Developing and connecting securities ecosystems

Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

Pension reforms are the key to unlock the true potential of the CMU

The Capital Markets Union (CMU) is one of Europe's flagship projects and it has been a long-standing priority for the EU. That is for a good reason as the CMU's overarching objective is to create a financial ecosystem which supports Europe's businesses in flourishing, offers new opportunities for investors and savers and makes the financial system more stable and resilient.

No doubt that there have been some early successes for the CMU. The introduction of a new framework to reinvigorate securitisation markets and reforms of prospectus regulation were a promising start. However, more is needed. The CMU can never be a game changer without enough long-term savings as they match firms' long-term funding needs.

It naturally makes one look at the pension savings and life insurance funds. They make up a significant amount which could boost long-term investments. In the euro area, pension funds hold assets of almost € 3 trillion. Adding insurance companies (both life, property and casualty), the number grows by another € 8 trillion. Pension funds and life insurance companies would also benefit by having more long-term investments giving the similar maturity as their liabilities.

Hence, there is symbiosis between investing to generate competitive long-term returns and funding the investments that generate real economic value for future generations. Pension reform is the key to unlocking that symbiosis and developing capital markets in the EU.

Furthermore, if reforms are made the right way, they could also help to cure a severe headache for future generations. Most European countries have large future pension liabilities challenging the sustainability of their public finances. It partly reflects the heavy reliance on pay-as-you-go pension schemes. The power of such schemes depends on workers outnumbering seniors, i.e. on population growth. However, the tide is changing, and in most European countries there is an urgent need to build up a funded pension system. If politicians solve this problem correctly, it could also create the instruments to truly create a capital markets union.

There is already a trend away from traditional pension products. Products that resemble asset management products replace defined-benefit products. On the one hand, >>>

>>> this makes sense. Defined-benefit products have become too expensive in terms of the companies' capital needs, or alternatively offer too little capacity to take risk and thereby generate a better return in the long run.

The commitment of pension funds to their customers in such a regime would be looser than the commitment in traditional defined-benefit products. The advantage would be that the expected return – and thus future pensions – would be higher, as pension funds move their investments out on the risk curve. The disadvantage is that returns and pensions could be lower. This is important, as pension and life schemes produce the basic income of people who have little opportunity of other income.

Hence, politicians will have to decide on the outer limits for risks that are acceptable to the basic income of pensioners. Pension and life companies should be required to define their objectives in relation to generating basic income and the risks to which their investment policies expose these objectives. Supervisors will then have to supervise the consistency between the investment policies of pension funds and their objectives, in terms of return and risk.

A last observation a decade after the great financial crisis is that a well-functioning capital market based on long-term savings may provide a robust supplementary source of funding to bank lending. Hence, it may act as Allan Greenspan's famous spare tire for the economy helping to minimise the costs of the next financial crisis. This is important as the last crisis revealed the costs of having a bank-dominated EU financial system. ●

Hank Erbe III

Global Head of Strategic Relationship Management & Public Policy, Fidelity International

Developing stronger SME market ecosystems in the EU

With two thirds of the EU working population employed by Small to Medium Enterprises (SMEs) there is a clear case for safeguarding the global competitiveness of this sector in particular. This in turn relies on ensuring that SMEs continue to find the funding they need to grow.

Robust new issuance of SME securities and the maintenance of healthy and liquid secondary market become vital for job creation and economic growth, especially against the backdrop of a decline in bank lending to SMEs.

And yet extreme fragmentation of the financial services landscape, and the ongoing reliance that SMEs have on bank rather than market funding, continue to be key concerns. Four years on from its launch, and with the end of the Juncker Commission approaching, obstacles to successful implementation of the Capital Markets Union (CMU) Action Plan still remain and still require policymakers' attention.

One policy objective should be more diversified sources of market funding for SMEs. Diversification increases competition and improves financial resilience. As things stand, however, the significant cost of public listing combined with the abundance of private equity has significantly extended the reliance SMEs have on private capital and bond financing. This not only concentrates market funding but does so into two channels that proved particularly susceptible to disruption during the financial crisis. >>>

>>> Regrettably, with a notable exception of Nasdaq Nordic North, EU27 listing markets for SMEs remain relatively small. With the largest and well-established SME equities platform - The LSE's Alternative Investment Market (AIM) - pending departure from the EU market, the near future for SME ecosystems is challenged.

Then there are the impacts - albeit unintended - that MiFID II seems to be having on the trading of issued SME securities. To take two examples, as feared, brokers do indeed seem to be cutting back on the research coverage they give to SMEs in particular; while market makers are reporting that they are finding it harder, more costly or both to generate liquidity pools under MiFID II trading and disclosure rules.

One could make several recommendations to address such challenges, from tackling structural inefficiencies to alleviating regulatory burdens to creating an interlinked pan-European network.

For our part, we continue to recommend the Commission to refresh the CMU agenda by creating a Task Force focused on IPO reform and subsequent trading conditions for SME securities in particular. Such a force should be comprised of professionals representing the entire ecosystem of SME capital formation – venture capitalists, institutional investors, experienced CEOs, securities exchanges, regulators and capital markets bankers. And its aim should be to provide recommendations for restoring effective access to the public markets for emerging, high-growth companies.

We believe that opportunities exist to introduce innovative FinTech into the issuance process, for example. But also, to make changes to existing rules to bring the existing regulatory structure (MiFID II) in line with current market realities (leadership trading platforms such as Euronext and NASDAQ OMX).

Both types of intervention would help re-establish access to the public capital that SMEs need to hire new employees, develop new products and grow innovative businesses in home markets and globally.

We would also recommend the creation of a pan-European network for capital market infrastructure. The deep pools of capital within the UK and Swiss markets simply cannot be ignored if the EU's CMU initiative is to take effective flight. Although the political climate may lean against the adoption of such proposals at this precise moment, as the dust settles policymakers will ultimately need to re-centre debate back onto the best interests of Europe's SMEs and savers alike.

If the CMU's ultimate objective - to "strengthen the European economy and stimulate investment to create jobs" - is still valid then we should start thinking realistically about its delivery. ●

Carmine Di Noia

Commissioner, Commissione Nazionale per le Società e la Borsa (CONSOB)

Building a financial ecosystem: some clues from Italian experience

An ecosystem is a community of living organisms in a particular environment that interact as a system. The efforts of the past years at European and national level have certainly developed the European financial ecosystem.

The EU regulatory framework reached a commendable level of technical advance, under the CMU umbrella, aimed at boosting the ability of all businesses to access different sources of market-based financing, while keeping investors protected. In addition to the proper environment (rules and markets infrastructure), there is also a striving community of living organisms (companies and investors). What we need to work out is how all these players interact with each other.

In this sense, Italy represents an interesting point of observation.

Italy has many vibrant and dynamic companies. Net wealth of investors >>>

>>> remains stable and a significant portion of the financial wealth is held by affluent and sophisticated investors. Where we lag behind is the (historical) reluctance toward market-based financing, experienced on both side of the equation (companies and investors).

In recent years, Italian policy maker has undertaken important initiatives to strengthen capital markets. These include individual saving plans, the mini-bond market framework and the allowance for equity capital. It is also worth mentioning the ELITE project, a training program for unlisted SMEs provided by the Italian stock exchange.

Thanks to that, capital market is becoming an increasingly important source of funding for Italian companies, who have realized the importance of developing alternative financing options and the danger of relying excessively on bank lending.

What remains to be done? By way of example, consideration should be paid to the following priorities:

1. Regulatory simplification. Regulation should be perceived as an asset, not a liability. Therefore, it is crucial to fix some unintended consequences of current regime and devise friendly regulatory environment. Two examples: imposing the same disclosure obligation of companies listed on regulated markets to those traded only on MTFs (even when issuing only a minibond of 1 million) may have the unintended consequence to squeeze SMEs out of the market. The currently disclosure regime set forth in the market abuse regulation (MAR) should be confined to regulated markets alone and should not apply to MTFs. Secondly, prospectuses concerning securities issued by SMEs should be replaced with lighter documents reporting a limited set of key information items.
2. Develop a focused investor base. “Ad hoc” investors need to be developed. SMEs funding, for instance, should be boosted by favoring specialized instruments, as it has been the case for years in the UK: in this way, savers and institutional investors may invest fully aware of their illiquidity which is a feature, not necessarily a flaw. In this regard, one of the suitable instruments to be favored is ELTIF.
3. Educate entrepreneurs. We should keep raising awareness on the importance of thinking long term, opening up to different financing options (complementary to the banking one) and develop internally sound corporate governance. ●

Lauri Rosendahl

President, Nasdaq Nordics

Active local ecosystems are critical for economic growth

While cross-border trade, interconnected capital markets and collaboration across Europe is good, most companies still raise capital in their home markets. Based on evidence from Nasdaq Nordic’s markets, I am convinced that efforts need to be put into developing active and dynamic local ecosystems around the companies.

Every successful and sustainable economy needs a dynamic capital market, where one of the core pillars is an active IPO market. IPOs generate capital for new investments, R&D and job growth at a time when young growing companies need it the most. IPOs enable companies to move from private to public funding – with increased transparency and visibility as a result – while allowing early stage investors to recycle capital and fund new job creating growth companies.

Nasdaq Nordic has seen strong inflows of new listings in recent years, primarily to our junior growth market Nasdaq First North. Our Swedish market saw record years in 2015 and 2017, while Finland showed an all-time record in 2018. In total, 389 companies have listed across our Nordic markets since 2015, raising 19.4 billion EUR in total. Perhaps more importantly, 38 companies matured and switched from Nasdaq First North to our Main Market during these four years. The Nasdaq First North All Share Index have increased by 80 percent during the same time-period. A true win-win.

Nasdaq invests a lot of efforts in developing local ecosystems across the exchange markets we operate. The Nordic markets have well-functioning networks of financial advisors, small and micro-cap funds, and other players specifically supporting SMEs. Also, we have a strong equity investment culture where both institutional and retail investors are willing to take risk. These elements create a dynamic capital market environment that allows smaller companies to tap the benefits of public equity finance.

However, there is still work to be done. We need to ensure that all players in the ecosystem have a viable business case to work with. For instance, some equity research and analysts are struggling as a result of MiFID II, leaving SMEs in a visibility gap. We also need further education directed to both issuers and investors about the benefits of public equity finance. Given the current low interest rate environment, European households need to be better aware of the potential upsides of investing in SMEs, rather than primarily keeping personal savings in bank accounts.

“Efforts need to be put into developing active and dynamic local ecosystems around the companies.”

\- LAURI ROSENDAHL

The SME Growth Market label introduced by MiFID II is a good initiative, and Nasdaq has applied for the designation across all our seven Nasdaq First North markets. I would welcome for EU and national institutions to prioritize further cooperation on measures, which can allow each SME Growth Market to play its part fully. For this, I believe a precondition for success is to recognize the different starting points of each local ecosystem, and allowing room for local adaptation of necessary measures.

In order to reach long-term sustainable growth across Europe, both SMEs and investors need better access to capital markets. By doing that, more companies will be able to raise critical capital for expansion, while both large and small investors are offered an opportunity to participate in the growth journeys. ●

Guillaume Prache

Managing Director, Better Finance

Employee share ownership: the single most powerful action to reach the CMU goals

The EU CMU project aims to rebalance the funding for the EU economy from banks to capital markets. The key requisite for this to happen is to foster retail investments into capital markets.

Following a proposal from BETTER FINANCE, the EC added a new CMU action in 2017 to "develop best practices in employee share ownership schemes" to develop the equity culture in Europe.

Even if it would just reach the level it enjoys in the US, employee share ownership (ESO) would be multiplied by 6 in the EU – adding two trillion € in equity market capitalization - and even by much more as far as SMEs (the main job creators) are concerned. This alone would boost the EU 28 market capitalization by about 20%, and thus get the CMU significantly closer to its goal.

But there is much more: studies show that people who have been exposed to employee share ownership plans often become shareholders of other listed companies.

Retail financial intermediaries have stopped promoting direct investments into listed shares and bonds for decades, in favor of more complex and fee-laden "packaged" products such as funds, life insurance and pension products, increasingly estranging EU citizens from the real economy assets their savings are supposed to fund. ESO is the only – but powerful - way left to enable EU citizens as employees to learn about shares, equity ownership and capital markets.

This is why the EC links this "CMU" action to the promotion of an equity culture.

The promotion of ESO is the single most powerful means to achieve the CMU's priority goals, … and more:

Sustainable finance

Over the last five decades the European economy has progressively gone from a people capitalism to a financial capitalism: in 1969 EU citizens directly owned 40 % of the EU economy (the shares of EU listed companies); today only about 10%. Financial intermediaries, on the other hand, have now seized a major share of our economy's capital and voting rights: what one of the founders of the US SEC, Louis Brandies, and present-day Professor John Kay of the UK both call "other people's money".

Looking only at the time horizon, active asset managers ("other people's money"), on average, hold their equity assets for less than a year; versus thirteen years for employee shareholders in France, for example. Other studies show that ESO also improves social responsibility and governance.

Not only are the interests and time horizon of agency owners too often poorly aligned with those of the end-investor and of the real economy in the long-term, but in terms of governance and democracy it means the EU economy is increasingly de facto controlled by financial intermediaries and not by citizens as long-term savers. It is a very serious - although underestimated - threat to democracy.

For all these reasons, it is all the more a pity that the EC has been dragging its feet for so long on ESO: Already in 2002, it announced the need for a European Action Plan on ESO, and concluded again from a "Pilot Project for the promotion of ESO and Participation" in 2014 that an Action Plan focused on an awareness-raising campaign should be launched.

EU Authorities have now a unique opportunity to make it right: The 2017 CMU Action on ESO (due to be completed this year) must follow-up on this 2014 "Pilot Project" at last. ●

James Cunningham

Senior Advisor, Public Policy and Regulatory Affairs, BNY Mellon

Securities eco-systems and the Capital Markets Union - a broader view

The topic of securities eco-systems is a core question for the Capital Markets Union project. It relates directly to the biggest single problem of EU capital markets, namely, the great differences in capital markets participation across member states, and the fact that participation in some member states is very low.

Capital market participation depends heavily on the existence of capital market institutions, and of a strong capital markets eco-system, at the member state level. Such eco-systems depend heavily on sufficient volumes of activity, and on a sufficient diversity of market participants.

Eco-systems that have a greater diversity of market participant are more resilient to external shocks, deliver better quality outcomes, and have a strong positive impact on economic performance. Capital markets are heavily embedded in national economic, legal, and institutional structures, so that it is inevitable, and indeed desirable, that the different national eco-systems across the European Union be diverse. >>>

>>> But this raises two important questions: whether the existence of different national eco-systems creates obstacles for the single market and for the Capital Markets Union project; and whether pan-European single market initiatives are a threat to national eco-systems.

If we are not careful, the answer to both these questions is yes. It is well known, since at least the Giovannini reports, that national specificities can be an obstacle to market access, and to the creation of a single market.

For a weak, relatively undiverse eco-system, EU single market measures, such as MiFID and MiFID 2, can represent an external shock that weakens the eco-system. Yet market opening measures can also deliver increased volumes, and increased diversity, through the presence and activity of new market actors.

With respect to trade policy, it is a well-established proposition that a tax on imports also has the effect of being a tax on exports. The same reasoning applies to market access. Obstacles to access to an eco-system weakens that eco-system, and as a result makes it more difficult for actors in that eco-system to access other eco-systems.

"A major challenge is to build and strengthen national securities eco-systems."

\- JAMES CUNNINGHAM

A major challenge is to build and strengthen national securities eco-systems, so that these eco-systems are not harmed by, but rather benefit from, pan-European market opening measures. The reports of the Giovannini Group and of the European Post Trade Forum have often been viewed as setting out an agenda for the European authorities to impose on recalcitrant member states.

We need to take a broader view. These reports set out many detailed steps – on securities account opening procedures, on tax documentation, on registration practices, and on access to market infrastructure – that member state authorities can take to facilitate access to their national capital markets for domestic and foreign investors and intermediaries, and thus to increase volumes of activity, and the diversity of their national eco-systems. ●

Lee Foulger

Head of International Department, Financial Conduct Authority (FCA)

The importance of open, connected, global securities markets

At Eurofi in September 2018, the FCA's Chief Executive Andrew Bailey made the case for balancing regulatory autonomy, global co-operation, and a commitment to international standards, in the interests of the effective oversight of open and mutually supportive financial markets. His arguments have remained relevant in the months since September – for the UK, the EU and across the globe.

Open and interconnected financial markets – including securities markets and the "ecosystems" that support their operation – will always remain vital to support trade in goods and services. Such markets help to diversify risk, increase efficiency and reduce fragility in the financial system, and help our companies access deeper pools of capital.

This is true of every aspect of the securities market's ecosystems – spanning regulated markets, other trading venues, market participants, issuers and other capital raisers, clearing and settlement arrangements, reporting and transparency frameworks.

Europe has created an impressive regional initiative to promote effective interconnected markets through Capital Markets Union (CMU), and I am proud to have been one of its enthusiastic parents. Key elements of CMU address precisely those aspects of securities markets ecosystems I have just mentioned. MiFID II is of course paramount in setting foundation standards for securities markets, supported by such measures as EMIR, CRD/CRR, the Investment Firm Review, Regulations on Prospectuses and Benchmarks, sustainable finance proposals – to name but a few.

The FCA maintains strong support for these reforms, as our recent work to prepare for UK Withdrawal has underlined.

But CMU is a convenient term that should not imply that regional capital market ecosystems – however well founded - are the best way to promote open securities markets that meet the needs of those they aim to serve. They are a valid means to maintain agreed standards, but need to be inclusive rather than exclusive. It is imperative that we don't slip into a model of fragmented regulation, with competing philosophies and regulatory agendas.

Over recent months, the FCA's perspective on interconnected global securities markets has been well demonstrated by several initiatives. These include our preparations for UK Withdrawal based, where possible, on the recognition of home country supervisory standards; our discussions with our European counterparts on agreements to support future co-operation and information sharing; our first Mutual Recognition of Funds memorandum of understanding with the Hong Kong Securities and Futures Commission; and our agreement with the US Commodity Futures Trading Commission to ensure the continuity of derivatives trading and clearing activities between the UK and US.

"Connections should span securities market ecosystems across both European and non-European centres."

\- LEE FOULGER

The priority going forward must be to maintain connections between different securities market ecosystems across the EU and with non-EU centres (and their regulators), and to resist any temptation to strengthen local frameworks in inconsistent ways.

We will continue to work with all our counterparts to develop and implement standards which are strong but flexible enough to enable competition and innovation. This remains our day-to-day regulatory approach, and our long-term vision for global markets and their ecosystems. ●

Antonio J. Zoido

Executive Chairman,
Bolsas y Mercados Españoles (BME)

Status of the connection of securities ecosystems in the EU

Amongst the objectives of the Capital Markets Union, there was the aim to make it easier for companies to raise capital on public markets and to foster retail investment. While a lot of progress has been achieved, granting easier access to SMEs to financial markets was in the list of pending tasks as stated in the communication of last November.

BME has a long track record on initiatives to foster companies of all sizes, including SMEs, access to financial markets. In specific relation to SMEs, our MAB, the Alternative Equity Market, will turn ten years old next July. This market segment targets small companies trying to expand so that they can raise capital benefitting from the advantages offered by the market. I mean, we have a first-hand experience on know hard this task is.

Attracting issuer companies, and particularly SMEs, requires a holistic approach. Fiscal barriers have been identified for decades and debt-biased taxation is a common place in these discussions long since. However, the barriers still remain and discourage equity financing. To add difficulties to this, some fiscal proposals such as FTT will pose a serious danger to the European equity markets. We have explained the negative effects of this kind of tax in a detailed way, with hard data showing the impact on equity trading. Still, it is surprisingly on the political agenda.

One of the negative impacts of FTT will be the shift of trading towards those non-FTT countries, which leads me to another barrier: cross-border differences in market supervision and regulatory enforcement. We need a playing field where supervision is uniform, with clear roles assigned to ESMA and the NCAs under the principle of supervisory convergence.

Finally, I cannot ignore one of the main sources of discouragement: overregulation. We have suffered a legislative fever during the last years that has resulted in a maze of norms and regulations, in my opinion, highly costly. The European Commission will carry out a study on the costs of compliance due to the financial regulatory and reporting obligations. It remains to be seen how efficient this regulatory framework will be in the coming years to make issuers access to capital markets easier. It is also unclear the final effect on the local financial ecosystems, although some indicators, such as declining IPOs, do not allow for optimism.

"There is a long way to go before achieving friendly European financial markets, particularly for SMEs and retail investment."

\- ANTONIO J. ZOIDO

In fact, data suggest that compliance costs, which add to listing costs, discourage small companies listing in public markets and leads the to resort to private equity as an affordable source of financing. Although private equity has a significant domestic component, access to this source outside the home market has grown in the last years, with the corresponding exit from public markets eroding the local financial ecosystems.

But if we turn to retail investment, the prospects are not much better. A number of measures have been taken: the Consumer Financial Services Action Plan, the regulation on a pan-European personal pension product... However, retail investment is declining in the European securities markets. The retail share of the Spanish market fell from 30,5% in 2000 to 19,7% in 2017. It is obvious that things are not being done as they should.

In sum, in spite of the well-intentioned measures already taken and the proposals in the making, there is a long way to go before achieving friendly European financial markets, particularly for SMEs and retail investment. ●