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NEW FINANCIAL Rethinking capital markets

THE BENEFITS OF CAPITAL MARKETS TO HIGH POTENTIAL EU ECONOMIES

ANALYSIS OF THE GROWTH OPPORTUNITY FOR CAPITAL MARKETS IN CENTRAL AND EASTERN EUROPE

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> Deeper capital markets in Central and Eastern Europe could unlock more than €200bn in long-term capital, deliver more than €40bn a year in extra funding for companies, and help restore rapid economic growth across the region

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2) Introduction

The benefits of capital markets to high potential EU economies

This report is a collaboration between New Financial and AFME (the Association for Financial Markets in Europe) and analyses the potential role and benefits of deeper capital markets in the high potential economies in Central and Eastern Europe. The report is structured as follows:

- pages 4 to 8 examine closely linked developments in the EU11 economy and financial system
- pages 9 to 11 discuss the economic structure and business environment in the EU11
- pages 12 to 20 measure the size and depth of EU11 capital markets and estimate their growth potential based on a stretching but achievable benchmark.

Throughout the report we discuss the extensive efforts of national governments and local market participants to encourage the development of capital markets, and the challenges they are addressing. Page 3 summarises our main findings and page 22 makes some policy proposals for further growth.

AFME advocates stable, competitive and sustainable financial markets in Europe that support economic growth and benefit society. New Financial believes that Europe needs bigger and better capital markets to help drive its recovery and growth. Nowhere is this more important than in Central and Eastern Europe, where despite significant progress over the past 25 years, capital markets are much less developed than in the rest of the EU. We have called the 11 countries in this study 'high potential economies': they have lower GDP per capita than the EU average, but before the financial crisis this was converging rapidly with the rest of the EU as they generated significantly higher growth in GDP and productivity than more developed EU economies. This report argues that capital markets can help get that productivity and GDP growth back on track.

Methodology:
The report analyses the depth of capital markets relative to GDP across 23 different metrics – from pensions and insurance assets, to stock and bond markets and venture capital – in 11 EU member states:

The Visegrad 4:	Czech Republic, Hungary, Poland, and Slovakia
The Balkans:	Bulgaria, Croatia, Romania and Slovenia
The Baltics:	Estonia, Latvia, Lithuania

We refer to these countries throughout the report as the EU11 or HPEs. While each country is different, in many cases their similarities in the depth of capital markets, economic challenges and historical context are far more striking than the differences between them. Between them, they account for 20% of the EU's population, 8% of its GDP, but just 2.5% of capital markets activity.

The report addresses some of the following questions:

- How developed are EU11 capital markets? And how reliant are the EU11 on bank lending?
- What was the impact of the financial crisis on the EU11 economies?
- What is the growth potential of capital markets in the EU11?
- What are the main obstacles to developing capital markets in the EU11 and what initiatives are already underway?
- How can the EU, national governments, and market participants promote further development?

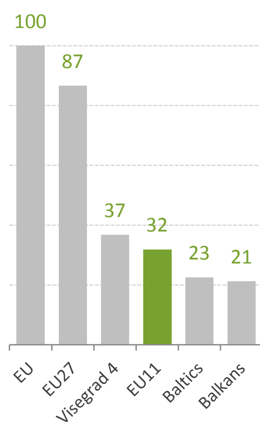
Acknowledgements:
We would like to thank Dealogic and Preqin for their valuable help with some of the data and our members for their support. We would also like to thank individuals at the following organisations who agreed to be interviewed for this project, including: CEESEG, Elite, Erste Asset Management, the EBRD, European Commission, Invest Europe, Lithuanian Financial Markets Institute, Nasdaq Baltic, SEB and UniCredit; as well as government officials in Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania and Slovenia.

This report is a work in progress on a broad and vital topic. We would welcome feedback on the results.

3) Summary

Fig.1 Relative depth of capital markets in the EU

(23 sectors, relative to GDP, 100 = EU in 3 years to 2015)



Source: New Financial

Unlocking capital markets in the EU11

The high potential economies in the EU11 could benefit significantly from more developed capital markets. Here is a summary of the main findings of this report:

1. Economic growth in the EU11 has virtually halved since the financial crisis, productivity growth has slowed, and the rate of convergence with the rest of the EU has stalled. EU11 countries with deeper capital markets and larger pools of long-term capital have seen less shrinkage in GDP and productivity growth rates since the crisis.

2. The slowdown in GDP and productivity growth in the EU11 since the crisis coincided with a falling investment rate. EU11 corporates largely rely on internal profit generation to fund their expansion. Greater access to external funding, particularly from the capital markets, could spur more investment and raise the sustainable growth rate.

3. The EU11 economies have made sustained progress over the past 25 years. Today, their capital markets are around one third as developed as in the EU as a whole when measured across 23 different sectors of activity relative to GDP (see Fig.1). Capital markets in the Balkans and Baltic states are about one fifth as deep as the EU average.

4. Companies in the EU11 are more heavily reliant on bank lending than in the rest of the EU. Bank lending represents 85% of corporate debt compared with 75% in the EU; however the flow of new bank lending has fallen by nearly 30% since the financial crisis as foreign banks reduced their exposure to EU11 markets.

5. The pools of capital in the EU11, particularly pensions and insurance assets, are only one third as large relative to GDP as the rest of the EU, with households making more use of cash deposits for their savings. Lower personal disposable income in the EU11 helps to explain lower savings rates and smaller investment pools.

6. Overall, capital markets in the EU11 have shrunk relative to GDP by a fifth since 2006. EU11 bond markets have more than doubled relative to GDP over the past decade but equity markets have shrunk significantly in relative and absolute terms.

7. The potential growth opportunity in EU11 capital markets is huge: if each country had markets as deep as the 'best in class' (the most developed country in the EU11 in each of the 23 sectors we analysed) it would mean an extra €225bn in pensions and insurance assets to put to work in the EU11 (about 20% of GDP), and annual flows of financing for companies in the EU11 of around €45bn (4% of GDP).

8. There are range of obstacles to developing capital markets in the EU11, including the relative ease of accessing bank funding, limited market breadth and liquidity, the relatively smaller size of firms, fragmented market infrastructure, and public policy.

9. National governments, market participants and international bodies are active on a number of initiatives to boost capital markets, including regional cooperation, investor education, and legislative reform. Several EU11 governments now have defined programmes in place to develop their domestic capital market.

10. The CMU project has pushed capital markets up the political agenda in the EU11 and could help remove barriers to cross-border investment. The EU should focus on how best to tailor CMU to benefit those countries with less developed capital markets.

4) The impact of the financial crisis on economic growth

A brake on growth

The financial crisis hit the economies of the EU11 harder than most of the rest of the EU, and had a significant impact on economic growth, productivity, and the convergence of the EU11 members states with the rest of the EU.

While average GDP growth of 3.2% in the EU11 economies has outstripped the 1.1% in the rest of the EU over the past 15 years, this disguises the impact of the crisis. In the four years before the financial crisis, average GDP growth in the EU11 was 6.4%, double the EU average. But since 2010, growth in the EU11 has slowed to 1.9% a year, compared with 1.0% for the rest of the EU (see Fig.2).

In 2009, EU11 economies slumped by 7% (with the Baltic economies shrinking by 14%), a much deeper fall than the 4% fall in the rest of the EU.

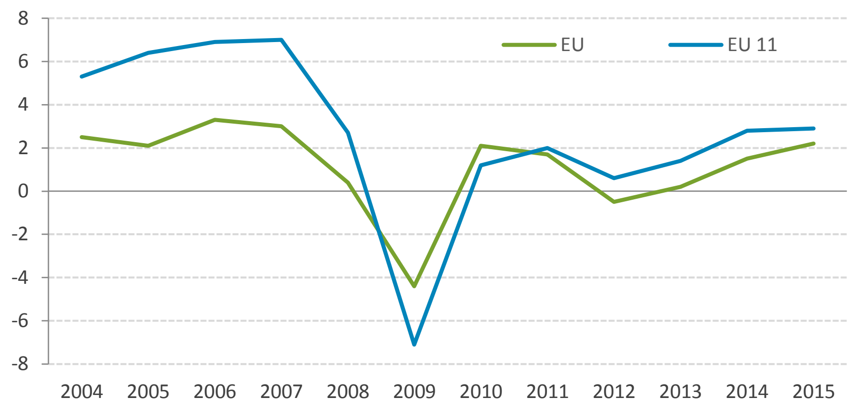
The crisis has also hit productivity (see Fig.3). In the four years before the crisis, median total factor productivity growth in the EU11 was 2.5%, three times the level of the rest of the EU, but productivity growth has slowed dramatically since 2008.

Slowing convergence

The net effect of lower growth and slowing productivity growth is that the convergence of the EU11 economies with the rest of the EU has decelerated (see Fig.4). In the seven years before the crisis, average GDP per capita in the EU11 rose from 28% of the EU average to 37%, an increase of 1.1 percentage points a year. Since the crisis, even though GDP per capita in the EU has flatlined, the rate of convergence in the EU11 has halved to an average of 0.5 percentage points a year.

Fig.2 Economic growth in the EU before and after the crisis

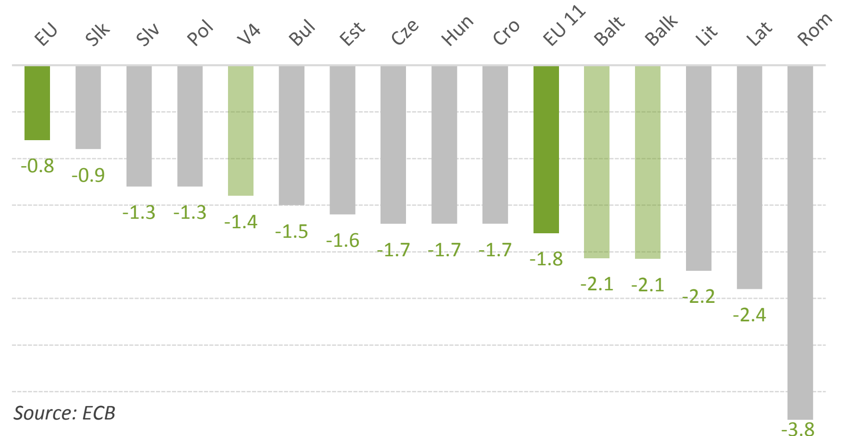
Annual GDP growth in the EU and EU11 economies 2004 to 2015 %



Source: Eurostat

Fig.3 The change in productivity since the financial crisis

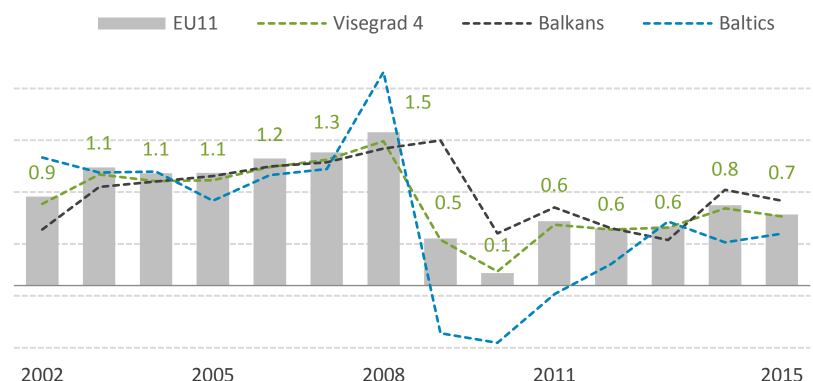
Absolute change in total factor productivity growth: 2008-2013 vs 2000-2007 %



Source: ECB

Fig.4 The slowdown in convergence since the crisis

The annual convergence rate in GDP per capita in the EU11 vs rest of EU (percentage points)



Source: Eurostat

5) The relationship between capital markets depth and growth

Dependence on bank lending

The dependence of the EU11 economies on bank lending (see page 8) appears to have been a significant drag on economic growth and recovery since the financial crisis.

Those economies in the EU11 that were most reliant on bank lending rather than corporate bonds and stockmarkets were hit harder than others (see Fig.5) and have recovered more slowly. And those countries which went into the crisis more reliant on bank lending (measured as a percentage of GDP) have seen the most rapid deleveraging since the crisis.

The scale of banks in the EU11 does not appear to be the problem. Across the EU11, bank assets were valued at 90% of GDP in 2015, according to the ECB; a little up from 88% in 2008. This is well below the EU average of nearly 300%. It is also clearly below the 100% of GDP threshold, above which the IMF argues the banking system can act as a drag on growth.

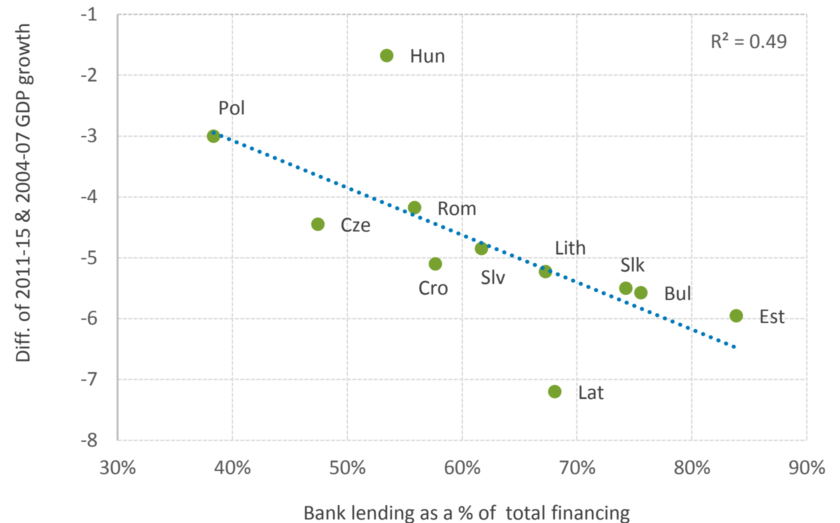
Building the foundations

Instead, the problem appears to be the reliance on bank lending relative to other financing channels. For example, countries that went into the crisis with larger pools of long-term capital (as measured by the value of pensions and insurance assets relative to GDP) have seen less shrinkage in GDP growth rates in the period since the crisis (see Fig.6).

For example, pensions and insurance assets in Latvia (in the bottom left hand corner of Fig.6) were less than 2% of GDP before the financial crisis (compared with an EU average of 84%), and its GDP growth rate has fallen from more than 10% pre-crisis to less than 4% since.

Fig.5 The impact of the crisis vs reliance on bank lending

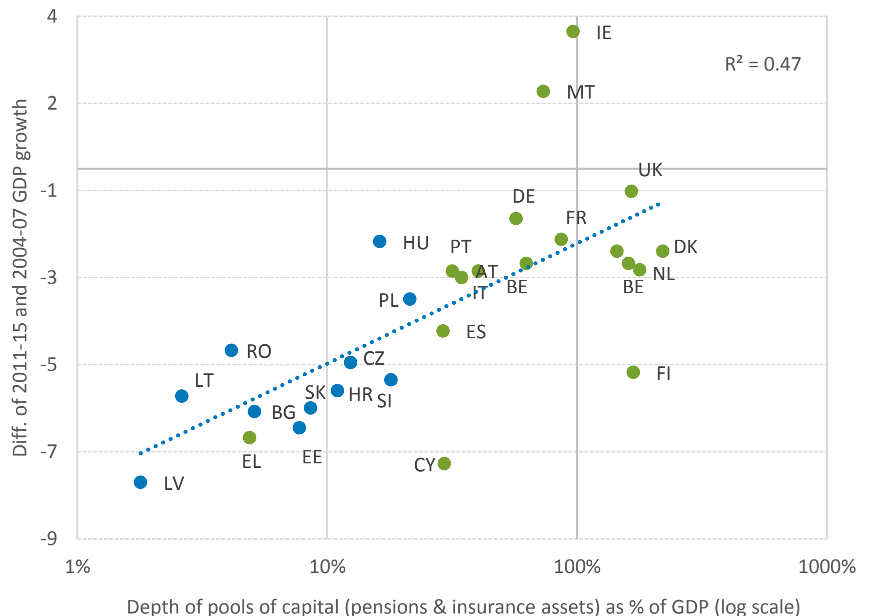
Change in GDP growth pre- and post-crisis relative to reliance on bank lending



Source: ECB, AFME

Fig.6 Shallow pools of capital

Value of pensions & insurance assets as % of GDP vs change in GDP growth rates since crisis

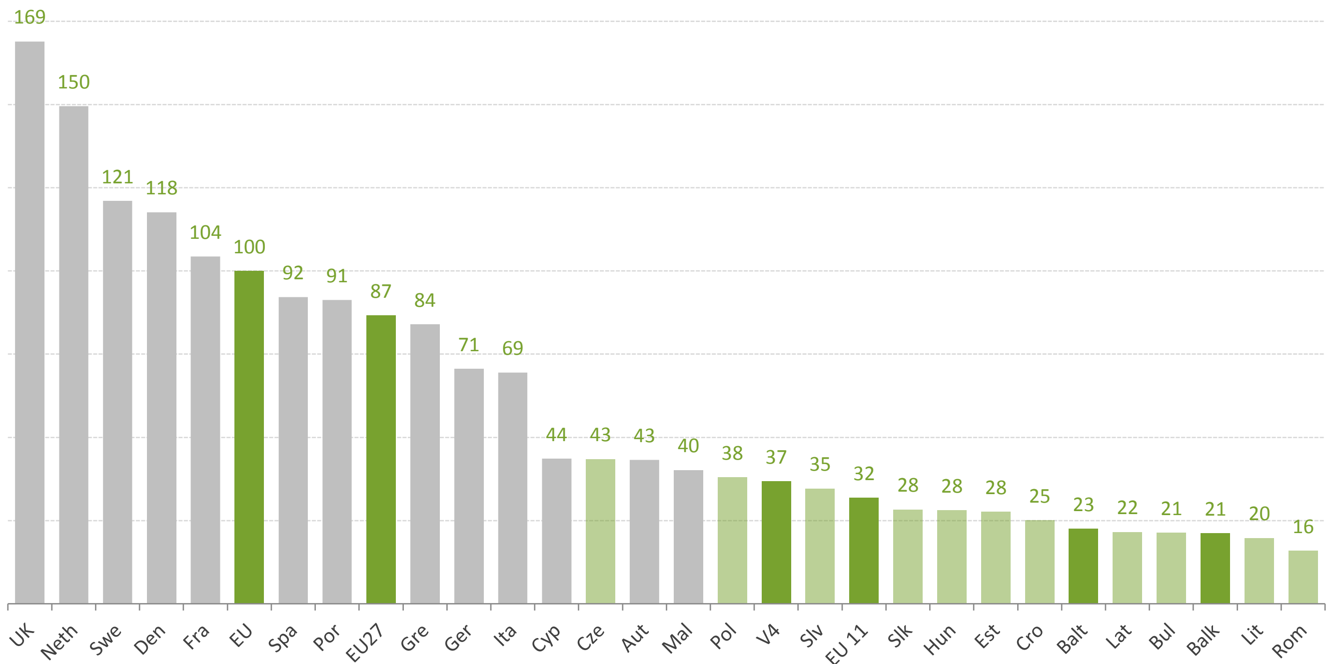


Source: ECB, New Financial, AFME

6) How developed are capital markets in the EU11?

Fig.7 The range in depth of capital markets in the EU

The relative depth of capital markets in different countries across 23 different sectors over the past three years, relative to GDP
Rebased to EU = 100



Source: New Financial

A wide dispersion

There is a wide range in the depth and development of capital markets across the EU, although a common feature is that EU11 countries have significantly less developed capital markets relative to GDP than the rest of the EU. Fig.7 shows the relative depth of capital markets across 23 different metrics in a selection of countries in the EU over the three years to the end of 2015, adjusted to GDP and rebased to the EU average of 100.

Capital markets in the EU11 states are one third as developed as the EU average. The Czech Republic has the deepest capital markets in the EU11 (43) while Romania has the least developed (16). The Visegrad 4 countries are the most developed (37), while the three Baltic states are around a quarter as developed as the EU average (23), and the four Balkan states (21) are the least developed, with an average depth of around one fifth of the EU average.

It would be unrealistic to expect the EU11 to match the depth of capital markets in more developed European economies. It is little more than 20 years since EU11 states reopened their capital markets after half a century during which they had largely remained closed.

From a long-term perspective, the growth in EU11 capital markets in recent decades is a signficant achievement. Nonetheless, the overall low level of development across the EU11 and the closely bunched distribution between countries suggests there remains a huge opportunity to expand capital markets further; and also that the similarities between the 11 countries in developing their capital markets are more striking than the differences between them.

7) Pools of long-term capital in the EU11

Starting from a low base

The starting point for deep and effective capital markets is deep pools of capital. On this metric, a large gap remains between the EU11 and the EU average. Fig.8 shows the total size of household financial assets as a percentage of GDP.

Overall, the value of all classes of household financial assets in the EU11 add up to €1.25 trillion. This represents 98% of GDP, less than half the level of 206% in the EU excluding the UK.

The main source of this gap is the low level of pensions and insurance assets: in the EU11 these account for 17% of GDP, compared with 66% in the EU27. Direct individual holdings of funds, stocks and bonds in the EU11 represent 9% of GDP, compared with 34% in the EU27.

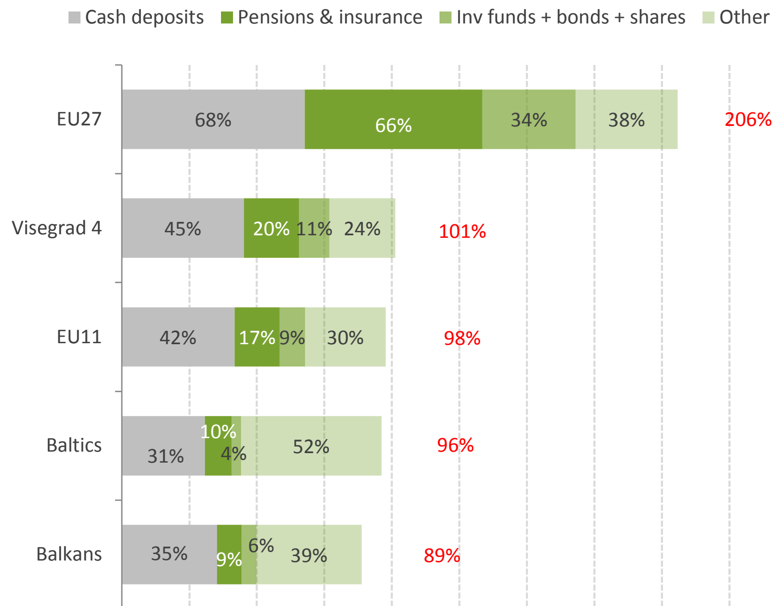
The difference in the depth of pools of capital between different countries can be explained by the variations in personal disposable income. Countries with higher disposable and higher total income per capita have the capacity to accumulate a higher proportion of savings in the form of financial assets.

Enterprise savings fund the largest proportion of EU11 investment, while the household savings rate is equivalent to about half that of the EU28. Unlocking household savings, for example through pension and insurance savings, could contribute to a more rapid accumulation of capital and investment.

Over the last five years, the average investment rate of EU11 stood at 22% GDP per year, which is not substantially above that of the EU28 (20% of GDP) and hardly contributes to accelerate the economic convergence of EU11 with the EU28.

Fig.8 The depth of pools of capital in the EU11

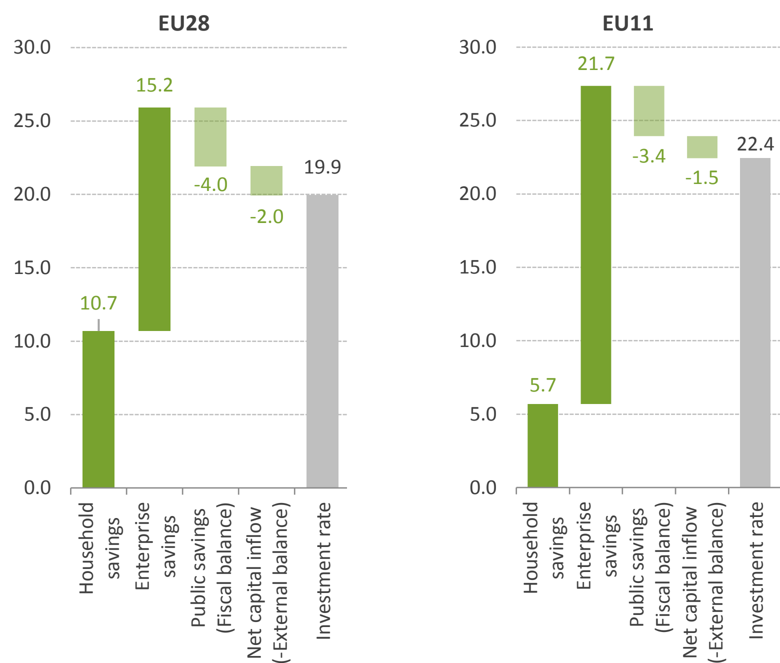
The value of household financial assets in the EU11 as a % of GDP in 2015



Source: Eurostat

Fig.9 The savings breakdown and contribution to total investment

EU11 savings rate (private, public and net capital inflow) and investment rate as a % of GDP



Source: Eurostat, World Bank, AFME

8) The change in bank lending to companies since the crisis

A decline in lending

Banks across the EU11 have struggled to maintain the same level of lending to companies as before the crisis. Fig.10 shows the value of the outstanding bank lending to non-financial companies across the EU in 2015 relative to the size of bank lending in 2008.

The 3% fall in bank lending across the EU11 appears marginal (implying a reduction of only €8bn) and lower than the EU as a whole. However it masks huge variation at national level. In Poland, outstanding bank lending rose by 30%, whereas lending in the other EU11 states fell by 13%. In the Balkans and the Baltic states, the value of bank lending has dropped by nearly a fifth.

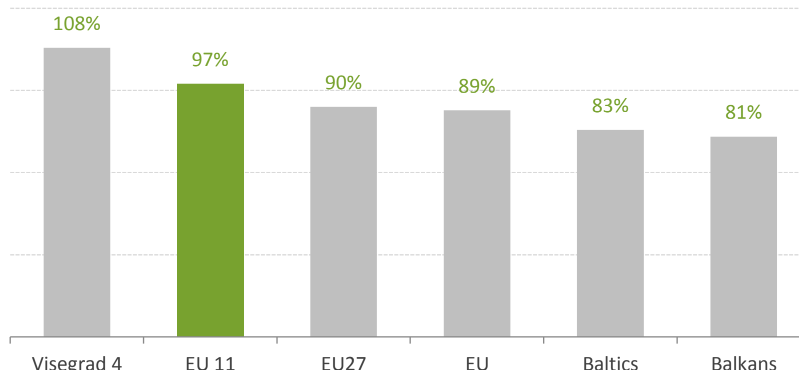
The slowdown in bank lending is compounded by the fact that companies in EU11 economies are far more dependent on bank lending than in the rest of the EU (see Fig.11). On average, bank lending represents 85% of corporate debt for companies in the EU11, higher than the 76% average across the EU.

Foreign banks own around three quarters of the banking system in Central and Eastern Europe. This posed challenges during the financial crisis, given the dependence on parent funding for these banks. Banks are now largely funding loans with domestic deposits, which reduces the potential impact on local activity of a slowdown in foreign bank flows.

The average loan-to-deposit ratio of banks in the EU11 fell dramatically, from nearly 200% in to 82% in 2015 (see Fig.12). The result is that the EU11 banking system is more stable and solid than before the crisis. The corollary is a much reduced appetite and capacity for EU11 banks to rapidly expand their balance sheet.

Fig.10 The decline in the value of outstanding bank lending

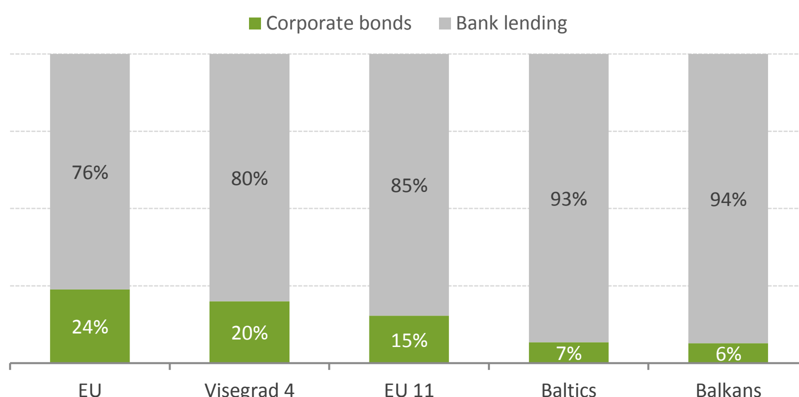
Value of outstanding bank lending to non-financial corporations in 2015 as a % of 2008 value (calculated in €bn)



Source: ECB

Fig.11 The reliance of companies in the EU11 on bank lending

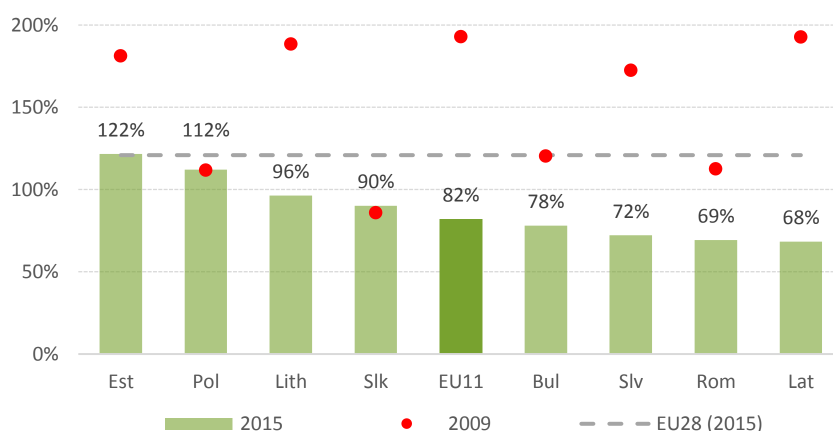
The value of bank lending and corporate bonds as a % of corporate debt, 3 years to 2015



Source: ECB, IMF

Fig.12 A more stable platform for lending

Loan-to-deposit ratios at EU11 banks in 2009 and 2015 %



Source: IMF, ECB, EBA

9) The economic landscape of the EU11

The role of SMEs

Small and medium enterprises (SMEs) generate 41% of economic output in the EU11, compared to the EU28 average of 36% (Fig.13). This would indicate a wider demand in the EU11 for alternative financing channels such as venture capital, private placements, equity crowdfunding, and angel investing in. The IMF has highlighted the provision of such risk capital as crucial to innovation and economic growth in the EU11.

Services are the main economic activity in both EU28 and EU11, although industry and agriculture both generate a share of GDP in EU11 countries (see Fig.14). This may indicate a transition from manufacturing and agricultural activities to services as the EU11 converges with the rest of the EU.

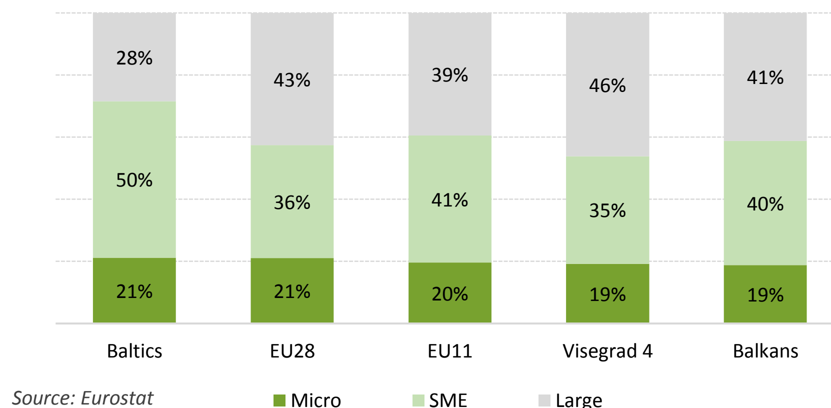
Crowding out the private sector

State-owned entreprises play a more significant role in EU11 economies than in the EU as a whole, and are particularly active in the energy and transport sectors. Fig.15 shows the importance of SOEs as measured by the OECD index, which tracks the percentage of sectors in which SOEs are active and scores countries from 0 to 6. Large economies in the EU11 such as Poland and Romania have SOEs operating in more than three quarters of all economic sectors.

Data from the IMF shows a similar effect: EU11 governments invest about 1.5% of GDP a year in SOEs, three times the EU average.This can crowd out the private sector. However it also highlights the potential for domestic capital markets to inject private capital into these SOEs through the bond or equity markets.

Fig.13 The dominance of SMEs in the EU11 economy

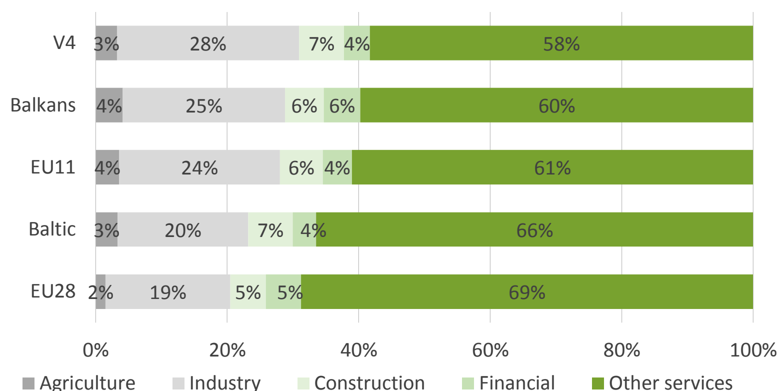
The contribution to value-added by size of firm (2014 or latest available data) %



Source: Eurostat

Fig.14 The importance of different sectors to the economy

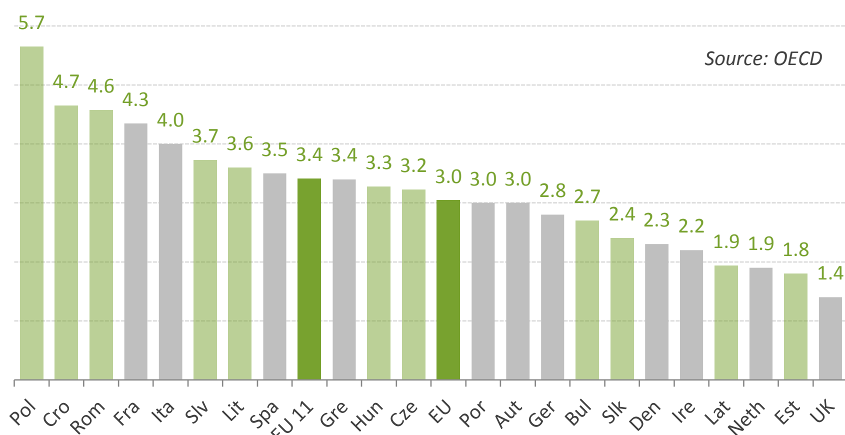
Proportion of GDP by sector of activity %



Source: Eurostat

Fig.15 The importance of state-owned enterprises in the EU

Index of the importance of state-owned enterprise to the economy (0 = min 6 = max)



10) The ease of doing business in the EU11

An improving environment

Capital markets rely on a thriving private sector, high level of trust in business practices and a strong legal system. EU11 countries continue to make progress across this agenda. However, in a composite index of entrepreneurship and ease of doing business across the EU, they still trail the EU average (see Fig.16).

The same pattern appears in a combined ranking of rule of law, perceived corruption and legal efficiency. In order for capital markets to flourish, national governments in the EU11 will need to do more to create a more open and certain legal framework.

A liberal tax regime

The tax regime in the EU11 is aimed at being attractive to business and investors from a corporation tax rate point of view and at attracting FDI through the use of tax incentives. The Effective Average Tax Rate (EATR) in the non-financial sector of EU11 countries was approximately 15.7% in 2014. This compares to 21.1% in the EU28.

One of the aspects of the tax system affecting capital markets in particular is the way in which countries deal with the debt bias in corporate taxation, that is, the tax rate wedge between equity and debt financing.

Fig 17. shows the ranking of debt bias in the EU11. Most EU11 jurisdictions have a lower equity bias than the EU28, mainly due to low rates of overall corporate taxation. The tax wedge could be narrowed further by introducing an allowance for corporate equity to reduce the cost of equity capital for firms and stimulate issuance of equity by corporates.

Fig.16 Ease of doing business, entrepreneurship & the rule of law

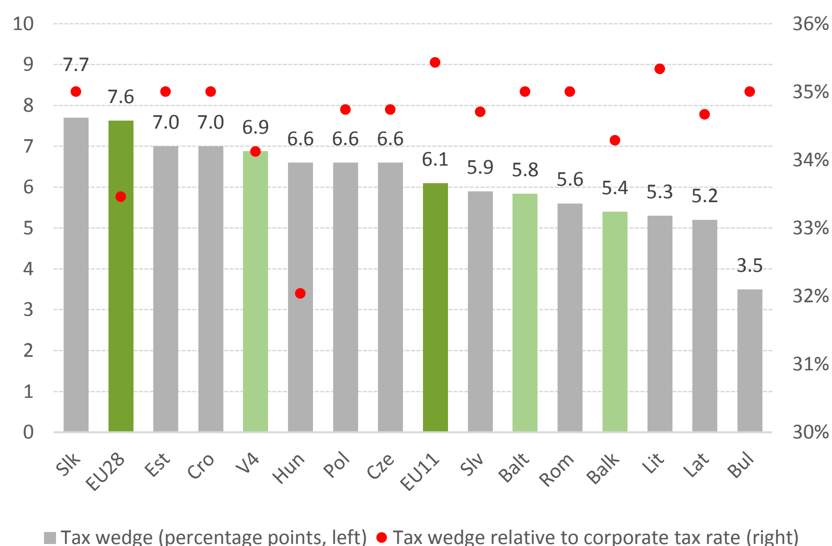
Where EU11 countries rank in the EU in indices of ease of doing business and the rule of law

	Entrepreneurship & ease of doing business		Rule of law, legal efficiency and perceived corruption		Quality of insolvency regime	
Country	**Rank in EU (1-28)**	**%**	**Rank in EU (1-28)**	**%**	**Rank in EU (1-28)**	**%**
Estonia	10	68	12	55	19	65
Lithuania	12	67	17	49	26	49
Latvia	13	66	21	48	20	64
Slovenia	16	63	18	49	7	84
Poland	17	63	16	50	17	76
Slovakia	20	61	22	44	18	71
Romania	21	59	27	41	22	59
Czech Republic	22	59	20	48	16	76
Hungary	23	59	24	43	25	51
Bulgaria	24	58	28	40	21	59
Croatia	27	56	23	43	24	56
EU average	-	**65**	-	**62**	-	**72**
EU11 average	-	**62**	-	**49**	-	**66**

Note: The entrepreneurship index combines the GEDI 2016 global entrepreneurship index and the World Bank ease of doing business index; the rule of law index combines measures of corruption and rule of law from the World Bank, Transparency International, and the World Economic Forum.

Fig.17 The debt / equity bias in the EU11

Tax wedge in percentage points and relative to corporate tax rates
(Tax wedge = the difference between tax rate on new equity issuance and debt financing)



Source: ZEW

Demographic challenges

Countries in the EU11 face significant challenges in labour force dynamics that could constrain their future growth. Productivity in the EU11 is about 70% of the EU average. While this gap has closed over the past decade, the lower share of the workforce with some form of tertiary education appears to slow the convergence process.

Just three of the EU11 states have a higher level of tertiary education than the EU average of 27%, and the level in most states is around 20% (see Fig.20).

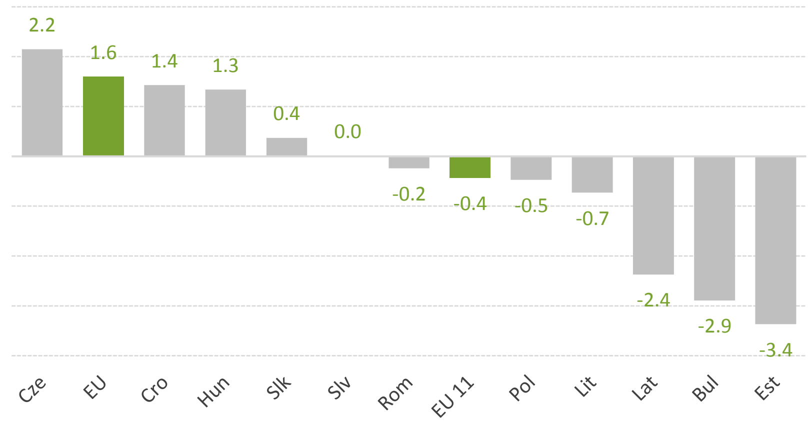
The EU11 states have younger populations than the EU average and a lower dependency ratio of adults over 65 years old compared with those aged 15 to 64. However, this is forecast to match the EU average by 2050, and a deeper pool of pensions assets in the EU11 will be required to limit the strain on the public finances.

Perhaps the biggest challenge is migration. Six of the 11 countries had negative net migration in 2014, with more people leaving the country than settling in it (see Fig.18). On average net migration in the EU11 is -0.04% compared with +0.16% for the EU as a whole.

The combination of an ageing population and net negative migration means that over the past 15 years, the active workforce in the EU11 has shrunk by 5%, compared with overall growth of 4% across the EU (see Fig.19). This is particularly pronounced in Latvia and Bulgaria, where the workforce has shrunk by more than 10%.

Fig.18 The importance of migration in the EU11

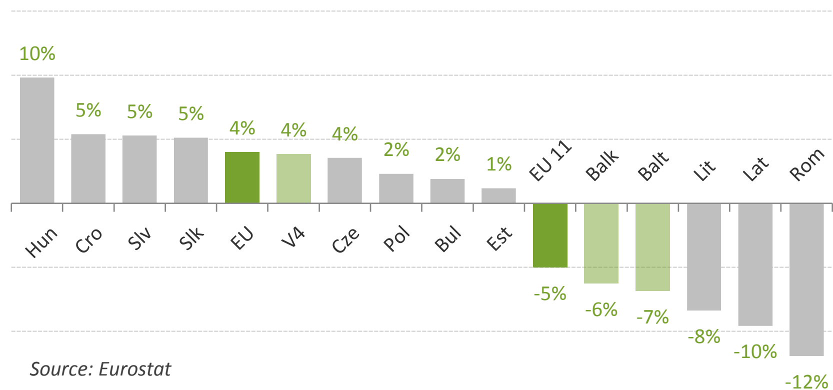
Levels of net migration in EU11 states in 2014 per 1,000 of population



Source: CIA World Factbook

Fig.19 A shrinking EU11 labour force

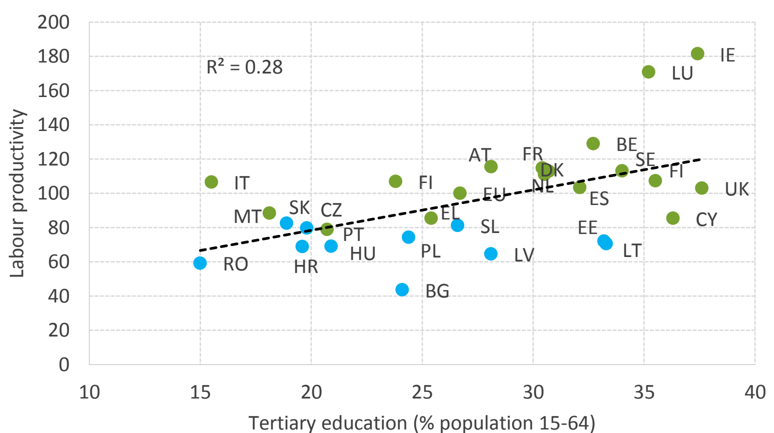
The change in workforce in EU11 states 2002 to 2015 %



Source: Eurostat

Fig.20 The skills and productivity challenge

The change in population in EU11 states 2002 to 2015 %



Source: Eurostat

12) Growth in capital markets over the past decade

A rollercoaster ride

While capital markets have grown across the EU11 in recent years, it has been something of a rollercoaster ride over the past decade - and activity has still not recovered to the same levels as before the financial crisis.

Fig.21 shows the change in depth in capital markets in the EU11, Visegrad 4, Balkans and Baltic states relative to GDP over the past decade. The depth is rebased to the EU average in the three years to 2015, and we have used a three year rolling average to smooth out the volatility in capital markets activity from one year to the next.

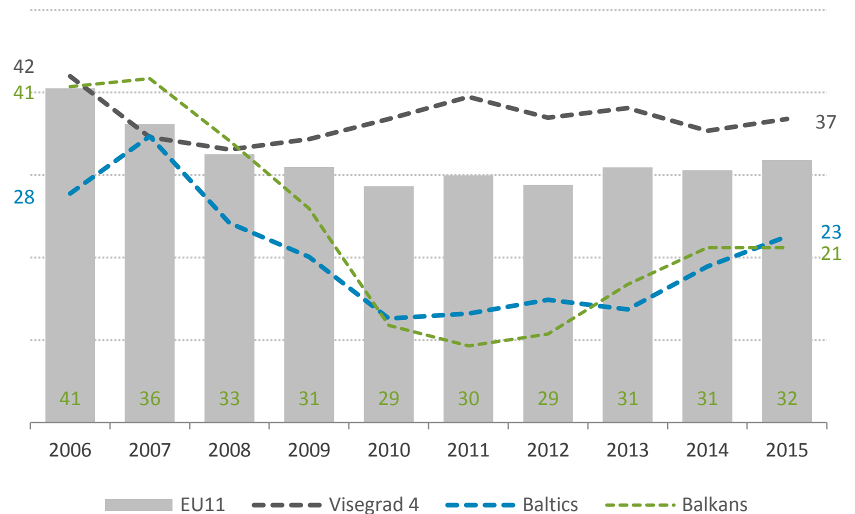
Overall, the depth of capital markets has shrunk by around one fifth from 2006 to 2015 across the EU11, while it has halved in the Balkans. In the Baltic states, capital markets activity halved in the few years after the crisis, but has since recovered.

Fig.22 shows the change over the past decade in different sectors of capital markets activity relative to GDP. There are some areas of real concern in equity markets. Notably, the value of EU11 stockmarkets relative to GDP has shrunk by nearly a third; M&A activity has halved; the value of IPOs has dropped by three quarters relative to GDP over the past decade.

The trends in credit markets are more encouraging. For example, the value of leveraged loan issuance in the EU11 has more than tripled relative to GDP over the past decade, while bond issuance has roughly doubled. Another positive development is that long-term pools of capital in the form of pensions and insurance assets have increased by a fifth relative to GDP.

Fig.21 A decade of change in EU11 capital markets

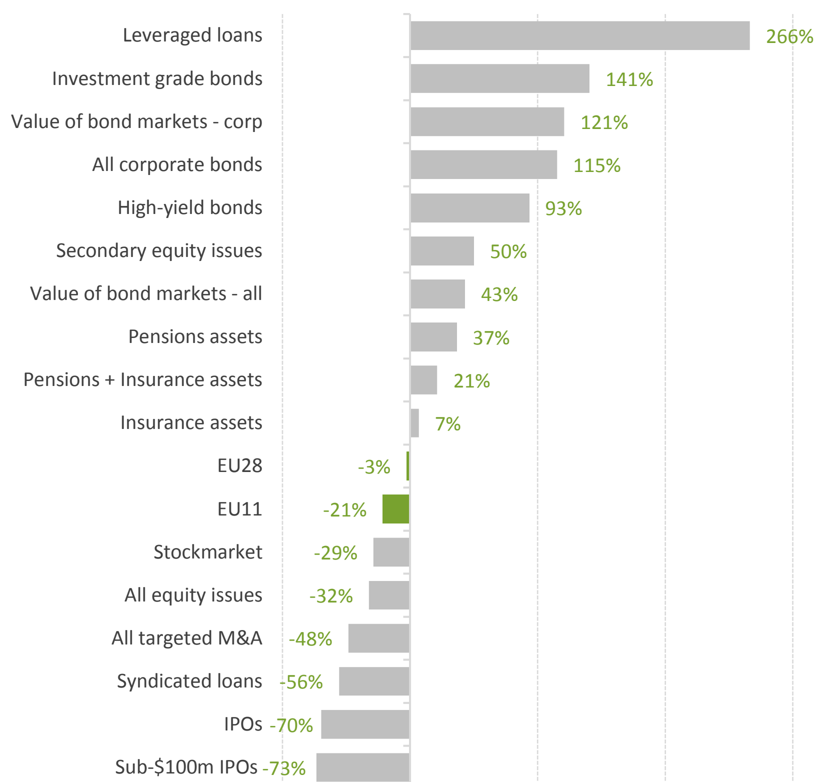
The change in depth in capital markets in the EU11 on a three year rolling basis 2006-2015
Rebased to EU = 100 in the three years to 2015



Source: New Financial

Fig.22 Growth in EU11 capital markets by sector over a decade

Change in the depth of EU11 capital markets by sector relative to GDP between 2006 and 2015



Source: New Financial

13) The range in depth of capital markets in the EU11 by sector

A steep hill to climb

There is a very wide range in the depth of individual sectors of activity across the EU11. Fig.21 shows the depth of each sector of the capital markets in the EU11 relative to GDP and to the EU wide average over the past three years.

It also shows the range in depth between different countries from the second most developed to the second least developed (in order to smooth out the effect of outliers), as well as highlighting the 'best in class' country in each sector (ie. the country with the most developed markets).

For example, across the EU11 issuance of leveraged loans (a form of syndicated loans for smaller or higher growth companies that is often seen as a stepping stone to the capital markets) is around two thirds as developed as in the EU as a whole relative to GDP.

There is a wide range in activity from zero to 77, and the Czech Republic is the most developed country for leveraged loans, with 50% more issuance relative to GDP over the past few years than the EU average.

At the other end of the scale, insurance assets in the EU11 are just 12% the size, adjusted for GDP, as in the EU, and the best in class country (Slovenia) is only one quarter as developed as the EU average.

It is encouraging to see that in some sectors – leveraged loans, private equity activity and high-yield bonds – the most developed country in the EU11 is better than the EU average. This provides a realistic target over time for other EU11 countries in terms of developing different sectors of the capital markets.

Fig.23 The depth of different sectors in EU11 capital markets

Depth of capital markets by sector in the EU11 relative to GDP over three years to 2015

The depth of each sector has been rebased to the EU wide average of 100 (so a value of 50 means that EU11 activity in that sector is half as deep relative to GDP as the EU average)

(The red bar shows the range in depth from the 2nd to the 10th most developed country)

Source: New Financial

Note: in addition to the sectors above, we also included the following sectors in our overall analysis: household financial assets, securitisation market value, securitisation issuance, investment funds by domicile, assets under management, and bank lending relative to corporate bond market.

14) The development of pensions in the EU11

A solid start

Pensions systems in the EU11 have made significant progress over the past 20 years.

Most countries in the EU11 introduced some form of funded pension schemes in the late 1990s (see Fig.24), usually following a three pillar approach. The first pillar of state pensions are all unfunded pay-as-you-go schemes providing a minimal level of pension. The second pillar of occupational schemes often involves mandatory contributions to pension funds by both employers and employees, and the third pillar involves voluntary private pensions.

Over the past decade, the pool of pensions assets in the EU11 has increased by 55% to just over €90bn.

Deeper pools of pensions assets encourage the development of equity markets in the EU11 by creating additional demand for investing in long-term assets. For example, the rapid growth of pensions assets in Croatia (from 6% of GDP in 2006 to 23% of GDP in 2015) has boosted the domestic equity market, which is the deepest in the EU11 with a market capitalisation equivalent to 35% of GDP.

One of the big challenges for pensions in the EU11 is political intervention. In both Hungary and Poland, a significant pool of private pensions have affectively been nationalised, and many countries in the EU11 place restrictions the range of assets in which pensions schemes can invest.

Expanding participation in occupational and private pensions, creating a more certain legal framework, and easing the investment regime for pension funds will help these pools of long-term capital grow.

Fig.24 A summary of pensions systems in the EU11

The main metrics on EU11 pensions systems

Country	Pensions assets 2006 (€bn, % of GDP)	Pensions assets 2015 (€bn, % of GDP)	Summary of local pensions system
Bulgaria	€0.8bn 3%	€4.8bn 11%	Three pillar system introduced in 1999. Pay as you go unfunded state pension; mandatory funded workplace pensions; and voluntary private pensions insurance introduced in 2007.
Croatia	€2.2bn 6%	€10.3bn 23%	Pay as you go unfunded state pension; mandatory funded workplace pensions and voluntary private pensions introduced in 2002.
Czech Rep.	€5.3bn 5%	€13.8bn 8%	Pay as you go unfunded state pension; mandatory funded workplace pensions introduced in 2013 but subsequently closed after limited take-up; and voluntary private pensions.
Estonia	€0.5bn 4%	€2.7bn 13%	Pay as you go unfunded state pension; mandatory funded workplace schemes introduced in 2002; voluntary individual private pensions introduced in 1998. Reforms in 2015 to increase range of asset classes.
Hungary	€9.1bn 11%	€4.4bn 4%	Pay as you go unfunded state pension; mandatory and voluntary pensions schemes introduced in 1997. In 2011, the government abolished the second pillar and transferred assets into the state scheme.
Latvia	€0.1bn 0%	€0.3bn 1%	Pay as you go unfunded state pension from mid-1990s; voluntary individual accounts introduced in 1998, and mandatory workplace scheme introduced in 2001.
Lithuania	€0.1bn 0%	€2.2bn 6%	Pay as you go unfunded state pension from 1995; mandatory workplace schemes and voluntary private pensions introduced in 2004.
Poland	€32.4bn 12%	€35.6bn 8%	A three pillar system was introduced in 1999: pay as you go unfunded state pension, mandatory funded pensions insurance and voluntary individual and occupational accounts introduced in 2004. In 2014 the government sequestered 2nd pillar pensions assets.
Romania	-	€5.8bn 4%	Pay as you go unfunded state pension; mandatory defined contribution pensions system and voluntary private pensions introduced in 2007.
Slovakia	€1.3bn 3%	€8.1bn 10%	Pay as you go unfunded state pension; mandatory defined contribution scheme introduced in 2005 and voluntary individual pensions reformed in 2006
Slovenia	€0.9bn 3%	€3.0bn 8%	Pay as you go unfunded state pension from 1999; mandatory workplace schemes for public sector employees and voluntary private pensions introduced in 2001.

Source: New Financial, OECD, ECB, EBRD, European Commission

15) The obstacles to deeper capital markets in the EU11

The challenges ahead for capital markets in the EU11

Each of the 11 countries included in this analysis face unique challenges in developing deeper capital markets based on their history, economic development, and legal systems. However, in many respects the similarities in these challenges are more important than the differences between them. Here is a summary of some of the main obstacles EU11 countries face in building deeper capital markets:

1. **A long-term game –** Building deep and effective capital markets takes many decades. It is little more than 25 years since the fall of the Berlin Wall and 20 years since countries in the EU11 started implementing the legal framework and infrastructure for their capital markets. Many of them have have made commendable progress in a short time. It took the UK 30 years to build a pool of pensions assets from 20% of GDP to 100% of GDP. With the right momentum and political will, there is no reason why EU11 capital markets won't see similar levels of development in the coming years. One factor that could be addressed is improving levels of financial education among investors and issuers.

2. **A question of scale –** Capital markets benefit from economies of scale and, apart from Poland, countries in the EU11 have relatively small populations. This limits the supply of companies that are large and developed enough to benefit from capital markets and acts as a brake on the development of a domestic investor base. Moreover, smaller markets may face higher costs from the fragmentation of market infrastructure, regulatory and legal systems. Such fragmentation raises costs and complexity for market participants, reduces liquidity, and acts as a barrier to international investors. There are signs that regional cooperation by governments, market participants and market infrastructure providers can help address this issue.

3. **Chicken or egg? –** A central theme from our interviews with market participants and policymakers was the difficulty of developing capital markets from a low base. Building the right institutional framework and market infrastructure – while useful in attracting cross-border financing – will not on its own lead to deep capital markets. Policymakers and market participants also need to build up a local base of issuers and investors. EU11 countries could encourage state-owned enterprises to lead the way by issuing bonds or listing, while promoting access to capital markets for smaller companies at the same time.

4. **A low appetite –** In most EU11 countries the appetite for capital markets is low among issuers and investors. One reason is that bank financing is at historically cheap levels, and potential market participants are not as comfortable with capital markets as in much of western Europe. In some countries, high market concentration may have limited the incentive to develop new capital market products. Another factor is the impact of the crisis, which hit just as capital markets were beginning to gather some momentum in much of the EU11, and left many investors feeling wary of capital markets.

5. **The political perspective –** Flourishing capital markets rely on trust and certainty in the legal and regulatory regime. In some cases, political intervention in capital markets (such as Poland and Hungary effectively nationalising parts of their private pensions systems) has been widely described as undermining this trust and sending warning signals to local and international investors. Similarly, calls for some form of protection for the smaller capital markets or regulatory dispensation (a frequent theme in our interviews) risk permanently embedding the differential in development between capital markets in the EU11 and the rest of Europe.

16) A summary of initiatives underway to develop capital markets

Unlocking capital markets in the EU11

Over the past few years, national governments, market participants and supranational organisations such as the EBRD have been actively engaged in a wide range of initiatives to encourage the development of capital markets in the EU11. In the online appendix to this report we provide a comprehensive summary of these initiatives but here is a thematic outline:

1. **Regional cooperation:** while there have been relatively few examples of formal regional cooperation, there is plenty of evidence of informal cooperation between national governments, market infrastructure and trade associations to help share best practice and develop common policy positions.

2. **Investor education:** governments and stock exchanges (including in Hungary, Latvia and Romania) have been active in developing financial and investor education programmes to raise awareness of the potential benefits of capital markets and increase financial literacy.

3. **Growth / SME markets:** while it is difficult to build a capital market on the basis of SMEs, seven of the 11 countries in the EU11 have launched dedicated stock markets for SMEs, and several more are in the pipeline. Some, such as Nasdaq Baltic, have also launched bond markets for smaller issuers.

4. **Issuer programmes:** several organisation such as Elite have set up programmes for issuers to connect them with potential investors and other market participants, often partnering with local banks. For example, there are 21 EU11 companies in the Elite programme. This has been accompanied by the development of networks to bring together issuers and investors, such as biznest and new legislation to encourage business angel investment in Romania

5. **Tax:** several governments have recently passed legislation to create tax incentives for issuers and investors, such as the Investment Incentives Act in the Czech Republic that reduces tax payable on the sale of large equity investments by funds.

6. **Insolvency:** since the financial crisis all countries in the EU11 have reformed their insolvency proceedings to reduce the amount of time to resolve insolvencies and / or increase the recovery rate. Greater harmonisation of insolvency proceedings, boosted by the CMU project, would remove a significant barrier to more international investment in the EU11.

7. **New products:** the limited range of products available for issuers and investors has acted as a brake on development, and many countries have actively developed new products, such as covered bonds in Croatia and Poland, or crowdfunding in the Baltic states.

8. **Pools of capital:** most countries in the EU11 have expanded their second and third pillar pensions systems (workplace and personal pensions). More recently, countries such as Croatia and Estonia have expanded the range of assets in which pension schemes are allowed to invest.

9. **The political agenda:** capital markets have moved up the political agenda in recent years, with governments including Poland and Romania launching programmes to encourage the wider growth of markets, while Estonia and Hungary have enacted legislation to streamline the process and reduce the administrative burden for market participants.

10. **The EBRD:** the EBRD's local capital markets initiative launched in 2010 has been active in providing technical expertise, helping develop market infrastructure (by linking stock exchanges and developing a regional central counteparty), helping countries develop new product frameworks, and directly investing in securities.

Full steam ahead?

The relatively low depth of capital markets in EU11 economies presents many challenges, but it is also a huge opportunity for growth. One way of measuring this potential growth is to analyse what would happen to levels of activity if capital markets in each country in EU11 were as developed as the country that is 'best in class' in the EU11. This gap analysis sets a realistic long-term target for growth in EU11 capital markets.

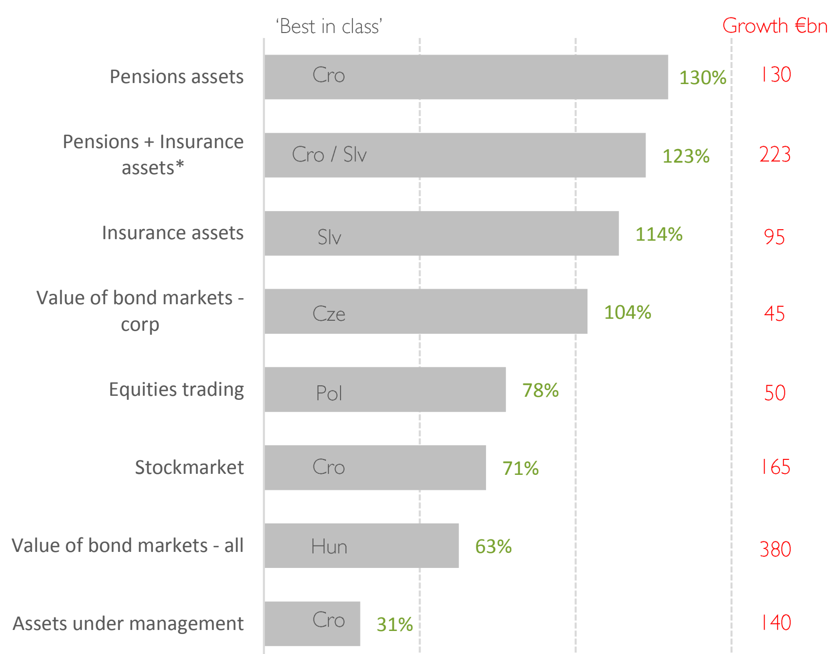
Fig.25 shows the percentage increase in pools of capital and assets if each country were as developed as the best in class, and what that growth translates into in terms of actual money.

For example, if pensions assets in each country in the EU11 were as developed as in Croatia, where they are just over 20% of GDP, it would mean growth of 130% in pensions assets across the EU11 – equivalent to an additional €130bn in long-term capital that could be put to work in EU11 economies. On the same basis, the potential increase in pensions and insurance assets would be €223bn, the corporate bond market would more than double, and EU11 stockmarkets would be 70% bigger.

Fig.26 shows the same effect on the annual flow of capital markets activity (from leveraged loans, bond issues, equity issues and venture capital). While the absolute numbers are relatively small, if all countries in the EU11 had capital markets as deep as the best in class in each sector, it would translate into nearly €45bn in additional capital markets funding a year flowing into the EU11 economy (€22bn from corporate bonds, €14bn from leveraged loans, €7bn from equity issues and €0.5bn from venture capital).

Fig.25 Growth in pools of assets and capital

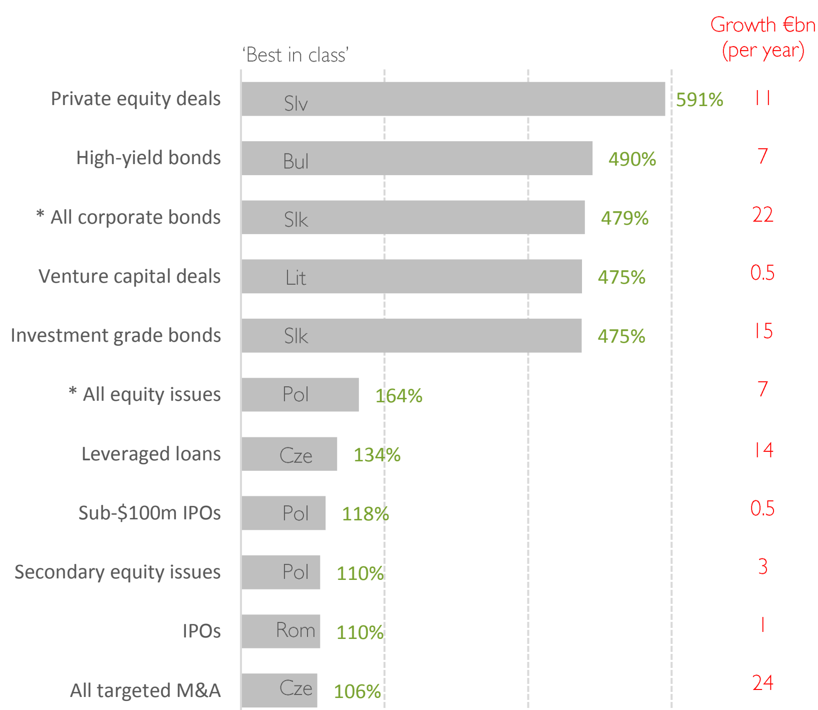
The potential growth in EU11 activity if all countries were as developed as 'best in class' (% / €bn)



Source: New Financial

Fig.26 Growth in flow of capital markets activity

The potential growth in EU11 activity if all countries were as developed as 'best in class' (% / €bn)



Source: New Financial

**Note: the potential growth in pensions and insurance assets, corporate bonds and equity issues is calculated off the 'best in class' in each of their separate sub-sectors (eg. IPOs and secondary equities)*

18) The growth opportunity (ii)

A deeper pool of capital

Another way of looking at the growth opportunity in EU11 capital markets is to drill down into the potential growth in individual countries.

Fig.27 shows the potential growth in percentage terms in the value of pools of long-term capital if each country in the EU11 had pensions assets as developed as in Croatia (20% of GDP) and insurance assets as developed as in Slovenia (16% of GDP). On this basis the combined pensions and insurance assets in each country would be 36% of GDP.

The biggest potential beneficiary in relative terms would be Latvia, where pensions and insurance assets would increase more than tenfold from just over 3% today.

Pools of institutional capital would quadruple in size in the Baltic states, translating into growth of €22bn in assets. They would triple in the Balkans (+€67bn) and double in the Visegrad 4 countries (+€135bn).

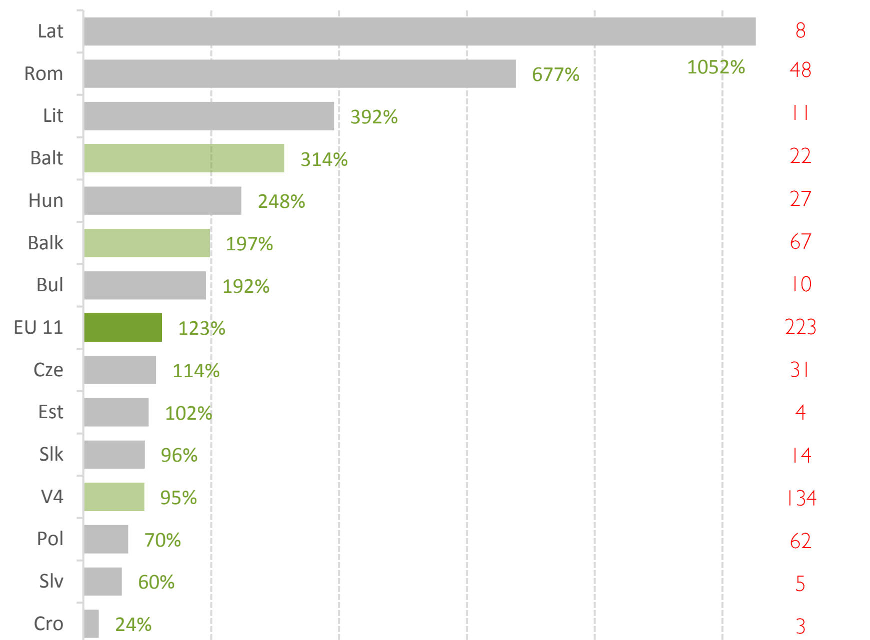
Perhaps a better way of expressing this potential growth is to express it relative to GDP (see Fig.28). If all countries in the EU11 had pensions and insurance assets as developed as the best in class, the growth in the pool of long-term capital would be equivalent of 18% of EU11 GDP.

It is interesting to see that the growth potential expressed as a percentage of GDP is more closely bunched. In other words, all countries would benefit by growth equivalent to between a fifth and one third of GDP.

Even the two 'best in class' countries would benefit: the potential growth in Slovenia's pensions assets would be equivalent to 16% of GDP, while the growth in Croatia's insurance assets would add up to 6% of GDP.

Fig.27 Potential growth in pools of capital

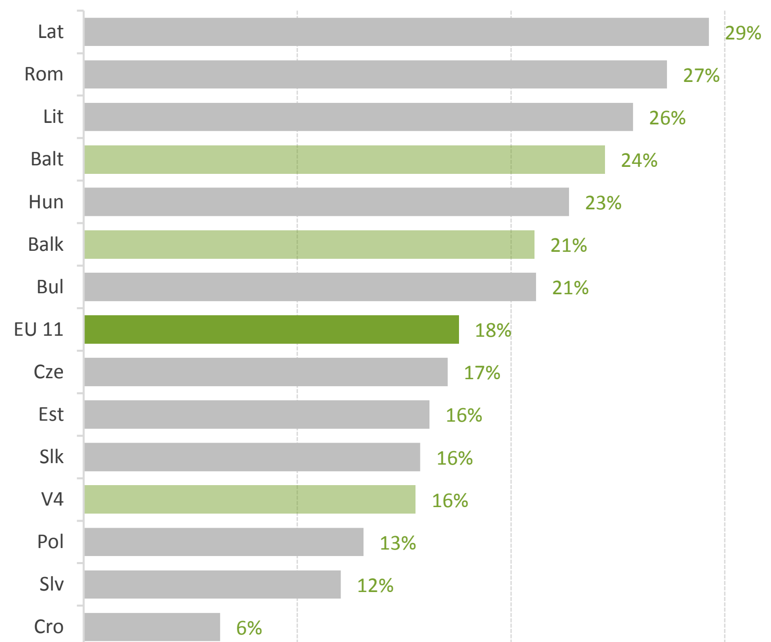
Potential growth in pensions and insurance assets if each country were as developed as the 'best in class' in the EU11 (% and €bn)



Source: New Financial

Fig.28 Growth in pools of capital as a % of GDP

Potential 'best in class' growth in pensions and insurance assets expressed as a % of 2015 GDP



Source: New Financial

A shot in the arm?

The same analysis at a country level highlights the potential growth in each country in the annual value of capital markets funding if the markets in each country were as developed as the best in class in the EU11.

In other words, what would be the impact if each country in the EU11 had a leveraged loan market as developed relative in GDP as the Czech Republic, a corporate bond market as developed as Slovakia, an equity market as deep as Poland, and a venture capital market as active as Lithuania? While that is a tall order, it is a realistic long-term aim for developing capital markets in the region.

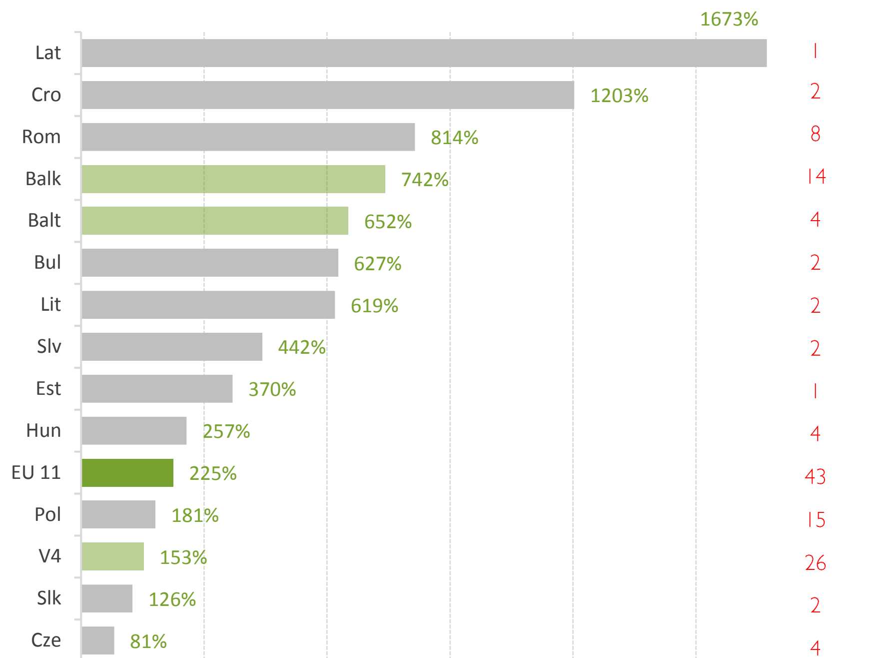
While the absolute numbers are small, this hypothetical increase would be huge in percentage terms (see Fig.29. The annual value of capital markets funding would increased more than tenfold in Latvia, and would grow more than six times in the Balkans and the Baltic states. Across the EU11, it would translate into growth of 225% from current levels, or an extra €44bn a year in funding.

Fig.30 expresses this potential growth in the annual flow of capital markets funding as a percentage of GDP in 2015. Across the EU11, the increase in annual activity would add up to a shot in the arm each year of 3.4% of GDP (and nearly 5% a year in Latvia and Croatia).

Given the impact of the financial crisis on economic growth in the EU11, the slowing convergence with the rest of the EU, future economic challenges and the reliance on lending from struggling banks, this potential boost to funding could be a welcome stimulus.

Fig.29 Potential growth in capital markets activity by country

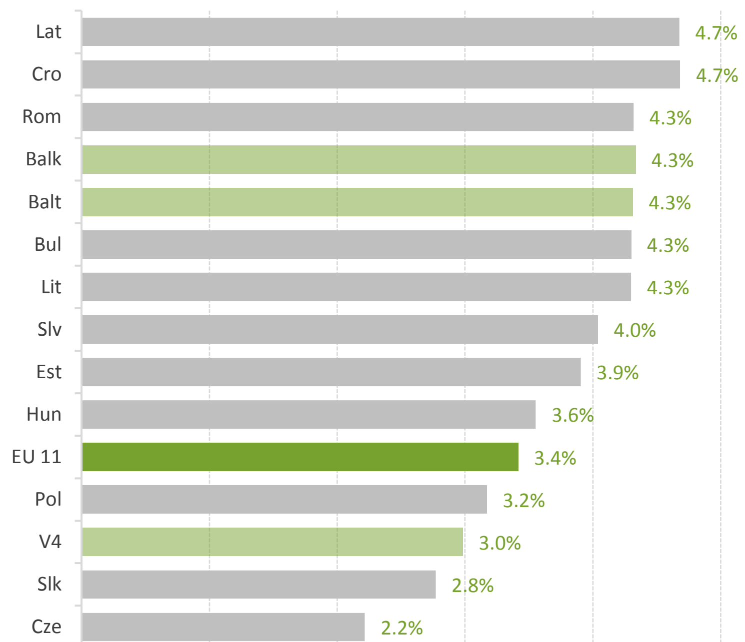
Potential growth in annual capital markets funding if each country were as developed as the 'best in class' in the EU11 (% and €bn)



Source: New Financial

Fig.30 Growth in capital markets activity as a % of GDP

Potential 'best in class' increase in annual flow of capital markets funding as a % of 2015 GDP



Source: New Financial

20) The market infrastructure challenge

A fragmented patchwork

One of the main challenges for capital markets in the EU11 is their fragmented market infrastructure, which raises costs and complexity for market participants and can act as a barrier to international investors.

Fig.31 is a simplified table of the market infrastructure for equity markets in the EU11. If it looks complicated, that's because it is. There are 11 different exchanges, and at least 11 different clearing houses and central securities depositaries. With the exception of Poland, Bulgaria and Croatia, each country has just a few dozen listed companies, and the overall value of stockmarkets in the EU11 of €220bn is just 2.4% of the EU total.

Market capitalisation as a percentage of GDP is 20%, less than a third of the EU average. And annual trading volumes of just over €100bn represent 44% of market value, compared with nearly 200% for the EU. Seven of the EU11 markets have launched dedicated markets for SMEs or growth companies, but with the exception of New Connect in Poland, they have struggled to gain traction.

There have been some limited efforts towards creating regional market infrastructure: Nasdaq Baltic operates the exchange, clearing and settlement in Estonia, Latvia and Lithuania, and this year the Zagreb Stock Exchange bought it's Slovenian counterpart.

Stockmarkets benefit from scale and the pooling of liquidity. While national exchanges act as an important platform for local companies and investors, more collaboration and more regional infrastructure would reduce costs and potentially make smaller markets in the EU11 more attractive to both issuers and investors.

Fig.31 A summary of market infrastructure in the EU11

The main metrics on EU11 stockmarkets and market infrastructure

Country (Year of launch)	Stock exchange	Listings (# of companies, €bn market cap, % of GDP)	Trading (€bn value, % of mkt cap)	SME / growth market (# listings)	Clearing / settlement
Estonia (1995)	Nasdaq Tallinn	# 15 €1.9bn 9%	0.2 9%	First North Baltic (1)	EVK
Lithuania (1993)	Nasdaq Vilnius	#31 €3.4bn 9%	0.1 3%	First North Baltic (1)	Lithuanian CSD
Latvia (1993)	Nasdaq Riga	# 26 €1.3bn 4%	0.1 4%	First North Baltic (1)	Latvian CD
Slovenia (1989)	Ljubljana Stock Exchange	# 46 €5.5bn 15%	2 43%	Entry market (26)	KDD
Croatia (1991)	Zagreb Stock Exchange	# 152 €15.4bn 35%	7 43%	-	SKDD
Poland (1991)	Warsaw Stock Exchange	# 905 €126bn 33%	68 54%	New Connect (418)	KDPW
Slovakia (1991)	Bratislava Stock Exchange	# 50 €4.3bn 5%	2 43%	-	CDCP
Romania (1995)	Bucharest Stock Exchange	# 84 €17bn 11%	2 12%	Aero (276)	Depositarul Central
Czech Rep. (1993)	Prague Stock Exchange	# 25 €24bn 14%	10 43%	START (0)	CSD Prague
Hungary (1990)	Budapest Stock Exchange	# 45 €16bn 13%	10 63%	-	Keler CCP
Bulgaria (1997)	Bulgarian Stock Exchange	# 365 €4.4bn 11%	2 43%	-	CDAD
EU11	-	**# 1,744 €220bn 20%**	**105 44%**	**-**	**-**

Source: New Financial, local exchanges, WFE, Fidessa

21) Capital markets union and the EU

The EU context for capital markets in the EU11

The development of the single market in financial services and capital markets in the European Union, while incomplete, has played a significant role in the development of capital markets in EU11. In particular, smaller economies with less developed capital markets are potentially the biggest beneficiaries of the capital markets union project. Here is a summary of the context for EU11 capital markets at an EU level:

1. **Relevance –** Support for the main aims of capital markets union was virtually unanimous among the market participants and policymakers we interviewed, particularly around encouraging SME financing, non-bank financing, rethinking the prospectus directive and the securitisation initiative. Some warned that while countries with less developed capital markets stand to gain most from CMU, there is a danger that it is of limited relevance for some countries where markets are the least developed. We also encountered some concerns that CMU would enable bigger markets and bigger market participants to become larger at the expense of their smaller counterparts. One challenge for the EU and the European Commission is to focus on making CMU directly relevant to EU11 countries and articulating that case.

2. **A voice at the table –** Some market participants thought EU11 countries had a limited voice at the table in setting the direction of policy at an EU level. While it may not be a good idea to create a separate forum for EU11 countries within the EU, informal cooperation between smaller countries to develop common policy positions, combined with more focus from the Commission in actively seeking their views, could help. EU11 countries also need to make their own voices heard: Poland and the Czech Republic were the only two governments to respond to the Commission's call for evidence and less than half of EU11 countries responded to Commission's the CMU green paper consultation. Having Valdis Dombrovkis, the former Latvian Prime Minister, as Vice President for Euro and Social Dialogue, Financial Stability, Financial Services, and Capital Markets Union could help address this issue.

3. **Show me the money –** In many cases, the main relationship between the EU and EU11 countries was financial. EU sources of funding such as the European Investment Fund, and regional development funds have played a significant role in kickstarting capital markets in the EU11, particularly in venture capital. While these funds are useful in 'priming the pump' and in providing a stamp of approval to help attract international interest, there is a danger that market participants can become too dependent on money from the EU. Public money can also distort the market and crowd-out private sector money. Where possible, EU funding should be matched or supported by national governments, and co-invest along side private sector funding.

4. **The regulatory burden –** Many market participants expressed concerns that recent regulatory reforms were putting too much of a burden on smaller local market participants, which are less able to absorb the cost of regulation than large international operators. A common suggestion was for the EU to develop a more proportionate regulatory regime for less developed capital markets in the EU to help build up the local industry before exposing it to full competition from the rest of the EU. However, this risks creating distortions, limiting cross-border capital flows, and permanently embedding the gap in development between the EU11and the rest of the EU.

5. **The big levers –** One of the main challenges for the European Commission in helping to build deeper capital markets in the EU11 is that the main levers that would have the most impact – tax incentives for investing and building a deeper pool of pension assets – are beyond its remit. Regarding tax, people we interviewed were encouraged that reviewing the differential tax treatment between debt and equity is part of CMU. And with pensions, the plan to build a portable personal pension product across the EU could help move pensions further up the national political agenda in EU11 states.

22) Some policy proposals

Unlocking capital markets in high potential economies

There is no magic bullet for national governments of the European Union to accelerate the development of capital capital markets in the EU11. However, here are some policy suggestions based on best practice in the region and on existing initiatives in individual countries that could be considered at a national and regional level:

1. Ease the investment regimes of local institutional investors to allow pension funds or insurance companies to invest in a wider variety of assets such as venture capital, unlisted securities, real estate funds, infrastructure and other capital markets instruments. This would help unlock investment to SMEs, diversify investment and maximise risk-adjusted returns.

2. Encourage the diversification of the sources of financing for growth companies at pre-IPO stage. Promote alternative financing for SMEs via instruments such as business angel investing, venture capital, private equity, private placements, mini-bonds or equity crowdfunding.

3. Continue the efforts towards developing the financial market infrastructure (trading platforms, CCPs and CSDs) simplifying trading and guaranteeing appropriate levels of market liquidity. Consider regional collaboration and potentially regional structures to improve capital markets infrastructure.

4. Strengthen the business environment to encourage entrepreneurship, ease the regulatory burden on businesses, and help boost the functioning of capital markets and the wider economy. Ensure security, stability, and accountability of the rule of law for all market participants. And continue the efforts towards improving insolvency frameworks that give viable companies a second chance to restructure and provide more certainty to investors.

5. Simplify the tax systems, including simplification of capital gains tax and withholding tax. Consider the use of tax incentives for business angel investment via venture capital, or private equity to support funding to SMEs, and of tax incentives to issuers and investors alike.

6. Governments and institutions can help educate retail investors about personal finance and the benefits of diversifying away from bank deposits. This could include education programmes about the risk-return benefits of investing in financial instruments like exchange traded products or venture capital funds, among others.

7. As part of financial literacy programmes, governments and exchanges can support and accompany local issuers along the path towards accessing capital markets. This could include programmes to improve accounting standards, transparency, and governance.

8. National governments should guarantee the availability of sufficient staff resources at Ministries of Finance, Supervisors and Central banks to develop and implement financial regulation and supervision.

9. National governments could consider their role in encouraging state-owned enterprises (SOEs) to lead the way in capital markets via bond issues or IPOs.

10. European institutions like the EBRD, the ECB and the European Commission can provide valuable institutional support to develop the necessary capital markets reforms tailored to the local business environment, and provide technical assistance for the implementation of local reforms and EU legislation. This could include a comprehensive review of best practice in different sectors of the capital markets.

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NEW FINANCIAL Rethinking capital markets

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New Financial is a think tank and forum that believes Europe needs bigger and better capital markets to help drive its recovery, growth and prosperity. We think this presents a huge opportunity for the industry and its customers to embrace change and rethink how capital markets work. We are a social enterprise that launched in September 2014, and we are funded by institutional membership from different sectors of the capital markets industry.

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