU company with a market capitalisation over EUR 100 billion that has been set up from scratch in the last fifty years.'* fcbc7ada-213b-4679-83f7-69a4c2127a25_en

Annex B: Structural differences in company funding EU vs US[23]



Source: ECB Flow of Funds; US Federal Reserve Flow of Funds; EBA (2015); ECB; and IMF staff calculations.
Notes: Euro area: 2022 Q4 data except for investment firms' assets which are based on EBA 2015 data, categories 1-4, 8, 10, 11. US data: 2022 Q4 data. Security brokers and dealers include holding companies, funding corporations. Mutual funds include real estate and investment trusts, exclude hedge and private equity funds.



Sources: OECD; and IMF staff calculations.

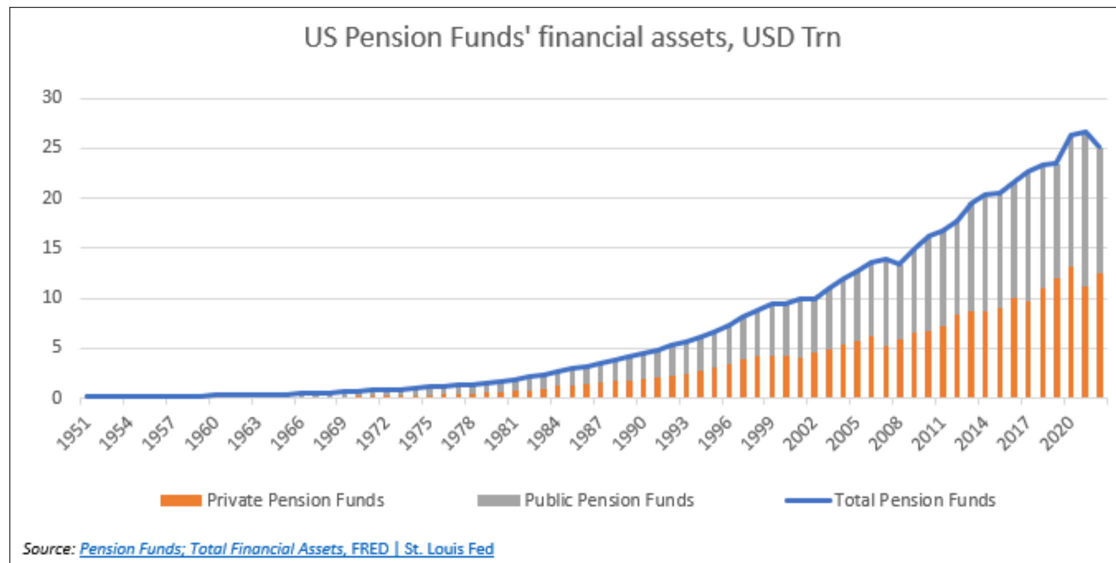
Source: Haver Analytics and IMF staff calculations.

[23] Data from IMF Working Paper, July 2024, Stepping Up Venture Capital to Finance Innovation in Europe

Annex C: Comparison - Evolution of assets held by US pension funds

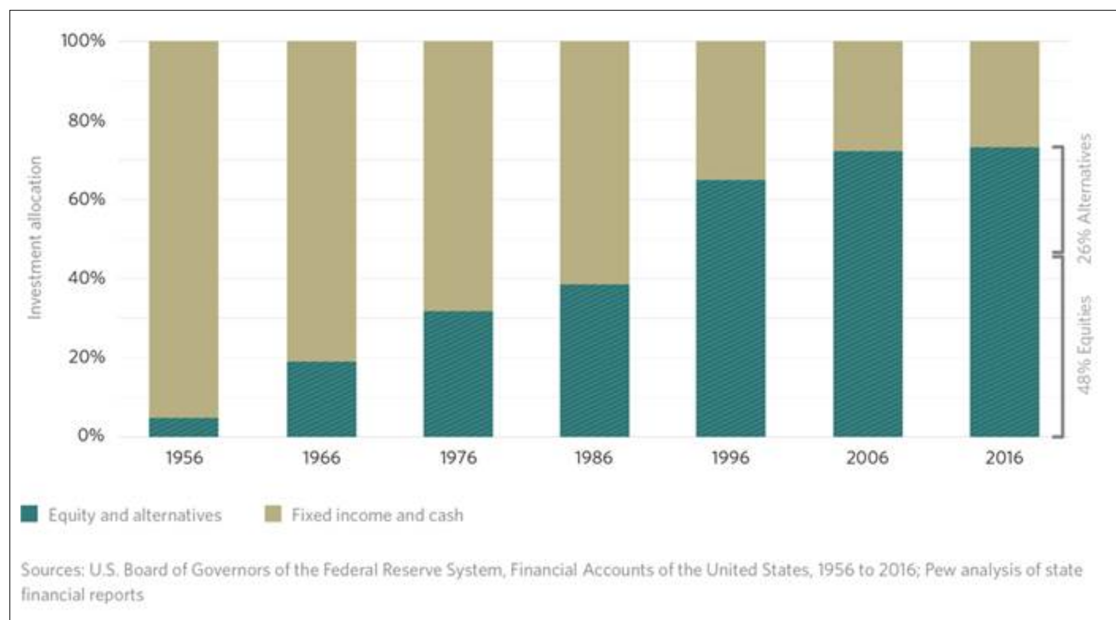
The graphs below show that the value of assets held in the US multiplied by a factor of 20 between the mid-1970s and the mid-2010s. This shows a long-term trend, supported by stable policies.

The picture in Europe is very different and in aggregate not far from reversed, matched by lower growth. In some European countries, such as Finland, equity investments have grown to 57 % and fixed income has dropped to 25 %. At the same time, the Finnish pension market is small in relation to the Dutch pension fund market. Over the past number of years, Dutch and especially UK pension funds have reduced their equity investments.



Source: Pension Funds; Total Financial Assets, FRED | St. Louis Fed

In parallel to the development in the amount of assets, the allocation picture has also changed massively:



Sources: U.S. Board of Governors of the Federal Reserve System, Financial Accounts of the United States, 1956 to 2016; Pew analysis of state financial reports