Feasibility study for the creation of a CMU Equity Market Index Family

Executive Summary

A study prepared by CEPS in collaboration with Prof. Aleš Berk Skok, Prof. Igor Lončarski and NorthGrant Consulting for the European Commission, Directorate-General for Financial Stability, Financial Services and Capital Markets Union

June 2020

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The authors would like to thank all the consulted stakeholders for their inputs to the study.

EUROPEAN COMMISSION

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Executive summary

Only a selection of listed companies is included in the European equity indices managed by international index providers. Due to the underlying index methodology currently in use, existing equity indices mostly comprise large caps listed on developed markets.

Only about half of the equity markets in the EU are classified as developed markets; (DM) the others do not meet the respective DM criteria as defined by index providers such as MSCI and FTSE Russell. This happens even though such markets are similar to the DM members of the European single market and meet their qualitative criteria, and means that most companies are excluded from well-known international indices. This has an impact on smaller fragmented capital markets such as those in the Baltics states, Central, Eastern and South Eastern Europe.

It is worth highlighting that in most cases index providers construct and maintain country indices separately and then aggregate them into various regional composites. However, there are special circumstances in which European countries classified as DM and countries in the West African Economic and Monetary Union (WAEMU) are classified as single markets and constructed according to a combined equity universe – an ongoing approach by MSCI reinforced during the 19 February 2019 public announcement.

This allowed for WEAMU countries' securities to be included in global indices by the MSCI, even though none of these countries would have met the size and liquidity criteria individually. This approach is appropriate for the EU member states and will be further promoted via the CMU Index Family proposal.

Exclusion from indices puts markets and individual stocks at a significant disadvantage. Since they are less often considered by international institutional investors, the capital supply and liquidity in the market are reduced.

Objective

The creation of an equity index family as part of the Capital Markets Union (CMU) project could improve index weights for EU countries when compared to standard indices. The overall aim of this study is to assess the feasibility of creating a CMU Equity Market Index Family, guided by two specific objectives, namely to:

- **Develop an index setup for a CMU Index Family** with the definition of the investible universe, the set of inclusion criteria and weighting.
- **Assess the market potential of the CMU Index Family** and estimate the magnitude of the retail and institutional investor base expected to use it.

The CMU Index Family could contribute to the development of EU capital markets in line with the CMU project, including the development and integration of local capital markets within the EU.

Methodology

The feasibility of creating an CMU Equity Market Index is assessed using an extensive set of quantitative and qualitative data collection and stakeholder consultation tools. The EU-listed companies, equity indices and index-related investments have been mapped to determine the opportunity for a CMU Index Family. Moreover, a simulation was conducted to understand the likely composition and performance over the past five years. Additionally, interviews, surveys and workshops were conducted with about 125 stakeholders to collect information and validate all the different aspects of the CMU Index Family.

Status quo

There are about 6 300 listed companies in the EU-27 and the UK. About two-thirds of these companies are listed on regulated markets, with the remaining one-third listed on SME Growth Markets. Regulated markets account for the large majority of the market capitalisation, however. In fact, regulated markets are responsible for nearly 99% of the total market capitalisation, amounting to about EUR 15 trillion.

Brexit has reduced the number of companies listed on EU-regulated markets and SME Growth Markets significantly. The number of listed companies decreased from about 6 300 to 4 200 in the EU-27, which is about a third lower than before the UK's exit. In fact, the UK has about 1 900 listed companies, which is more than the approximately 1 400 companies in the 15 frontier and emerging markets in the EU.

The large majority of the listed companies consist of micro caps (up to EUR 100 million market capitalisation) and small caps (between EUR 100 million and EUR 1 billion). Only about one-third of the companies listed on regulated markets is mid-cap (between EUR 1 billion and EUR 5 billion) or large-cap (more than EUR 5 billion), but these companies account for 96% of the market cap. The stocks listed on SME Growth Markets are basically all micro and small caps, but the 1% of mid-caps account for about one-quarter of the market cap.

Approximately 5 000 indices include EU-listed companies. About a fifth of these indices is provided by stock exchanges, which mostly focus on the stocks listed on a single market or a sub-set of these stocks. It is noteworthy that emerging and frontier stock exchanges generally have fewer indices than the developed market exchanges. However, the large majority of the indices is supplied by independent providers (e.g. Stoxx and MSCI). These independent providers often issue indices that cover companies from multiple stock exchanges.

Stock exchanges and independent providers both issue all share, size, thematic and sectoral indices, but neither covers the stock exchanges from all EU countries. The regulated markets in most frontier countries (e.g. BG, HR, RO, SI, SK) as well as SME Growth Markets, are not covered or are only partially covered by independent providers. Moreover, European indices often cover a combination of EU and non-EU countries.

Indices are primarily used as a benchmark and to track a certain set of companies. Looking at the EU index-related investments in mutual funds and ETFs, mutual funds benchmarked against equity indices account for 85% to 90% of the equity-related investments, and ETFs tracking equity indices account for the remaining 10% to 15%. However, the share of ETFs has been growing rapidly in the past few years – especially for thematic ESG-driven ETFs.

Most of the indices used by mutual funds and ETFs benchmark/track developed markets, whereas **frontier markets, and to some extent emerging markets, are virtually non-existent.**

The business models of the index issuers rely on three main components. First, the stock exchanges that issue indices traditionally do so primarily to attract **more investment to their stock markets**. These indices are thus sometimes free for benchmarking and tracking use. Second, for independent providers the issuance of indices constitutes an important source of revenue. In general, they charge a **fee for the use of indices as a benchmark or track an index**. Third, the **sale of data** on the indices, but especially the underlying companies, is an important source of revenue for both stock exchanges and independent providers.

As a note, the current CMU Index Family proposal is a timely initiative given the opportunity to accelerate discussions about introducing an **EU-consolidated tape** which is currently under consultation for the review of MiFID II – as calculating the CMU Index requires uniform data format and real-time feed mechanism.

CMU Index Family opportunity

The fact that there is no equity-based index covering all EU countries does not mean there is no demand for a CMU Index Family. **It appears that in the current market structure, supply for such an index does not match the limited demand.**

Most of the larger institutional investors consulted for this study indicated that there was no real need to create a CMU Index Family as they are satisfied with the current indexing landscape. For large investors there are too many differences in EU equity markets for them to think in terms of a homogenous market landscape. When it comes to investing in frontier markets and micro and small caps, the main obstacles for investors are limited liquidity (major price impact when trading); free float (concentration of stock holdings); institutional aspects (market openness, limits on capital flow, specific local regulatory and infrastructural barriers etc.); and unfamiliarity with markets and/or companies (risk and risk perception). Moreover, if they wish to create a CMU Index Family covering all EU countries, they would ask an independent provider to construct such an index for them.

Nevertheless, there seems to be some potential for a CMU Index Family among domestic and regional investors (especially from the CEE region). The domestic and regional investors show an interest in indices that also cover frontier and emerging EU markets, but have fewer assets under management and are less willing to pay for the use of indices.

Domestic, regional and international investors all see a further rise of index-based passive investment products and increased interest in ESG investments.

CMU Index Family strategy and methodology

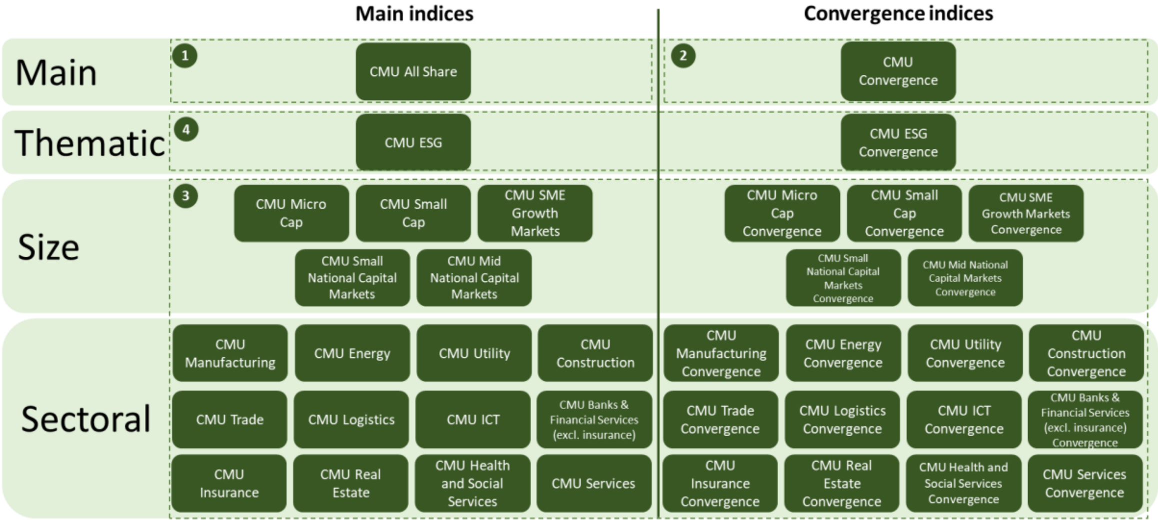
The proposed CMU Index Family consists of 38 indices in total.

The **CMU All Share Index** comprises the main index of the index family, covering around 3, 600 companies listed on EU-27 regulated markets and SME Growth Markets. Apart from solely UK-listed companies, another 600 companies with their legal headquarters outside the EU or with an average daily liquidity of less than EUR 1 000 have been excluded. All the other thematic, size, sectoral and convergence indices are made up of a sub-set of companies included in the CMU All Share Index.

The **CMU ESG Index** forms the main thematic index of the CMU Index Family. There is a growing demand for ESG investments, but still a significant challenge in measuring the ESG performance of companies. The current methodology is therefore simply based on the sector in which the company is active. In simple terms, the higher the pollution of the sector, the lower the weight in the index. As soon as the ESG-related disclosure of companies becomes more harmonised and comprehensive, the methodology could be revised to consider all relevant aspects. There are already several policy initiatives in this direction.

The CMU ESG Index can also leverage on the EU Green Deal backed by the European Commission.

Figure 1 CMU Index Family



Source: CEPS (2020).

There are five different types of size indices. The **CMU Micro Cap** and **CMU Small Cap** indices cover all eligible micro and small caps, respectively. The **CMU SME Growth Markets** cover all eligible companies listed on all markets registered as SME Growth Markets. The **CMU Small National Capital Markets** and **CMU Mid National Capital Markets** cover the smaller EU equity markets based on the total market capitalisation of the companies listed in these countries. The two national capital markets indices combined cover all the EU frontier and emerging markets, except for Poland.

There are 12 different types of sectoral indices. These sectors have been based on the NACE classification of companies, differences in the nature of their activities and the extent to which they are active companies for the sector. The main sectoral indices include the **CMU Manufacturing Index**, **CMU Energy Index**, **CMU Utility Index**, **CMU Construction Index**, **CMU Trade Index**, **CMU Logistics Index**, **CMU ICT Index**, **CMU Banks & Financial Services (excl. insurance) Index**, **CMU Insurance Index**, **CMU Real Estate Index**, **CMU Health and Social Services Index**, and **CMU Services Index**.

With the exception of the CMU All Share Index, all the main indices include companies of which the stocks have an average daily trading value of at least EUR 50 000. However, to stimulate market integration, every main index is also featured as a **convergence index**, covering all the companies with less liquid stocks. In convergence indices the average daily trading value of included stocks ranges between EUR 1 000 and EUR 50 000. Based on the trading values in the second half of 2019, about 45% or 1 600 companies would be covered by these convergence indices.

The indices are calculated as a price, gross return (including dividends) and net return (adjusted for dividend tax) indices.

All the indices are in principle weighted based on the free-float adjusted market capitalisation. The weight is capped at 10% of the index for a single company and 40% for the top five companies with the largest weight. This concentration capping ensures that more balanced indices can be used for UCITS funds. The CMU Index Family is conceived to be revised every six months.

CMU Index Family performance

The CMU All Share Index (price index) would have had a **return of about 19.4% or an annualised return of 3.6% per year over the past five years, excluding costs and dividends**. The return could have been about three times as high, if the index had not declined rapidly in response to the COVID-19 virus outbreak and related lockdown measures in early 2020.

The return is higher when the received and re-invested dividends are also included. The CMU All Share Index (gross return) would have had a return of 34.5% between April 2015 and March 2020 - about 80% higher than the price index. If the gross dividend tax rates are also considered, the net return would still be 29.8%, or almost 55% higher than the price return index.

The CMU All Share Index would also have performed well compared to some of the large international indices. The CMU All Share Index followed more or less the same developments as the MSCI World Index, S&P 500 Index and STOXX Europe Index. In terms of performance, it would probably have outperformed the MSCI World Index and STOXX Europe Index, and had the same performance as the S&P 500 Index.

Turning to the sub-indices, both the CMU Convergence Index and CMU ESG Index outperformed the CMU All Share Index in terms of return. The size indices show a large range of positive returns, both above and below the CMU All Share Index. The sectoral indices also show a large range of returns, including some indices with a negative performance (CMU Construction, CMU Logistics, CMU Banks & Financial Services [excl. insurance], CMU Insurance). This includes many sectors that were impacted heavily by the COVID-19 outbreak.

The liquidity of the CMU All Share Index and convergence indices is a concern. About half of the companies included had one or more days without trades over a period of six months. More than 35% of the stocks included in the majority of the convergence indices even had 10 or more non-trading days.

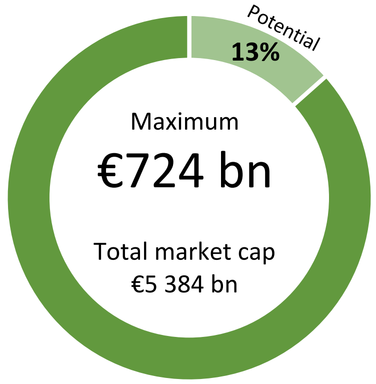
Significantly, **good past performance is no guarantee of future performance**. Moreover, the indices have different risk-return relations and the returns of the index-based investment products often deviate from the index return (tracking-error, replication costs, etc.). Furthermore, the index returns might be somewhat affected by the simplification of the index calculation. The index returns were calculated for the entire five-year period based on their composition at the end of 2019, which might give rise to a survivorship bias and over-weighting of good performers in the index.

CMU Index Family potential

Based on indications from investors there is a moderate interest in the CMU Index Family. Nevertheless, the index could have a significant impact on the development and integration of the smaller EU equity markets, noting the impact that a few very small funds already have in these markets.

Under optimal conditions the CMU Index Family could, according to investors, attract as much as EUR 725 billion or 13% of the total free- float-adjusted market capitalisation in institutional investments. For this, the CMU indices would have to attract as much investment as the most-used comparable indices. The investors would track or benchmark one of the indices.

Figure 2 Indicated investor interest in CMU Index Family



Note: The market capitalisation is free-float adjusted.
Source: CEPS (2020).

There seems to be little to no potential for the CMU All Share Index to be tracked. This is largely due to difficulties associated with the replication of the index. Looking at existing investments, no indices with more than 3 000 companies attract significant investments. If the CMU All Share Index is replicated, it is likely that investors will limit themselves to a sub-set of companies. This is possible as the mid-caps and large-caps represent 25% of the included companies (800) and 96% of the index weights. **Additionally, some investors might want to use it as a more comprehensive benchmark to inform their investment performance. The sub-indices with fewer companies could attract more investment.** The CMU ESG Index could attract the most investment.

The extent to which the potential of the CMU Index Family is realised largely depends on the conditions. These include governance, the quality of the index provider selected to set up the index, and marketing. But also the pricing and communication/sales strategy. If the entire or part of the CMU Index Family were to be offered free of charge – even for an initial transition period – this could contribute to attracting significantly more investment. The willingness to pay for the use of indices among the most interested national and regional institutional is often limited, however.

CMU Index Family implementation roadmap

Based on the feasibility assessment, it seems unlikely that any of the established private-index providers will issue the index family as an own initiative. **This leaves the public-private partnership as the most feasible governance model for the creation of the index family.** In such a partnership, the private partner would be responsible for the creation, maintenance and exploitation of the CMU Index Family, while the public stakeholders could provide initial financial and marketing support as well as high-level guidance to ensure consistency with public policy objectives.

This study proposes the creation of an implementation task force to launch the CMU Index Family. The task force should explore which public and private parties would be willing to create the CMU Index Family. The European Commission and/or the EBRD could offer logistical and secretariat assistance to such a task force.

If public stakeholders can be found, and decide to pursue the creation of the complete CMU Index Family, they would have to take several steps to realise the public-private partnership and create the CMU Index Family that is included in the implementation roadmap.

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Manuscript completed in June 2020

Luxembourg: Publications Office of the European Union, 2020

PDF ISBN 978-92-76-03741-5 doi:10.2874/724400 catalogue number: EV-01-19-457-EN-N

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