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REPORT

Europe's capital markets in transition:

Driving competitiveness through innovation and sustainability

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Place du Congrès 1, 1000 Brussels, Belgium www.ecmi.eu ecmi@ceps.eu

Adam Kostyál
PRESIDENT, NASDAQ STOCKHOLM

The success of capital markets in the Nordic region is not solely due to exchanges like NASDAQ. While NASDAQ operates exchanges across several countries, including Sweden, Denmark, Finland, the Baltics and Iceland, the key to the Swedish market's success lies in its bottom-up development. Unlike many European markets, which are often built from a top-down approach, Sweden's capital market grew organically, with a strong foundation based on household participation. This broad engagement, including both large and small investors, has been essential to its resilience.

In Europe, there is often reluctance to acknowledge that risk-taking is necessary for generating returns. A major issue in the current European market is that too much capital is tied up in savings accounts, offering low returns and failing to stimulate the economy. Unlike the US, which built its market on risk, Europe remains overly cautious, resulting in underdeveloped capital markets. The EU needs to encourage greater participation in risk-taking to create returns and economic growth.

Sweden's approach to initial public offerings (IPOs) exemplifies this mindset, where even small companies with market caps as low as EUR 2 million can access public markets. This model fosters growth from the bottom up, giving businesses the opportunity to develop through public market access, regardless of their size. While this is not without its challenges – smaller IPOs struggle to attract institutional investors – it demonstrates the value of opening capital markets to companies of all sizes, enabling them to grow organically. Institutional capital is necessary to support smaller businesses, and pension capital, which plays a significant role in Sweden's market, must engage with a broad spectrum of companies to ensure sustainable local growth and innovation.

Between 2019 and Q2 2024, Swedish companies accounted for 66 % (or EUR 64 billion) of the total proceeds raised across all Nordic markets where Nasdaq operates. They also represented 71 % of the 931 companies that raised funds during this period, with most proceeds generated in secondary markets. Early-stage financing is facilitated by the First North Market, where 90 % of listings have valuations below EUR 1 billion. Since 2007, 130 companies from Fist North Market have successfully transitioned to the Main Market.

The Capital Markets Union (CMU) is vital to overcoming these challenges, as it aims to break down barriers and harmonise regulations across Europe. This will improve market efficiency, increase liquidity and promote cross-border investments. The CMU's potential lies in enabling businesses, particularly startups and SMEs, to access the finance they need for innovation and expansion. However, for the CMU to be successful, it must focus on reform rather than mere regulation. The EU must prioritise investments over savings and ensure that capital flows into markets that can create value, particularly in areas like the green and digital transitions.

A well-functioning financial ecosystem is essential for driving economic prosperity, job creation and innovation. Europe's competitiveness is currently hindered by complex regulations and fragmented markets, which limit businesses' ability to scale across borders. The CMU will only succeed if it encourages local and regional market development, with EU institutions amplifying efforts at the national level.

Sweden's approach to pension capital deployment offers another critical insight for Europe. While capital should be allowed to flow freely into global markets, there must be a commitment to supporting local businesses and innovation. In Sweden, pension capital is not limited to domestic markets but is deployed with the understanding that supporting local growth benefits the broader economy. This is essential to ensuring that Europe's capital markets remain dynamic, encouraging investment in smaller, high-potential companies that drive long-term economic growth. By fostering a balanced approach to capital deployment, Europe can cultivate a more competitive and resilient financial ecosystem.

Ultimately, Europe must shift its focus from regulating the markets to fostering innovation and growth. Public markets must be seen as a key vehicle for deploying risk capital, particularly for smaller and mid-sized companies. By doing so, Europe can develop a more dynamic and competitive capital market ecosystem that benefits businesses and investors alike.

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A 28TH REGIME FOR EUROPE'S CAPITAL MARKETS

Karel Lannoo
General Manager, ECMI & CEO, CEPS
Moderator

Christian Noyer
Honorary Governor, BANK OF FRANCE

Luca Filippa
Director General, CONSOB

Josina Kamerling
Head of Regulatory Outreach EMEA, CFA Institute

Europe's capital markets face significant challenges as the green and digital transitions demand an estimated EUR 700–800 billion annually over the next decade. Public budgets and traditional bank lending cannot meet this need alone, making private capital essential. However, structural and regulatory inefficiencies hinder the development of the integrated and efficient markets needed to address these challenges.

Retail investors are largely excluded from higher-return opportunities due to restrictive consumer protection rules. This stifles capital flows into innovative sectors, limiting economic growth. Expanding access to diversified investment products could significantly enhance private investment. Another bottleneck is the near elimination of Europe's securitisation market, a tool to recycle capital and fund businesses. Reviving securitisation, with safeguards to ensure transparency and investor confidence, could unlock up to EUR 300–400 billion annually.

Fragmentation further complicates Europe's capital markets. Firms operating across borders face a patchwork of national regulations, increasing costs and reducing efficiency. Harmonising rules to create pan-European products is essential for reducing duplication, streamlining operations and encouraging investment. A systematic approach, such as a 'supervisory efficiency test' for legislation like MiFID or UCITS, could determine the most effective supervisory structures – whether national, mutual recognition-based or supranational.

Taxation, governance and shareholder rights, deeply embedded in national frameworks, add to the complexity. Any harmonisation efforts must proceed cautiously to avoid disrupting established practices. The gradual transfer of responsibilities, drawing lessons from the banking union, could foster trust and reduce resistance.

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A cultural shift is also required in Europe's regulatory approach. Policymakers must balance harmonisation with fostering innovation and growth. Simplifying cross-border procedures for asset managers and aligning rules could lower compliance costs while maintaining investor protections. Efforts to standardise prospectuses, track integration through KPIs and enhance trust using AI tools could further improve market access and efficiency.

To address these structural challenges, establishing of a '28th regime' under the European Securities and Markets Authority (ESMA) is a promising solution. This optional framework would enable firms to opt into centralised supervision for certain activities, reducing administrative burdens and fostering pan-European financial products. By providing a single set of rules and a unified supervisor for cross-border operations, the 28th regime could enhance market efficiency and attract investment.

Implementing such a regime requires careful design to respect the principle of subsidiarity, allowing national authorities to oversee domestic markets while delegating cross-border and systemic issues to a central body. This balance is crucial, as capital markets differ significantly from banking, where centralised supervision under the Single Supervisory Mechanism (SSM) has been more straightforward.

A well-designed 28th regime could position Europe as a global leader in sustainable finance, mobilising private capital to meet its ambitious environmental and economic goals. Delays in reforming Europe's capital markets risk leaving untapped capital and missed opportunities for growth. Now is the time for Europe to act decisively, blending ambition with pragmatism to achieve a unified, efficient, and globally competitive capital market.

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THE TOKENISATION OF FINANCIAL ASSETS: A NEW FRONTIER IN CAPITAL MARKETS

Apostolos Thomadakis
Head of Research, ECMI
& Research Fellow, CEPS
Moderator

Heinz Konzett
Senior Legal Expert,
LIECHTENSTEIN STATE ADMINISTRATION

Tony Ashraf
Managing Director,
Digital Asset Transformation,
BLACKROCK

Nadine Wilke
Co-Founder & CGO,
PARTICULA

Erik Veerman
Senior Consultant
Market Infrastructures
Securities and Digital Assets,
ABN AMRO

The tokenisation of financial assets, which involves placing traditional securities on distributed ledger technology (DLT), is emerging as a transformative innovation for capital markets. By enhancing efficiency, improving transparency and broadening access to financial products, tokenisation has the potential to reshape financial ecosystems while addressing inefficiencies in traditional markets.

Tokenisation is seen as a natural progression in market evolution, akin to the transition from paper to electronic securities. It streamlines infrastructure, reduces costs and mitigates operational risks, all while boosting liquidity in underdeveloped or inefficient asset classes. Tokenised funds, fractional ownership of real estate and tokenised bonds demonstrate its capacity to democratise finance by offering new distribution channels and appealing to digital-native investors. It also provides significant opportunities in niche markets like carbon credits and private credit, where traditional systems often fall short.

Despite its promise, several challenges hinder the widespread adoption of tokenisation. Regulatory frameworks, particularly in Europe, impose significant restrictions. For example, the Central Securities Depositories Regulation (CSDR) mandates the use of traditional book-entry systems, which limits the integration of blockchain-based solutions. Additionally, a lack of standardisation and interoperability between private and public blockchains complicates implementation efforts. While tokenisation shows promise in niche areas, the effectiveness of current financial systems for mainstream asset classes, such as stocks and bonds, diminishes its appeal. Furthermore, limited access to data on private blockchains restricts broader market participation and complicates risk assessment.

Globally, regions like Singapore, the UAE and the United States are taking the lead by adopting flexible regulatory approaches and investing in fintech innovation. In contrast, Europe – despite pioneering efforts such as Liechtenstein's Blockchain Act – faces the risk of falling behind unless it fosters a more supportive environment for tokenisation.

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To unlock tokenisation's full potential, several key steps are essential. Standardisation and collaboration across blockchain protocols are necessary to ensure seamless integration into existing financial systems, akin to the unifying role SWIFT plays in global payments. Enhanced education for stakeholders and greater investment in emerging technologies will also accelerate adoption. Infrastructure advancements, including unified ledgers and cash-on-chain innovations like stablecoins and central bank digital currencies (CBDCs), could also help to further scale up tokenisation and embed it into mainstream financial markets.

While adoption remains uneven, tokenisation has the capacity to transform capital markets, particularly in underserved sectors. Addressing regulatory, technological and operational barriers will enable a more efficient and inclusive financial ecosystem, redefining how markets operate and expanding opportunities for a broader range of participants.

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CORPORATE SUSTAINABILITY REPORTING AND THE COST OF GREEN COMPLIANCE

Apostolos Thomadakis
Head of Research, ECMI
& Research Fellow, CEPS
Moderator

Thomas Dodd
Team Leader,
Sustainability
Reporting,
DG FISMA

Chiara Del Prete
Sustainability
Reporting Technical
Expert Group Chair,
EFRAG

Bettina Grabmayr
Methodology and
Research Director,
ECOVADIS

Katrin Hummel
Professor of Accounting
and Reporting,
VIENNA UNIVERSITY OF
ECONOMICS AND
BUSINESS

Transparency in corporate sustainability reporting has become a key tool in managing the transition to a sustainable economy. By providing stakeholders with reliable data on environmental and social performance, sustainability reporting empowers informed decision-making and directs capital toward companies aligned with sustainability goals. The EU has been at the forefront of this effort, starting with the 2014 Non-Financial Reporting Directive (NFRD). However, limitations in scope and detail revealed gaps in the framework, prompting the adoption of the Corporate Sustainability Reporting Directive (CSRD) in 2021.

The CSRD significantly expands the scope of reporting requirements. While the NFRD primarily targeted large-listed companies, the CSRD includes SMEs and certain non-EU firms, aiming to harmonise and enhance sustainability data across a broader range of entities. Its ambition lies in ensuring high-quality, comparable information that benefits stakeholders by enabling investors, customers and partners to make better strategic decisions and helping companies identify and manage sustainability risks and opportunities internally.

The costs associated with sustainability reporting are a significant concern, particularly for SMEs. Unlike larger firms that have experience in complying with the NFRD, SMEs often lack the expertise and resources to meet the CSRD's detailed requirements. This has raised fears of reduced IPO activity and even delistings as smaller companies seek to avoid compliance complexities. However, the CSRD's phased implementation helps address these challenges. Larger firms, already familiar with sustainability reporting, will adopt the requirements first, setting a precedent and establishing best practices that smaller firms can then follow.

To further assist companies, the EU has developed comprehensive guidance, including sector-specific standards and materiality assessment tools. EFRAG, tasked with developing sustainability reporting standards, has provided practical resources such as flowcharts, illustrative examples and an online Q&A platform to address common concerns. Additionally, harmonisation with international frameworks like IFRS ensures companies operating in multiple jurisdictions can avoid duplicative reporting.

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The directive also recognises the challenges faced by SMEs, introducing voluntary reporting standards for non-listed SMEs while mandating reporting for listed SMEs only. This differentiation reflects the EU's acknowledgment of the discrepancies in reporting capacity between large firms and smaller ones. Voluntary standards are expected to help SMEs build their reporting capabilities gradually, preparing them for the growing demand for sustainability data from stakeholders.

Despite these challenges, the CSRD has the potential to transform how European companies approach sustainability, embedding it into the core of corporate strategy. It is more than a regulatory burden – it represents an opportunity for businesses to align their operations with long-term sustainability goals, fostering resilience, transparency, and value creation. Over time, as companies adapt and leverage the tools available, the directive can serve as a catalyst for sustainable growth and innovation, ensuring Europe remains a global leader in the transition to a sustainable economy.

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DANGEROUS LIAISONS? DEBT SUPPLY AND CONVENIENCE YIELD SPILLOVERS IN THE EURO AREA

Florencio Lopez de Silanes
Professor of Finance and
Dean of Academic Strategy,
SKEMA BUSINESS SCHOOL
Moderator

Matthias Gnewuch
Economist, Economic Risk Analysis,
EUROPEAN STABILITY MECHANISM
Author

Co-authors:

Cristian Arcidiacono
Ph.D. Candidate in
Economics,
UNIVERSITY OF BERN

Matthieu Bellon
Senior Economist,
Economic Risk Analysis,
EUROPEAN STABILITY
MECHANISM

The issuance of sovereign bonds by core European countries, such as Germany and France, has significant implications not only for their domestic economies but also for neighbouring countries. The authors of this year's ECMI Best Paper find that unexpected increases in bond issuance by a core euro area country tend to raise yields not only for the issuing country but also for other core countries, often on a near one-to-one basis. This spillover effect has critical implications for European fiscal coordination and common policies.

A key motivation for examining these dynamics lies in the relationship between sovereign interest rates and fiscal sustainability. Lower interest rates enable countries to manage debt burdens more effectively by reducing the cost of refinancing. While it is well-documented that increased debt issuance raises domestic interest rates, this research sheds light on the cross-border effects, where issuance in one core country (e.g. Germany) also raises yields in others (e.g. France). The mechanism behind this spillover is linked to the convenience yield of sovereign bonds, which reflects their liquidity, safety and resilience during economic downturns. When one country issues more bonds, investors may divert funds from neighbouring countries' bonds, raising their yields as well.

Interestingly, the spillover effect is less pronounced for non-core countries like Italy, Spain and Portugal. These bonds, lacking the same safe-haven status, exhibit different risk profiles and do not experience the same investor behaviour. This underscores the unique characteristics of core country bonds and their role in European financial stability.

From a policy perspective, the findings highlight the need for coordinated fiscal policies and common debt issuance rules in the EU. The spillovers act as a negative externality – when a country issues more debt, it benefits from the proceeds but shares part of the cost with others through higher yields. This creates an incentive for over-issuance, which could destabilise fiscal conditions across the eurozone. Strong fiscal rules are therefore necessary not only to prevent crises but also to ensure fair burden-sharing and maintain low interest rates across the region.

In summary, while sovereign bond issuance is a crucial fiscal tool, its broader implications for interest rates and fiscal policy coordination in Europe demand careful consideration. The findings reinforce the importance of common rules to mitigate negative externalities and promote stability across the euro area.

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