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European League for Economic Cooperation

ELEC position paper

Why EU Capital Markets Union has become a "must have" and how to get there[1]

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Executive Summary

Five proposals for policymakers

1. Harmonise the key elements of corporate insolvency proceedings and consider adopting an opt-in regime based on international standards, perhaps by "enhanced co-operation" among a willing group of Member States
2. Create the conditions for securitisations to become a complement to bank finance
3. Stimulate retail investment via an array of actions including tax incentives and more auto-enrolment in pension funds
4. Empower ESMA to become the supervisor of wholesale capital markets via joint supervisory teams with national competent authority (NCA) staff
5. Investigate the feasibility of developing the ultimate High Quality Liquid Asset for financial institutions – a "safe asset" in the form of a Eurobill fund

Five reasons why CMU has moved from being `nice to have' to `must have':

1. Europe's green and digital ambitions require more private capital and a more efficient deployment of the existing stock
2. Efficient financial markets with modest asset management fees can produce and protect wealth for ageing populations
3. Mature capital markets provide cheaper and more diversified sources of funding, spurring innovation and economic growth
4. Developed capital markets promote Europe's strategic autonomy
5. Deep and integrated capital markets strengthen financial stability by facilitating risk-sharing, reducing the strong reliance on bank finance and pricing risks efficiently

Introduction

The Capital Markets Union (CMU) is an opportunity for all European citizens. Policymakers and politicians often state that deeper and better integrated European capital markets strengthen financial stability and support economic growth. While this is certainly true, the narrative from the perspective of a European citizen remains opaque. There are clear and easy-to-explain channels through which the strengthened financial stability and enhanced economic growth positively affect the daily life of Europeans.

Today's great challenges – including radical shifts in the global distribution of power, climate change and digitalization – affect citizens' daily lives. The Russian invasion of Ukraine directly impacts the energy prices of European citizens and requires us to reconsider other dependencies on autocratic regimes. Climate change hits Europeans differently but inevitably: from droughts, extreme temperatures and forest fires in southern Europe to floods in northern Europe. And our societies and economies need to catch up with a world that is rapidly digitising.

The Capital Markets Union (CMU) is a cornerstone of a competitive and resilient Europe and can help realize the euro's potential for all EU citizens. While the euro is firmly established as a major asset for EU citizens, it is not yet delivering its full potential. For the success of the CMU, steadfast commitment of all stakeholders – in both public and private sectors, is needed. The essential questions are: how does the CMU benefit European citizens and how do policymakers make these benefits visible to citizens?

Developing the CMU provides resilience for EU citizens by simplifying, strengthening and securing:

- Deeper capital markets give citizens more options to invest their savings. The CMU simplifies the provision of cross-border investment services which can help reduce costs by leveraging economies of scale and competition. As a corollary, integrated capital markets increase competitiveness and cost-efficiency in funding markets and therefore help lower the costs to get a loan for a home, education or starting a business.
- The CMU strengthens the European Union by enhancing the risk-sharing through capital markets, making individual countries and its citizens less vulnerable to economic shocks.
- A European safe asset would strongly contribute to a CMU and provide investors with a secure and stable option for investment. This could lead to increased confidence in European financial markets, attracting more investments and potentially lowering the cost of capital for businesses. With an efficient set-up, it could lower the public debt of individual Member States

which increases the debt sustainability and therefore ultimately lowering the borrowing costs for EU citizens.

Will policymakers and politicians enable European citizens to exploit these benefits, or will Europeans be forced to stay in the old national silos and miss out on cheaper funding, better diversified pensions and long-term investments, and a greener and more digitalized Europe? Will European politicians offer their citizens the benefits of this new "CMU" or will they allow the current system to perpetuate? Citizens are adopting technology in their daily financial transactions, but the lack of a single capital market prevents them from gaining the full benefits of the euro and technology.

We recognise that there are inherent political challenges when integrating European capital markets. Part of the challenge lies in the fact that we have a collection of 27 national markets that are closely interlinked, yet all (want to) retain the full value chain for financial services. As with other industries where one jurisdiction may excel over another in producing a certain type of good – but with equal access for everyone within the single market – we should also recognise for capital markets that not every jurisdiction needs to do it all and have it all. Instead we should focus on a few centers of excellence across the EU for certain types of capital market activity. Doing so would ensure that activity naturally gravitates towards these centers and a critical mass builds up that then allows Europe to become internationally competitive.

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Five proposals for policymakers

1. Harmonizing fundamentals

Meaningful harmonization of corporate insolvency proceedings is necessary to facilitate cross-border capital flows – specifically in taking ownership of collateral swiftly. According to the IMF the EU needs to further harmonize key underlying 'fundamentals' such as tax procedures, insolvency proceedings and corporate governance to truly build a single capital market (IMF, 2019). Well-functioning insolvency proceedings across the EU Member States would better allocate scarce resources in an economy and thereby support economic activity. It would also help banks offload non-performing loans (NPLs) and recover more quickly after a downturn.

To reignite pending items from the 2020 CMU action plan related to withholding tax procedures, insolvency proceedings and facilitating shareholder engagement, the Commission should investigate if there is the necessary minimum of nine Member States to initiate "enhanced co-operation" – as provided in the Treaty on the Functioning of the European Union (TFEU) so that Union institutions can be used to operate the system.[2] In this context, one could also investigate the possibility of a common corporate insolvency law that bond-issuers could opt into. If that would succeed in moving corporate assets to participating countries, the force of competition might be a powerful incentive for Union-wide reform.

We see historical precedents for adopting international standards to spur harmonisation. In the past, the EU has shown itself willing to break logjams by adopting international standards: the European System of Accounts (ESA) was developed in 1995 by reference to UN standards; International Accounting Standards (IAS) were adopted in 2002 to avoid the problem of harmonizing the different standards of Member States. Most recently, the OECD standard for a minimum corporate tax rate was adopted. Doing so again in the field of insolvency makes sense. The general principles of an international insolvency code were set out by the IMF as far back as 1999.

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[2] In our view, there is a case to be made for enhanced cooperation in the field of insolvency. The Commission's Recommendation of 2014 led to the 2019 Directive on restructuring and insolvency, which failed to satisfy expectations due to the lack of harmonization necessary to create a single market in financing corporations (as documented in the IMF's detailed critique of the Directive in 2021). The existence of this Directive demonstrates decisively that the Treaty conditions for the application of enhanced co-operation are met.

2. Create the conditions for securitisations to become a complement to bank finance

The broad objective of the CMU is to endow the EU economy with a capital market on par with the sophistication of its economy, complementing the intermediation done by the banking system. In this perspective, it is concerning that asset backed securities (ABS) – a tool that can bridge the gap between the banking sector and the capital market – are so little used**.** ABS can make use of the best characteristics of the banking system – i.e. allocating credit and assessing risk – and those of the capital market, i.e. bearing risk over the medium and long-term. Tranching and securitization enhance the risk-bearing capacity of capital markets by offering a menu of risk-return combinations that enables investors to choose those best matching their taste and ability to manage risk.

The lessons of the 2008 US experience with securitizations were fully incorporated in the Simple Transparent and Standardized (STS) Regulation. Of course, as any powerful financial innovation, ABS can – and indeed was – misused and even abused. What happened in the US before the 2008 financial crisis is a textbook example of a poorly understood and regulated innovation leading to a crisis. Even if in Europe nothing like what happened in the US took place, the STS Regulation prohibits all elements that created problems in the US while requiring those features which proved useful. Overall, the STS Regulation establishes the basis for a sound and thriving market.

Some progress has been achieved since the Securitization Regulation was implemented in 2019. The quantitative progress is visible in the numbers of STS programs and their volume.[3] There has been progress, however – also in terms of quality – by extending the STS label to synthetic securitization, which allows issuers to reduce risk on their balance sheet even when they have no funding needs. However, what has been achieved so far is much too little in terms of the potential of the tool as shown in other jurisdictions and of the funding needs of the European economy, dealing with the demographic, digital and green transitions.

With the basic regulation for ABSs to realize their full potential in place, the last mile just requires a better calibration of some components: the capital charges for the holding of securitized assets by banks (in the Capital Requirements Regulation) and insurance companies (in Solvency II), the treatment of ABS in the Liquidity Coverage Ratio (Delegated Commission Regulation) and the disclosure and due diligence requirements, which need be made consistent with those imposed on other types of bonds.

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[3] The number of programs has increased from 125 in the first year over which STS applied (2019) to around 200 recently, with good diversification in terms of geography and underlying assets (see data by PCS Europe). In terms of volume, AFME data show that STS issuance is – since 2019 – a relevant presence in Europe (see e.g. slide 25).

3. Mobilizing funding through (in)direct retail participation

Channelling household savings – where appropriate – towards more remunerative, risk-bearing and long-term financial assets is key to deal with Europe's demographic, green and digital transitions. European households hold a large share of their financial assets in cash or deposits, even as the composition of households' financial assets varies strongly between Member States (see Figures 1 and 2). While cash and deposits are appropriate for saving with short-term horizons when nominal stability and liquidity are key, equity and debt held directly or indirectly through investment funds, insurance products and pensions funds can provide higher long-term returns when investment horizons are sufficiently long.[4] By holding, directly or through intermediaries, more capital market instruments (whether bonds or equities) EU households, including those less endowed with financial wealth, can share in the higher long-term returns compared to deposits that can be achieved on capital markets, while at the same time boosting funding available for risky, but promising, investment projects. Higher long-term returns earned abroad on Europe's old-age provisions can help cover import needs amid a shrinking working-age population, while a lower domestic cost of equity can boost the EU's growth potential. We encourage continued targeted financial literacy programs, which can help people understand the benefits of long-term investing.

The European Commission should look at how (national) tax codes affect households' investment choices. Some tax rules favour certain types of financial assets over others and not all tax codes enable citizens to defer income taxes when investing in financial products held for retirement purposes. The European Commission should examine the tax codes of Member States and issue country-specific recommendation in relation to such distortions. There is further a need to encourage auto-enrolment pension schemes, which have proved effective in shifting savings to capital markets, as in the United Kingdom, where they raised private pension participation from 42% to 86% in nine years (UK Department for Work & Pensions (2022)).[5] Currently, there are only a few EU countries with a

[4] As illustrated in Better Finance's 2023 country-by-country papers on the real return of long-term and pension savings.

[5] Pension fund assets matter both quantitatively and qualitatively. With their long-term liabilities, pension funds commit to firms which gives them the possibility to make investments that pay off only in the longer-run. Moreover, institutional investors like pension funds may engage with firms, providing them with expertise and advice and, fourth, having a pension fund investing in a firm may provide a positive signal to the market, making it easier to draw in other investors. Looking ahead, as the proportion of "retired lives" rises, accounting rules encourage the sponsor to minimize their exposure to possible deficits by moving the balance of investment away from equities and towards bonds that give certainty of income for the retirees. As an (extreme) example, UK Defined Benefit funds reduced their equity exposure from a peak of about 75% of assets in the early 1990's to well under 20% now.

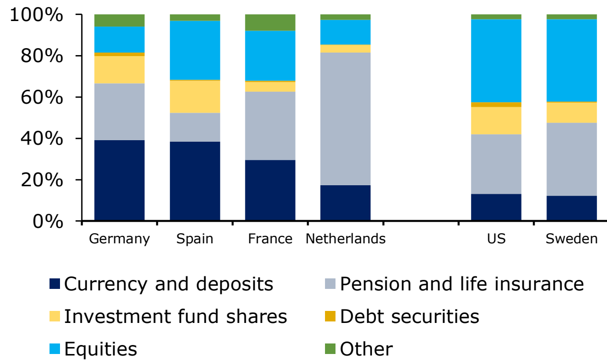
substantial funded pension sector, the most important ones being Denmark and the Netherlands, while insurance companies play a relatively large role in Germany. By far the largest source of income in retirement are public pensions financed through pay-as-you-go schemes. Keeping such systems afloat will become more and more difficult in view of the rising old-age dependency ratios.

We need more cross-border competition and economies of scale in the provision of EU retail investment products. EU citizens can only benefit from the gross returns available in financial markets when ongoing costs on retail investment products are modest. The observed heterogeneity in ongoing costs and performance fees on UCITS[6], retail AIFs[7] and structured retail products across Members States – as visible in e.g. ESMA (2023) – underlines the potential for increased competition to reduce overall costs and thereby boost net returns on retail investment products for EU citizens. The modest size of EU investment funds compared to US equivalents shows the potential for economies of scale to reduce the cost gap between EU and US.[8] In this regard, proactive policy measures can create a virtuous cycle between lower costs and larger capital markets. One way to stimulate competition would be through creating regulatory frameworks that are well-calibrated to all types of market participants. An often overlooked side-effect of the bank-centric model in Europe is that many regulatory frameworks look at market participants through a banking prism. This fails to appreciate the diverse activities of non-bank market participants and can often prevent them from adequately fulfilling their roles in the capital market ecosystem.

Prudential policies may need to focus more on mobilising long-term funding pools. Supervision is primarily aimed at the safety of individual institutions rather than the safety of the financial system as a whole or the consequences for the macroeconomy. Driving long-term savings towards low-risk assets, implies that at the macro-economic level a relatively small proportion of savings is directed towards risk-bearing investments, typically the type of investments directed at the development and adoption of new technologies.[9] We would therefore also encourage the European Commission to draft a policy report on the trade-off between micro prudential regulation and the supply of risk-bearing capital.

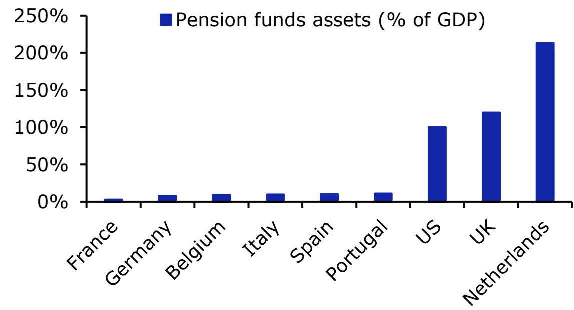
[6] Directive - 2009/65 - EN - UCITS - EUR-Lex (europa.eu)
[7] Directive - 2011/61 - EN - aifmd - EUR-Lex (europa.eu)
[8] For example: the average open-ended US mutual fund holds EUR 3,000mn om assets, while an EU UCITS fund held just above EUR 340mn – even while the EU holds 30% of global net assets compared to 48% for the US (see ESMA (2023)).
[9] For Danish registrar level data, Beetsma et al. (2023) find that pension funds taking an equity stake in companies, in particular unlisted and smaller companies, results in an increase in productivity of these companies

Figure 1: European households put a relatively large share of their savings in bank deposits



Source: OECD

Figure 2: The amount of pension fund assets lags more developed capital markets



Source: Global pension statistics - OECD

4. ESMA reforms

The next CMU action plan should enhance and broaden the role and structure of ESMA as the main EU markets authority. ESMA should be recognized as a fully-fledged supervisor with the necessary power and independence. A lot of work has been done to create a single rulebook, but it is still applied and enforced differently. This makes financial activities unduly expensive and increases regulatory uncertainty. The current EU supervision model does not reflect the high degree of interdependence in our financial markets. Supervision should be performed by a central authority when markets operate across borders to overcome the otherwise chronic vulnerability that lies in regulatory arbitrage. The successful reorganization of banking supervision following the Great Financial Crisis from a strictly national competence to a shared European responsibility demonstrates both the merit and the feasibility of a de facto federalization of supervision. The reform of ESMA should therefore draw inspiration from the established SSM-model where centralised decision-making goes hand-in-hand with utilizing local NCA expertise. Doing so, one would inevitably also create a European counterpart to the SEC, which is also promoted by ECB President Lagarde (2023).

ESMA supervision on critical cross-border market infrastructures, such as clearing houses, exchanges and securities depositories, would be a logical first step. In this context, we note ESMA has already been entrusted with the direct supervisory oversight of "third country" Tier 2 CCPs which dwarf EU-based CCPs and thus pose the greatest risk to the financial stability of the EU. The logic of extending that supervision to the home-grown sources of financial instability in capital markets is clear. More generally, ESMA should be given the task and the powers to supervise the entire wholesale financial market via joint-supervisory teams with NCA staff. On the conduct authority side, a similar case exists for centralizing supervision, albeit a bit less strong. Retail market supervision for instance is better left to NCAs given the stronger interaction with local language and culture, as is the case with the marketing of a specific retail product. ESMA should also improve, harmonize and centralize the collection of market and supervisory data, becoming a hub for information and analysis. To reinforce its independence and allowing it to endow itself of adequate technical expertise, ESMA's funding should come entirely from levies on the capital markets industry.

Overall ESMA could, together with the Commission, become a driving force behind the development of the CMU. As such it should identify barriers to integration and devise ways of surpassing them so that market participants can freely exploit the opportunities that a larger, more integrated capital market would offer. Schumpeterian creative destruction would powerfully contribute to a higher performance of the capital market thus benefiting the economy of the euro area.

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5. Safe assets in the EMU: a necessary condition for a genuine CMU?

A successful euro capital market would greatly benefit from offering investors – from retail savers to global institutions – a choice of assets throughout the spectrum of both riskiness and marketability. Both these aspects must be anchored at the point of least risk and greatest marketability (whether that is achieved by depth of the trading market or imminence of maturity). That anchor can best be delivered by short-maturity obligations of governments.

Currently euro area bond markets cannot compete globally, even though the euro area has the potential to develop a globally competitive bond market. The attraction of short-term bills has been demonstrated for decades by the global role of US Treasury bills – currently standing at €4.6 trillion equivalent. It is the foundation of the US dollar's pre-eminence and the pricing/liquidity anchor of the overall US dollar bond market totalling €49.9 trillion (BIS 30 June 2023). The euro area's competitive offering stands in sharp contrast. The bills of all euro area governments together amount to a mere €0.6 trillion. They anchor an overall euro bond market of €21.5 trillion, per BIS. However, if all euro area governments committed to convert all `under two-year obligations into a common pool, it would reach nearly €2.5 trillion – a genuinely global scale. The "problem" for the euro area is that its governments are significantly less indebted than the US and its financial stability is enhanced by having a much longer debt maturity (9.24 years) versus that of the US (5.92 years) – even if the longer maturities put the euro area in a more stable financial position.

The challenge for the strategic autonomy of the Union's currency lies in how to do it. One option is to pool bills into a fund whose safety is buttressed by a state's ability to borrow from the ESM to repay its bills – in the extreme (Bishop (2018)). Such a fund would fulfil many purposes, without increasing the net size of public debt nor mutualize it:

- Providing a `least risk', public sector yield curve for short maturities as the foundation of CMU – reducing dependence on derivatives operated by private sector CCPs and global banks.
- Re-enforcing fiscal rectitude: access to the ESM is limited to states complying with fiscal rules.
- Supplying the ultimate High Quality Liquid Assets (HQLA) for EU (and other banks dealing in euro) – thereby improving their stability and safety.

The next Commission should examine further the technical feasibility of a eurobill fund of global scale that would pool existing EU government short-term obligations to fulfil these three purposes.[10]

[10] The Commission's Expert Group of 2013/14 found the general concept to be technically feasible.

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Five Reasons why the CMU has moved from a *nice* to have to a *need* to have

Europe's capital market remains underdeveloped, despite significant efforts by the European Commission. The Commission has launched two action plans, in 2015 and 2020, to boost and integrate Europe's capital markets. The first plan aimed to diversify the sources of funding for businesses and long-term projects, and to remove barriers to cross-border capital flows. The second plan sought to create a single market for capital, to encourage savers to invest for the long term, and to make financing more accessible for firms. But the EU is far from achieving a true capital markets union, even if it implements all the actions in the existing action plans. The data measuring Europe's capital market development and integration show that the bloc's capital markets are still underdeveloped and fragmented (see e.g. New Financial (2023) and European Commission (2023)). The Commission has made some headway in improving the availability and comparability of information for investors across the EU, with flagship projects such as the single European access point (ESAP) and the consolidated tape. But it has made less progress in harmonizing rules and practices, such as insolvency laws and direct supervision by ESMA – along the lines of the success of the Single Supervisory Mechanism. And it has failed to increase the size of the EU's capital markets and to persuade households to shift their bank deposits to longer-term investments, while the CMU is now a must have.[11]

Five reasons why CMU has moved from being `nice to have' to `must have':

1. Europe's green and digital ambitions require more private capital and a different use

Europe's green and digital ambitions require a more robust and integrated capital market. As the EU enters a new legislative cycle, the costs of inaction are becoming increasingly constraining. The interest rate environment seems to have changed structurally from the lower bound episode between 2014-22, due to the funding needs of the twin transition, ageing European populations and increased public borrowing. The European Commission (2020) estimates that to achieve its 2030 climate target, annual investments of about 2% of EU GDP are needed, of which between 0.5 and 1% of GDP needs to come from public investment (Pisani-Ferry et al. (2023)). Meanwhile, there will be a growing fraction of retirees, who tend to dissave to maintain consumption. And on top of this, net borrowing by

[11] The latter is particularly startling as the EU endured a long period of minimal deposit rates while equites have given annual returns of more than 6%– comfortably above the average inflation rate (see e.g. Qontigo for historical returns on the Eurostoxx 600 and Total Market indices).

governments is resulting in high public debt levels that have come down only slightly on the back of high inflation but are set to rise again in the medium run.

2. Efficient financial markets can produce and protect wealth for ageing populations

Europe's demographic deficit puts a greater responsibility to prepare for a financially stable future. Taken as a whole, European households and governments are still overly reliant on pay as you go public pension schemes. This design choice is inherently more vulnerable for ageing populations as old-age dependency ratios worsen. By promoting (in)direct retail participation in capital markets, household wealth can be built or supplemented. This not only can take the pressure of public finances, but also is likely to improve the living standard of senior citizens in the long run. In this regard, it is noteworthy that (in)directly attracting more retail participants can create a virtuous cycle where economies of scale lower the costs and generate better returns. Indeed, mature capital markets with a diverse set of financial products can also help to protect retail participants from other financial risks related to climate change or other nature related risks.

3. Mature capital markets provide cheaper and diversified sources of funding which can spur economic growth

The EU has made some progress in creating a capital markets union, but it remains a patchwork of national rules and markets. This hampers the flow of capital and investment across the bloc and limits the financing options for businesses and savers. This is also an important factor which explains the observable financing gap of European firms, which particularly impacts SMEs (see ECB (2023)). Indeed, financial systems that are dominated by banks are generally less suited to provide equity funding to SMEs or innovative projects as they have strict collateral requirements. Such innovative investments generally imply higher risk, but also hold the promise of higher returns which in turn can lead to stable employment in a future-proof economy. Mature capital markets are also better able to price risks effectively which improves risk management.

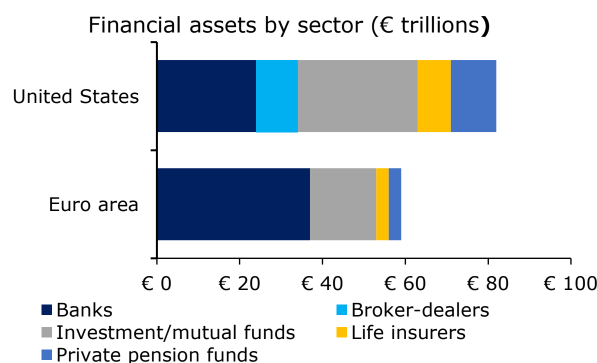
4. Developed capital markets promote Europe's strategic autonomy

The emergence of a multipolar world requires a more integrated and thus stronger EU to protect its interests and establish what has been labelled as open strategic autonomy. With regards to the European economy, in the end it is the innovative capacity that will determine its long-term relevance and competitiveness. As a result, Europe's strategic autonomy agenda also depends on the further development of the CMU. Indeed, mature capital markets can also bolster the international role of the Euro and lessen the dependence on third countries.

5. Integrated capital markets facilitate risk sharing and enhance financial sector resilience

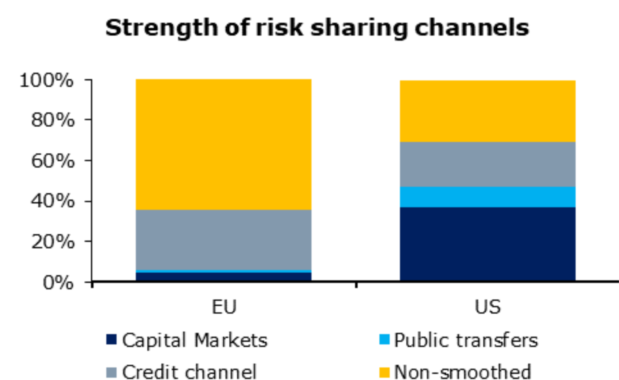
Developed and integrated European capital markets enhance the financial sector's resilience and spur economic growth. Europe's financial system is primarily bank-based, which leads to a suboptimal funding mix available for our non-financial corporations (see Figure 3). As banking sectors in many countries are rather concentrated with a strong domestic focus, many EU firms face unduly high borrowing costs. A more diversified and integrated system of capital markets would make the European economies more resilient and dynamic. But the EU lags far behind the US in the size and depth of its equity and bond markets[12], especially for riskier and more innovative ventures. This also limits the scope for private risk-sharing across borders, which could cushion regional shocks and reduce the need for public bailouts. The bulk of the difference of risk-sharing in the EU and US can be explained by the larger role of capital markets in the latter. The relatively lower share of public transfers in overall risk sharing channels (see Figure 4) suggests Europe is unlikely to obtain a high level of risk sharing by only developing fiscal integration which is also subject to several other constraints – including political ones. From the perspective of risk-sharing, both banking and capital market integration are necessary. While temporary shocks can also be shared through cross-country borrowing intermediated by the banking system, sharing shocks with permanent effects on income requires capital market integration (Martinez, Philippon and Sihvonen (2022)).

Figure 3: Euro area has a bank-dominated financial system



Source: IMF

Figure 4: With little risk sharing through capital markets



Source: ECB

[12] An important part of the difference can be explained by a different set-up of the residential mortgage markets which are financed by markets in the US and by banks in the EU.

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Appendix: Members of the ELEC Group of Wise Persons that contributed to the paper

ELEC members' views conveyed via this position paper are made in their capacity as private citizens. The content of this position paper does not reflect the official views of the organisations that ELEC members serve in their professional capacity.

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Appendix: Addressees of this letter

Dear Members of ECON, Commissioners UvL/McGuiness/Gentiloni/ Dombrovskis, Finance Ministers, Governing Council of the ECB, President of Eurogroup, Chair of Euro Working group

We – *the undesigned members of the European League for Economic Co-operation (ELEC)* – write to you ahead of the June European Parliament elections and subsequent appointment of a new European Commission for 2024/29. We realise that Capital Markets Union (CMU), to paraphrase Robert Schuman's famous statement: *"will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."* We believe that finishing the creation of a genuine and robust CMU is now essential for the growth of the European economy. Accordingly, we propose the achievement of five concrete steps during the next legislative term.