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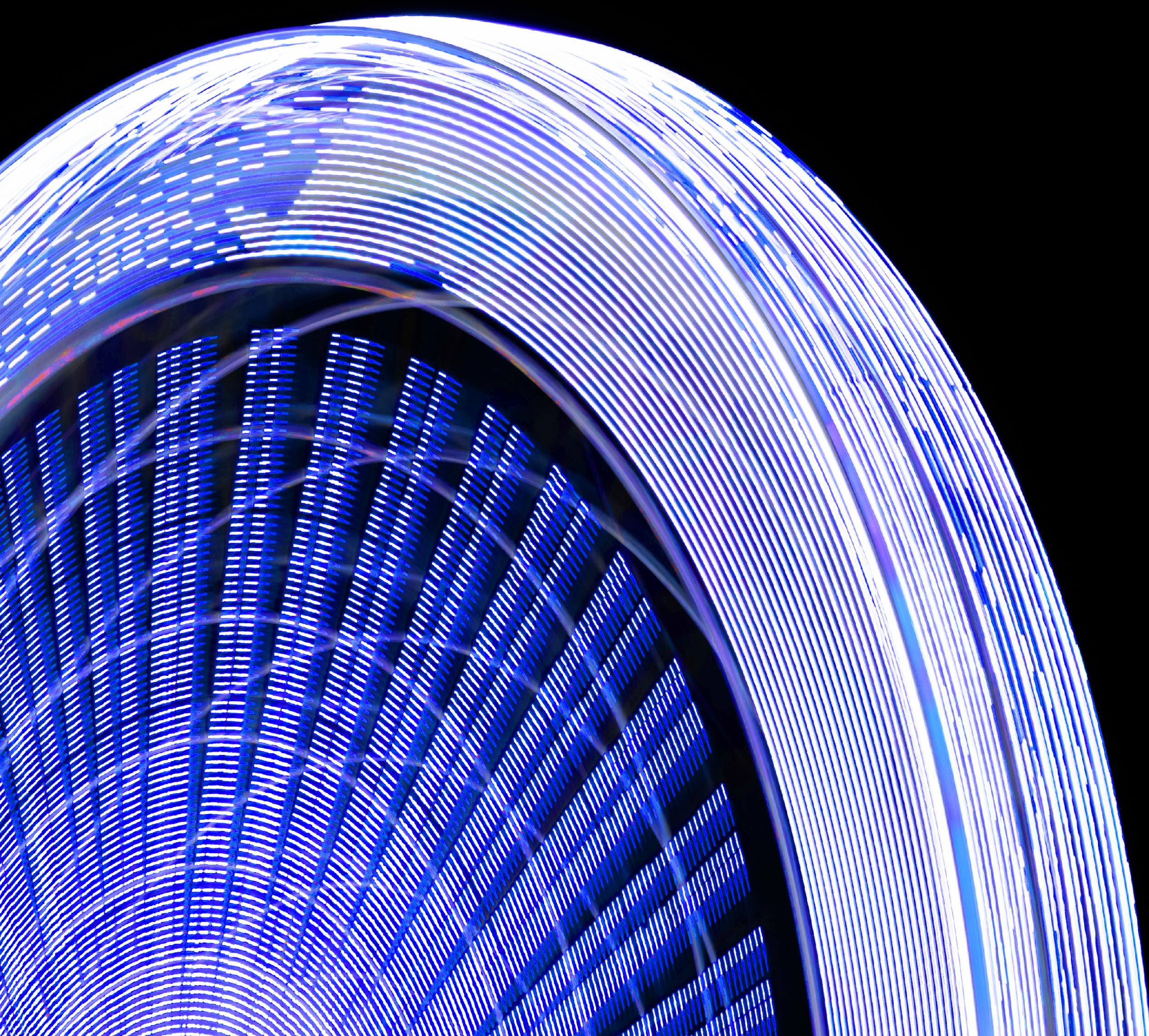
THE CAPITAL FLYWHEEL

European Capital Markets Report



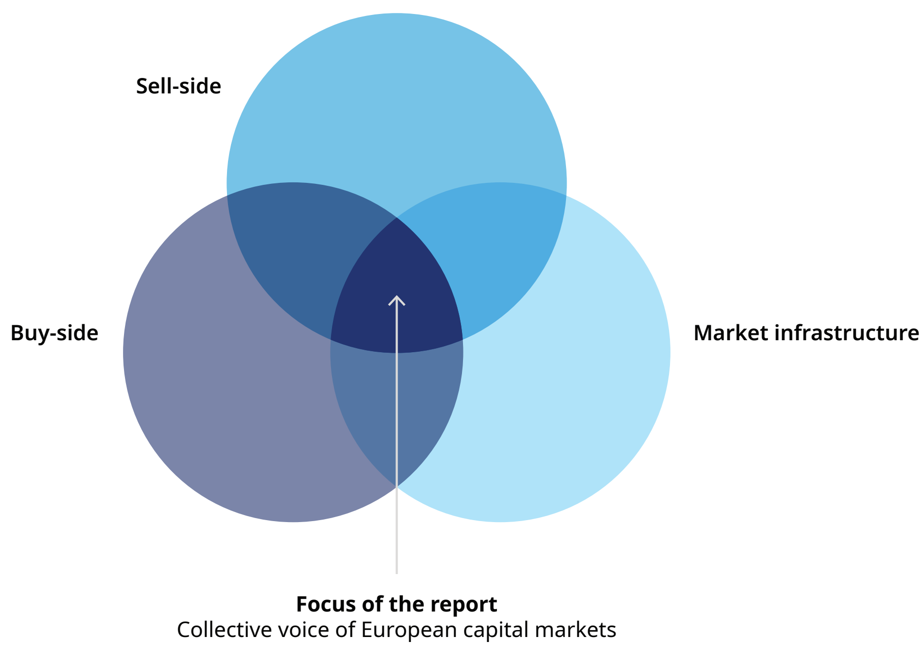
May 2024

This report sheds light on the development of European capital markets and provides recommendations on how to improve their competitiveness. It reviews progress made towards the capital markets union (CMU) and gathers insights from various capital markets participants on how to succeed in the coming decade.

The report has been authored by Oliver Wyman and is co-developed by the European Banking Federation (EBF), the European Fund and Asset Management Association (EFAMA), and Federation of European Securities Exchanges (FESE).

The findings of this report are informed by interviews with 37 senior industry stakeholders. Their feedback has been synthesized and simplified into a “collective voice” of European capital markets (Exhibit 1). We would like to thank all industry stakeholders for their time and participation.

Exhibit 1: Collective voice of European capital markets



Source: Oliver Wyman analysis

EXECUTIVE SUMMARY

European capital markets are losing their competitiveness, particularly when compared to the United States. This threatens to hold Europe back as capital markets are fundamental to finance innovation, deliver the funding needed for the green and digital transformations, and generate the necessary returns to support an ageing population.

Over the past decades, Europe has made significant efforts to develop well-functioning, harmonized, and resilient capital markets. Even as some country-level fragmentation remains, there are common rules, best-in-class regulations, and openness to global inflows. As an example, an investor in France can invest in a Greek company listed in Italy, at a reasonable cost, knowing they are getting a fair price, and that the trade will settle reliably. This has been achieved through considerable efforts by regulators and industry alike.

Between 2016 and 2022, Europe's equity capital market capitalization (as a share of GDP) rose from 48% to 66%, whereas in the US it increased from 104% to 157%. 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 time frame.

Europe is not using its capital markets infrastructure to its full potential. Europe has smaller overall capital pools than the US, with pension, insurance, and household assets amounting to six times GDP in the US, compared to only two to three times GDP in leading European economies like France, Germany, and Spain. It also invests far less of those assets through its capital markets, whether directly or indirectly, resulting in capital markets being over five times GDP in the US, compared to between one and two times GDP in the same large European economies. This is driven primarily by statutory pension systems that do not invest in capital markets, greater risk aversion of retail investors, and lack of appropriate incentives. Yet, countries like Sweden or Denmark show that one can operate leading capital markets within Europe with available capital pools and deployment to capital markets at rates similar to those of the US.

There is good news: Capital markets benefit from scale, and a "flywheel effect" exists. Deliberate demand-side and supply-side steps taken over the next five years can set the conditions that will build more momentum, attract additional investors, and create further investment opportunities.

To launch the flywheel, it is crucial to activate the demand side of capital markets. Europe needs to improve retail investors' access to attractive products and enhance their financial literacy to foster an investment culture. Also, Europe should incentivize retirement savings and create tax structures and vehicles conducive to long-term investments. European capital markets need to be promoted internationally, and accessibility for small- and medium-sized companies needs to be improved, to increase their attractiveness to global investors. Ultimately, these different measures must improve investor outcomes.

To maintain a self-reinforcing dynamic, Europe has to continue improving the supply side, too. Developing an integrated and harmonized single market should continue to be a primary goal, accompanied by reforming regulations with a balanced approach, maintaining the leadership in sustainable finance and boosting securitization markets. Achieving this will require greater collaboration between public and private sectors and leveraging new opportunities enabled by technology. Preserving a diverse range of funding sources for the economy, both in the short and the long-term, is also a factor of resilience of the EU capital markets.

While further supply-side measures to improve the functioning of capital markets are necessary, those measures alone are no longer sufficient. Europe needs to grow and deploy its pools of available capital. Without an influx of more capital, Europe's capital markets will continue to underperform and productivity growth and the green and digital transformation in Europe will inevitably be slower than in other regions.

EUROPEAN CAPITAL MARKETS ARE FALLING BEHIND

Europe's capital markets, by and large, function well. There are common rules, best-in-class regulations, and world-class institutions. European capital markets have successfully spearheaded initiatives such as the undertaking for collective investment in transferable securities (UCITS) regulatory framework and the recently adopted European Green Bond Standard. UCITS has gained global recognition for its robust investor protection features and transparency standards, contributing to the growth and development of European capital markets, and positioning Europe as a leading hub for investment fund activities. The European green bond standard (EuGB) seeks to boost sustainable finance by providing a clear framework for green bond issuances, further solidifying Europe's position as a leader in the green finance space.

Despite these encouraging developments, the key performance indicators for primary and secondary markets in Europe are lagging behind those of the United States. Since 2016, Europe's competitiveness gap versus the US has continued to widen (see Exhibit 2).

Primary markets

Equity funding relative to GDP has increased in both the US and Europe. However, the gap between Europe and the US stands at almost 100% and has become larger. Corporate debt funding has decreased on both sides of the Atlantic, and whilst funding conditions are better in the US, the gap between Europe and the US has remained relatively stable.

Secondary markets

Liquidity in EU equity markets has been relatively stable but has increased in the US, creating a large gap of 193% between the two regions (equity turnover of 227% in the US vs. 34% in Europe). In corporate debt markets, there is also a substantial gap in liquidity between the EU and the US, but over the past years, this gap has remained relatively constant. Furthermore, there is a significant gap between the US and Europe in derivatives markets, as well as global FX and commodity markets, that continues to grow.

Exhibit 2: US and European capital market
2016-2022

		EU27		US	
		2016	2022	2016	2022
Primary market	Equity funding (% GDP)	48%	66%	104%	157%
	Corp. debt funding (% GDP)	74%	69%	100%	96%
Secondary market	Equity turnover velocity	68%	52%	145%	145%
	Equity turnover (% of GDP)	33%	34%	151%	227%
	Corp. debt turnover velocity	21%	20%	40%	39%
	Corp. debt turnover (% of GDP)	16%	14%	40%	37%
	Notional value traded (x cash securities)	3x	2x	32x	32x
	Notional value traded (x GDP)	3x	3x	80x	82x
	Market share of global FX market	11%	8%	20%	19%
	Market share of global commodity market	<1%	<1%	60%	39%

Source: Oliver Wyman analysis (full list of data and sources provided in Appendix B)

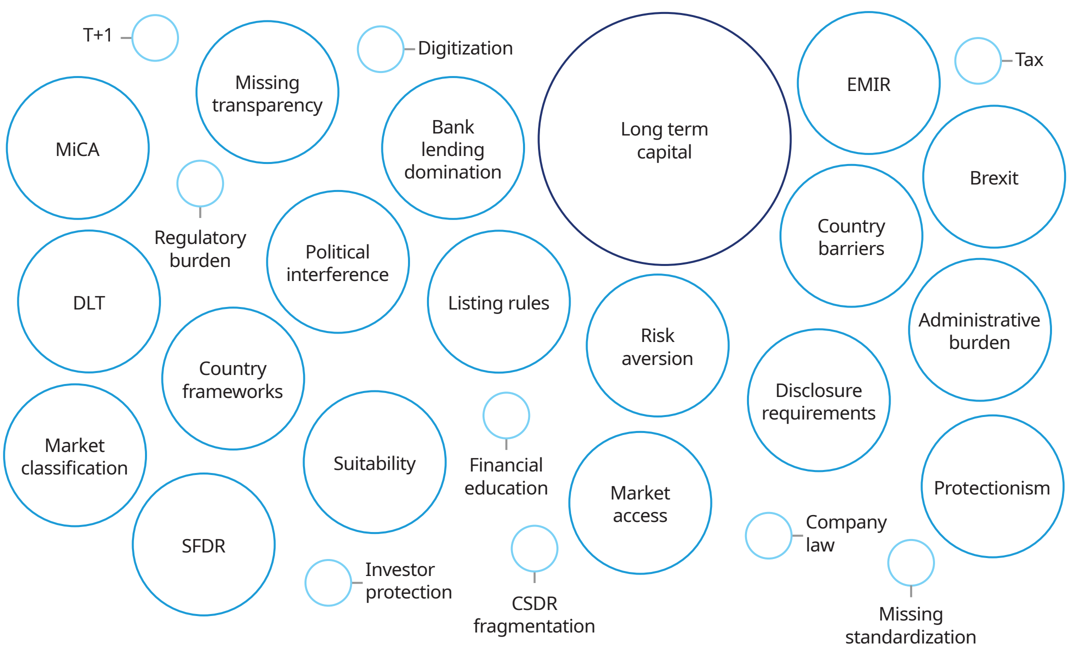
BUILT, YET UNDERUSED

What are the underlying reasons for the competitiveness gap between European and US capital markets?

Supply and demand

The gap between European and US capital markets can be attributed to both supply-side issues (impacting the activities of sell-side, buy-side and market infrastructures) and demand-side issues (touching on the activities of retail or institutional investors), as seen in Exhibit 3 which summarizes industry views. However, if there is one theme that market participants consistently stressed, it is the lack of long-term capital allocated to European capital markets by Europe's retail and institutional investors.

Exhibit 3: Reasons stated for lower competitiveness by industry stakeholders in interviews



Source: Oliver Wyman analysis

Available capital for investment in the US outstrips Europe

In the US, the assets available for investment, across all types of long-term investors (households, pension funds, and insurance companies) amount to 622% of GDP. Some European countries close to US levels include Denmark (654%) and Sweden (483%), both smaller countries with a strong long-term capital market investor base. At the same time, some major European economies lag significantly behind with 200% to 300% of GDP available for investment. Exhibit 4 shows the allocation of capital pools to capital markets across countries.

Of the available capital, US investors allocate more towards capital markets

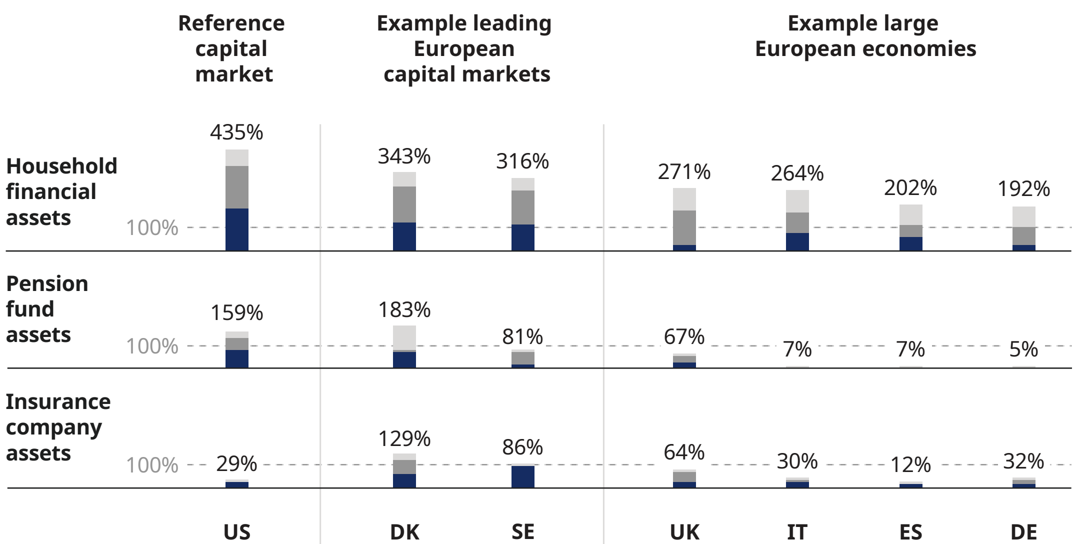
Not only are there more available assets in the US, but a far larger share are invested into capital markets. Investment types can be categorized into three groups:

- **Direct capital markets:** Shares/equity; bills and bonds; other securities
- **Indirect capital markets:** Investment funds/collective investment schemes; private equity funds; hedge funds; pension funds; insurance products
- **Non-capital markets:** Currency and deposits; land and buildings; loans

When it comes to direct investments into capital markets, the US far exceeds major European economies at 288% of GDP compared to 40% to 100% of GDP. Indirect capital market allocations are also higher in the US, despite Europe's mature investment fund industry. Overall, the US allocates 525% of GDP into capital markets, compared to 130% to 200% for the major EU economies.

Exhibit 4: Allocation of capital pools to capital markets in comparison to GDP

By investor type, 2022, 100% = GDP



	US	DK	SE	UK	IT	ES	DE
Total assets available for investment	**624%**	**654%**	**483%**	**402%**	**301%**	**221%**	**229%**
Direct capital market investments	288%	252%	217%	76%	103%	74%	43%
Direct and indirect capital market investm.	525%	468%	411%	297%	200%	131%	141%

Direct capital market · Indirect capital market · Non-capital market

Source: Oliver Wyman analysis (full list of data and sources provided in Appendix B)

ACTIVATING THE CAPITAL FLYWHEEL

Reaching US levels of investment in capital markets would require an additional €35 trillion of capital in Germany, Italy and Spain alone. To put this into perspective, the equity market capitalization of the entire European Union was €13 trillion in 2022.

There is good news: capital markets benefit from scale, and a “flywheel effect” exists. Deliberate demand-side and supply-side steps taken over the next five years can set the conditions that will build more momentum, increase the number and diversity of investment opportunities, and ultimately attract investors. This is shown in Exhibit 5.

Growing European long-term capital pools, and having those pools invested in capital markets, will naturally improve the depth, liquidity, and size of European capital markets. With deeper markets, company valuations will grow, and more international capital will flow into Europe reinforced by the increasing importance of global benchmarks and passive investing. These increased inflows will, in turn, attract more issuers across equity and debt markets, both public and private. This linkage has the potential to start a self-reinforcing trend, which we call the ”capital flywheel”.

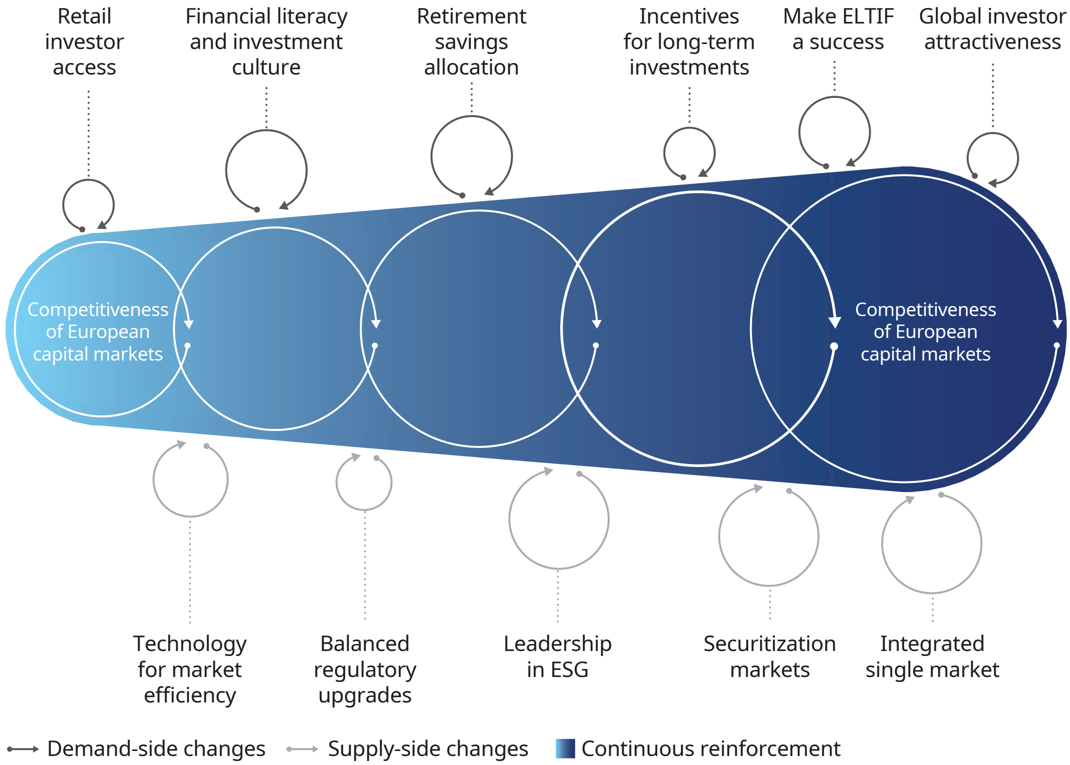
We need to attract more long-term investors in Europe and ensure a greater proportion of European savings are invested in European capital markets.

Eric Litvack, Managing Director and
Group Director of Public Affairs, Société Génerale

It is essential to mobilise more savings to invest in the European economy and finance in particular the green and digital transitions. Fostering pension and long-term investment solutions offered to retail investors with incentives (such as tax) would send the right signal.

Simon Janin, Head of Governance and Public Affairs, Amundi

Exhibit 5: Capital Flywheel for Europe



Source: Oliver Wyman analysis

Today, there are clear trends working against Europe's capital markets. Many European companies are incentivized to move overseas when they decide to go public. Listing conditions and growth potential are viewed as more favorable as they will encounter a less fragmented regulatory framework and can achieve higher valuations due to larger pools of available capital. In turn, this reduces investment opportunities locally and capital allocations to the region. A fragmented regulatory environment hinders not only the functioning of our markets but also the ability of our companies to stay in Europe and compete globally.

Setting virtuous cycles in motion on both the demand and the supply side is necessary to ensure that the flywheel can sustain its momentum and generate its full impact.

Addressing the challenges of pension systems and creating more capital pools are crucial for sustainable growth and financial stability in Europe.

Christoph Boschan, CEO, Wiener Boerse

RECOMMENDATIONS

European capital markets can be improved but already have the functionality needed to support efficient capital allocation. Demand-side measures, focused on allocating more capital to European capital markets, will be needed to kick-start the capital flywheel and get European capital markets to the levels of other regions. Exhibit 6 sets out market participants' key recommendations.

Exhibit 6: Demand-side measures to activate the capital flywheel

Improve retail investors access	Maintain access to affordable and high-quality financial advice and a vast range of products and services, simplify investor disclosures making full use of digital tools, and prevent excessive regulation that could hinder market development.
Improve financial literacy and foster an investment culture	Expand the scope of financial education programs, being more explicit when communicating the benefits of investing.
Promote retirement and long-term savings	Establish pension tracking systems, support Member States auto enrollment schemes in market-based occupational pensions, undertake a review of the public employees pension plan (PEPP) regulation to fix the issues faced by PEPP providers.
Create incentives for long-term investments	Promote tax and regulatory incentives for insurance and pension funds to invest in the EU's real economy, for example by encouraging tax-deductibility for long-term investments (equity, debt, infrastructures, etc.).
Foster investment diversity	Uphold the positive momentum around European Long-Term Investment Funds (ELTIF) 2.0 to broaden the investor base in non-listed assets, promote alternative investment strategies like venture capital.
Remain attractive to global investors	Foster transparency of capital markets, regulatory harmonization, reduce barriers for cross-border investments, raise the accessibility of smaller European markets and the profile of SMEs.

Source: Oliver Wyman analysis

Starting the capital flywheel will increase the competitiveness of European markets, products, and players. Yet, to maintain the self-reinforcing dynamic of the capital flywheel, European capital markets must be steadily improved and modernized as expectations and technology also evolve. Exhibit 7 sets out the key recommendations.

We need to overcome fragmentation in Europe via harmonization of rules and deployment of technology to make investing easier and more transparent.

Stéphane Boujnah, CEO, Euronext

Exhibit 7: Supply-side measures to sustain the self-reinforcing dynamics of the capital flywheel

Develop an integrated and harmonized single market	Reduce complexity and costs of accessing and using European capital markets, facilitate cross-border exercise of voting rights, and establish better-integrated rules for accounting, withholding taxes, and insolvency laws.
Streamline regulation and reduce red tape	Focus on better implementation of existing regulation, foster convergence of supervisory practices, conduct mandatory competitiveness checks for new regulation, analyze the cumulative effect of regulations.
Use technology to improve market efficiency	Level the playing field between digital and traditional capital markets; improve markets by delivering an efficient consolidated tape; further harmonize data standards and facilitate data-sharing; deploy new technologies like AI, DLT, or wholesale CBDC; create sandboxes for the safe application of new technologies in capital markets.
Maintain leadership in ESG	Increase regulatory pragmatism and use of principle-based guidelines to maintain Europe's leadership position without overshooting.
Boost EU securitization markets	Re-calibrate risk sensitivities and capital treatments to increase the appeal of securitised assets.

Source: Oliver Wyman analysis

Achieving a change of this scale for European capital markets will be a big, long-term effort and requires a coordinated effort involving policymakers, companies, investors, and industry associations.

We need to revamp EU securitization markets to increase markets-based debt financing and multiply financing capacity available via bank balance sheets.

Zeynep Ozturk, Head of Banking, Lending and Investment Solutions
Central Europe and US, Deutsche Bank

Reducing barriers for cross-border investments and fostering harmonised rules, notably in post-trade processes, is essential to sustain the attractiveness of European capital markets.

Sébastien Renaud, Head of Regulatory Change,
Pictet Asset Management

APPENDIX A. SURVEY METHODOLOGY

The core of this report is based on 37 interviews with senior stakeholders within European capital markets, who work across the asset management, banking and market infrastructure sectors (see Exhibit 8).

Exhibit 8: Participating organisations

- Amundi
- Allianz Global Investors
- AXA Investment Managers
- Bank of America
- Barclays
- Baillie Gifford
- Blackrock
- BNPP Asset Management
- BNY Mellon
- Börse Stuttgart
- Budapest Stock Exchange
- Bulgaria Stock Exchange
- CIBC Capital Markets (Europe) S.A.
- Citadel
- Deutsche Bank
- Deutsche Börse
- DWS
- Euronext
- Fidelity
- Invesco
- Luxembourg Stock Exchange
- Malta Stock Exchange
- M&G
- NASDAQ
- Optiver
- Pictet
- Prague Stock Exchange
- SE Sofia
- SIX Group
- Susquehanna International Group
- Société Générale
- TD Securities
- UBS
- UniCredit
- Virtu
- Wiener Stock Exchange
- Zagreb Stock Exchange

As part of each interview, we conducted a survey with market participants to capture their views across ten key themes impacting capital markets.

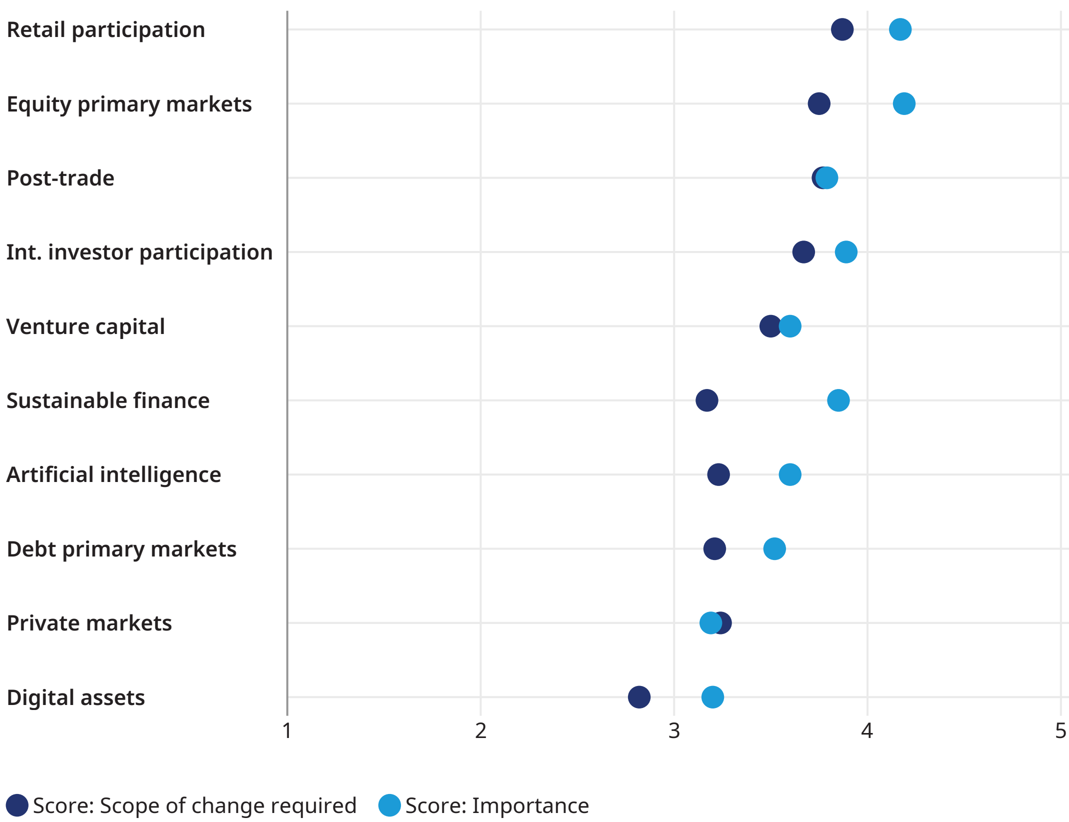
1. Direct/indirect retail participation
2. International investor participation
3. Equity primary market reform
4. Debt primary market reform
5. Venture capital and growth financing
6. Private markets
7. Post-trade
8. Sustainable finance
9. Digital assets
10. Artificial intelligence

In addition, market participants were asked to discuss the competitiveness of European capital markets from the perspective of each theme and then provide a rating from 1 (low) to 5 (high) on two dimensions:

- How much change is required for European capital markets to become competitive?
- How important is this theme for the competitiveness of European capital markets?

Exhibit 9 shows the resulting assessments by the interview participants.

Exhibit 9: Survey results



Source: Oliver Wyman analysis

APPENDIX B. DATA SOURCES

The calculations conducted for this report are based on data inputs from a variety of data providers. The data providers encompass international and development organizations, economic and statistical institutes, financial markets associations as well as media and analytics companies. Providers were selected based on their data quality, reputation, and trustworthiness in the market.

Exhibit 10 provides an overview of all data providers and the respective data used.

Exhibit 10: Data sources

Data provider	Used data	Data source	Exhibit
Bank for International Settlements (BIS)	• Debt securities outstanding by residence and sector of issuer • Turnover of OTC foreign exchange instruments and on exchange-traded futures and options	• BIS Debt Statistics and BIS Triennial Derivatives Statistics – stats.bis.org:8089/statx/srs/table/c1?f=xlsx – stats.bis.org:8089/statx/srs/table/d11.2?f=xlsx – stats.bis.org:8089/statx/srs/table/d2?f=xlsx	Exhibit 2
The International Capital Market Association (ICMA)	• Corporate Bond Traded Volumes in the EU	• ICMA, Secondary Market Practices Committee: European Secondary Bond Market Data (www.icmagroup.org/assets/SMPC-Secondary-Market-Bond-Data-H2-2022.pdf and www.icmagroup.org for more information)	Exhibit 2
LSEG Datastream	• GDP data (current prices) • FX rates	• LSEG Datastream/Oxford Economics GDP current prices • LSEG Datastream/WMR	Exhibit 2
Organisation for Economic Co-operation and Development (OECD)	• OECD data and statistics – Pensions and insurance (household financial assets, pension fund investments, investment by insurance companies) data – GDP and population per country	• data.oecd.org/hha/household-financial-assets.htm • www.oecd-ilibrary.org/finance-and-investment/data/oecd-pensions-statistics/pensions-statistics_data-00517-en • stats.oecd.org/index.aspx?DataSetCode=PT6 • data.oecd.org/gdp/gross-domestic-product-gdp.htm • data.oecd.org/pop/population.htm	Exhibit 4
Oxford Economics	• GDP (at current prices) for EU, and the US	• Through LSEG Datastream as per 1.3.2024	Exhibit 2

Data provider	Used data	Data source	Exhibit
Securities Industry and Financial Markets Association (SIFMA)	• Corporate bonds trading volume in the US	• SIFMA, FINRA TRACE and the Federal Reserve	Exhibit 2
Statistics Sweden	• Sweden-specific capital allocation figures	• www.scb.se/en/	Exhibit 4
TRAX	• Corporate Bond Traded Volumes in the EU	• Raw data from TRAX / iTRAX accessed through ICMA and European Commission reports – www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/ICMA-SMPC-report-Secondary-Market-Bond-Data-270423.pdf, page 36 – finance.ec.europa.eu/system/files/2017-11/171120-corporate-bonds-analytical-report_en.pdf, page 41	Exhibit 2
World Federation of Exchanges (WFE)	• Domestic market capitalization • Equity market value traded • Value of commodity and FX derivatives transactions	• World Federation of Exchanges, Annual Statistics Guide 2016 and 2022	Exhibit 2

Note: Online sources retrieved on 1. March 2024

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About EBF

The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from 45 countries. The EBF is committed to a thriving European economy that is underpinned by a stable, secure and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere. Website: www.ebf.eu Twitter: @EBFeu.

About EFAMA

EFAMA is the voice of the European investment management industry, which manages around €28.6 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book. More information is available at www.efama.org.

About FESE

The Federation of European Securities Exchanges (FESE) represents 35 exchanges in equities, bonds, derivatives and commodities through 16 Full Members and 1 Affiliate Member from 30 countries. At the end of 2023, FESE members had 6,726 companies listed on their markets, of which 18% are foreign companies contributing towards European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium-sized companies across Europe to access capital markets; 1,461 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their regulated market and multilateral trading facility operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union. FESE is registered in the European Union Transparency Register: 71488206456-23.

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