BANQUE DE FRANCE

EUROSYSTÈME

CAPITAL MARKETS UNION REVISITED

CEPR Symposium

14 December 2024

AGNÈS BÉNASSY-QUÉRÉ

OUTLINE

1. What is at stake?
2. Where do we stand?
3. A tentative roadmap

1. WHAT IS AT STAKE?

From CMU to SIU

Capital Markets Union (CMU)

- Launched in **2014**, after GFC and EA sovereign debt crisis, emphasis on macro **stabilization.**
- Capital markets in the US deliver more risk sharing than the federal budget (Asdrubali et al., 1996) and way more than capital market in the EU (Alcidi et al., 2023, Cimadomo et al., 2023).
- In the EU: **a complement to banking union**.

New branding: Saving and Investment Union (SIU)

- Draghi and Letta reports (**2024)**, emphasis on **allocation:** to finance innovation and transition
- Capital markets **in the US** are deeper, more liquid and better equipped to finance risky investments (equity).
- **In the EU**: lowering intermediation costs will improve the risk-return trade-off for savers.

➔***CMU/SIU two sides of the same coin => a better capital allocation through enhanced risk-sharing***

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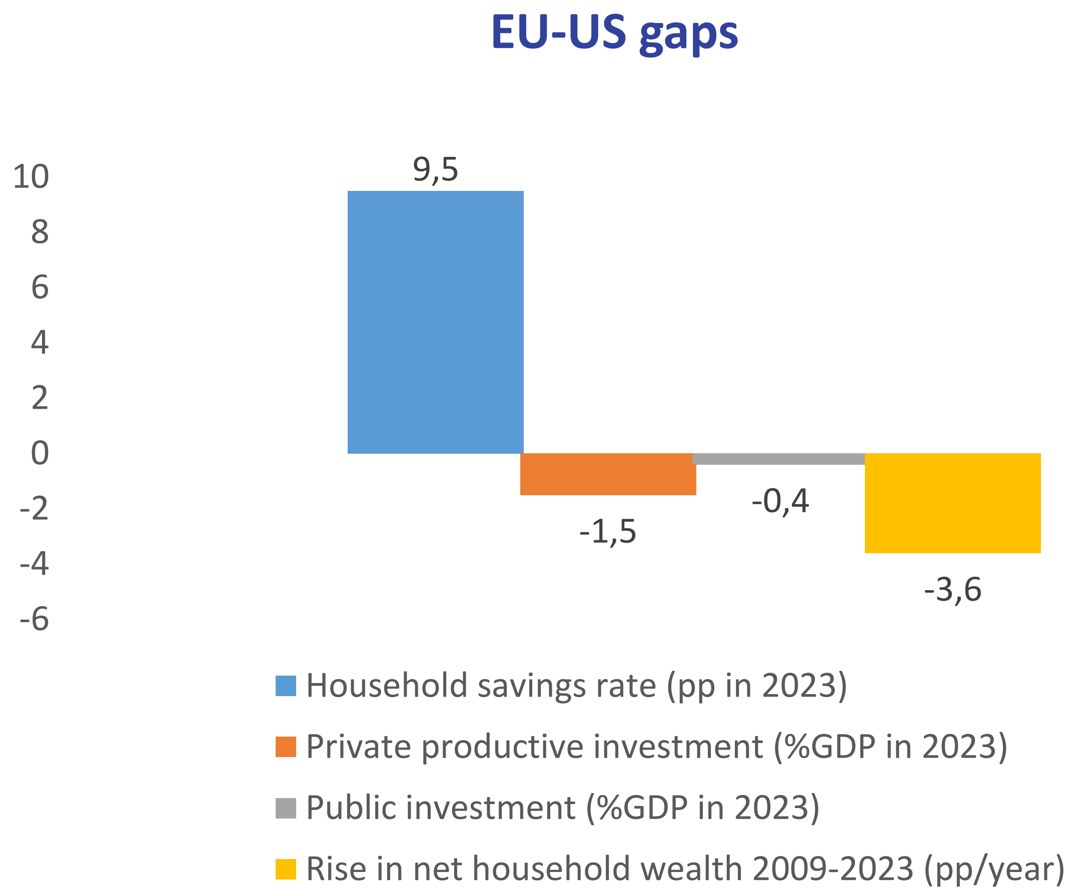
EU CAPITAL ALLOCATION PROBLEM



Source: based on Draghi report (2024), part B, p. 281.

Shared diagnosis:

- **Lack of equity**, caused by (i) prominence of bank intermediation, (ii) lack of pension funds, (iii) lack of exit options for venture capital;
- **Market fragmentation**, due to (i) different legislations (taxation, insolvency regimes), (ii) fragmented market infrastructure (CCPs, CSDs), (iii) fragmented supervision.
- Lack of **portfolio diversification**, due to (i) limited size of funds, (ii) limited securitization.
- **Fragmented and complex public-private co-financing**.

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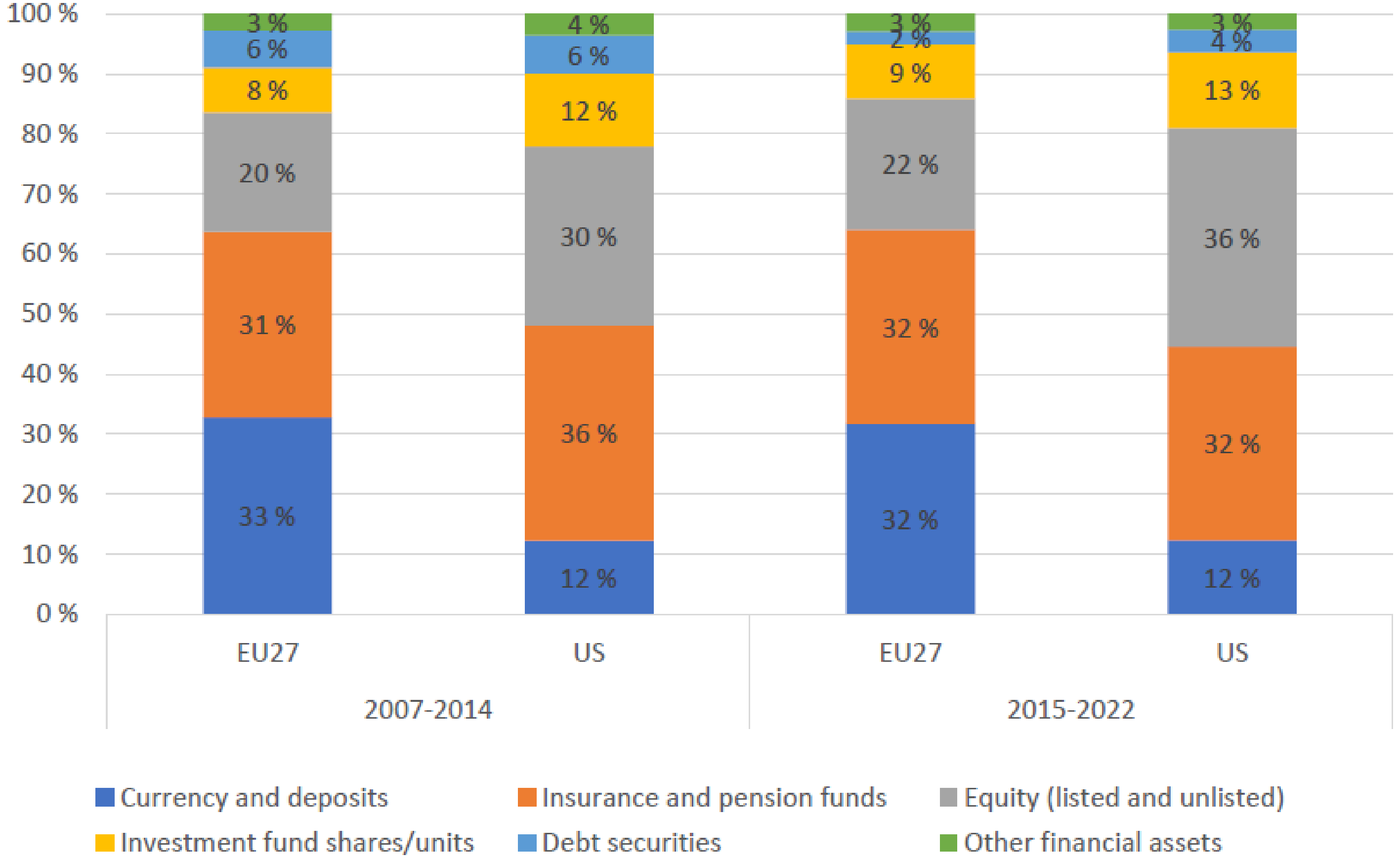
EU SAVERS HOLD LIMITED EQUITY

Household financial assets in the EU27 and the US (% of total financial assets, average 2007-2014 and 2015-2022)



- **Very little evolution** of the structure of financial portfolios of EU households.
- EU households still hold **32 %** of their financial assets in **cash and deposits**, compared with **12 %** for US HH.
- US HH invest nearly **50 %** of their savings in **equity** and **investment funds**, compared to about **30 %** for their European counterparts.

Source: CEPS, 2024. European Capital markets Institute, (Berg, Lannoo, Thomadakis, Arnal)

Note: The category 'Other financial assets', for the EU includes other accounts receivable, financial derivatives and loans. For the US it includes other miscellaneous assets and loans.

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SIU COULD PROVIDE MORE RISK-SHARING AND BETTER RISK-RETURN

More risk-sharing

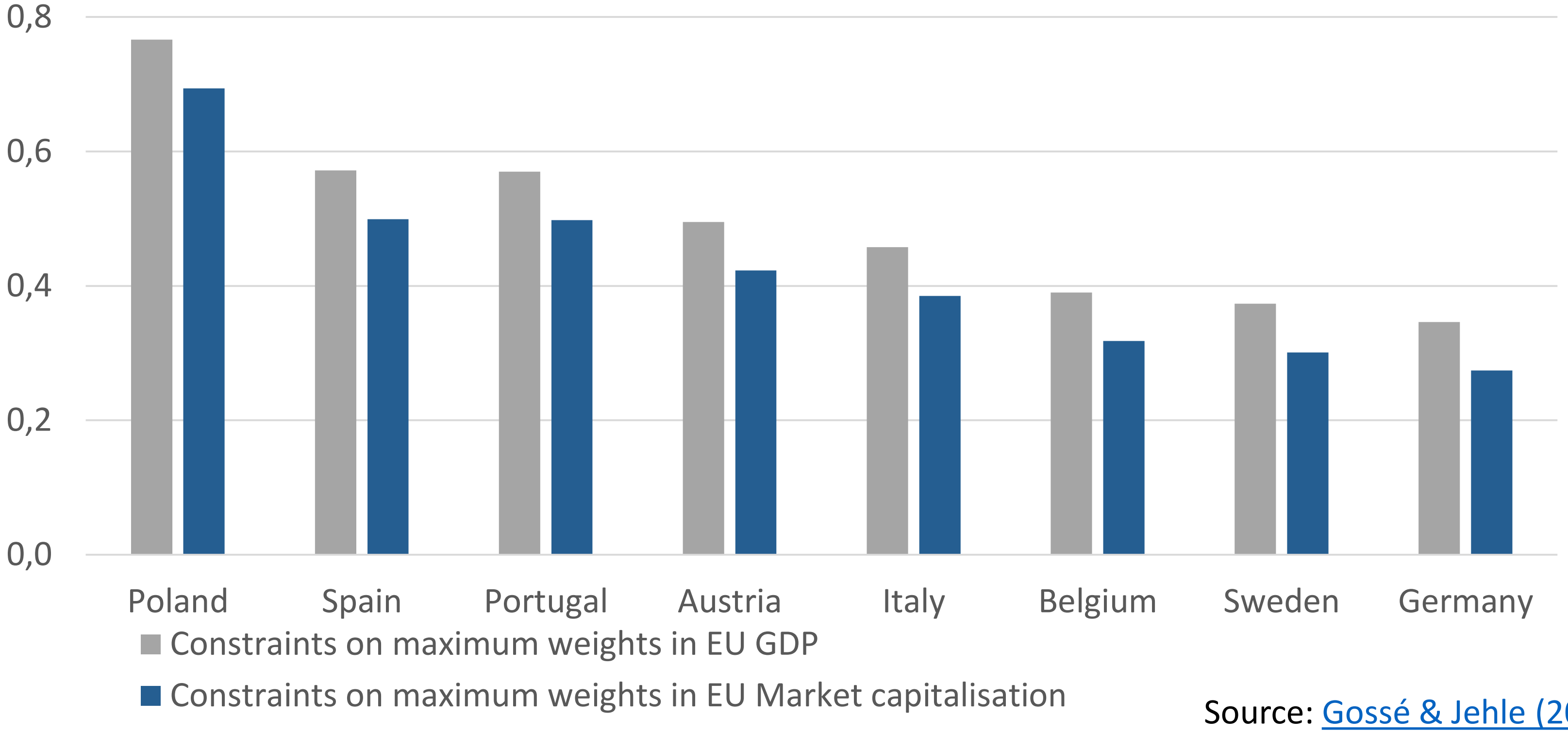
- Martinez, Philippon & Sihvonen (2002): A "money market union" (single monetary rate) smoothes demand shocks efficiently, but only a capital market union (cross-border equity holdings) can smooth supply shocks which affect the value of private assets.
- Hoffmann et al. (2019): risk-sharing is enhanced by cross-border banking and by equity holdings, but not by mere cross-border interbank market. Consistent with Martinez et al. (2022).
- Dufrénot, Gossé & Clerc (2020): higher integration in the bond and equity markets improves risk sharing in the long term.

Better risk-return

- Investors in several EU countries could improve their investment's risk/return by further diversifying portfolios (Gossé & Jehle, 2024).

POTENTIAL BENEFITS FOR SAVERS

Estimated potential diversification gains in listed equities the EU over 2012-2023 (change in Sharpe ratios)



Source: [Gossé & Jehle (2024)]

Note: The Sharpe ratio compares the return of a portfolio to its risk. The change in Sharpe ratio is the difference between the annualised Sharpe ratios of the optimal portfolio and a national reference portfolio (see Gossé and Jehle, 2024).

Reading: in Poland, investing in the optimal portfolio would have brought an additional 0.75 annual pp return corrected for risk, compared to the benchmark portfolio, over 2012-2023. Benchmark portfolio relies on equity holdings in 2014, including through mutual funds in Ireland and Luxembourg.

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2. SIU: WHERE DO WE STAND?

ACTIONS SINCE 2015: 2 ACTION PLANS, MORE THAN 30 MEASURES ADOPTED

Objective	Text
Encourage long term investment	**Solvency II review**: more favourable capital treatment for long-term equity.
Foster investments in innovative projects	**Regulation** (EU) No 345/2013 **EuVECA**: allows venture capital funds to market themselves across the EU with a "passport".
Enable a smoother flow of financial information	**ESAP** (European Single Access Point): digital single access point about EU companies and EU investment products.
Harmonize insolvency law in the EU	**EU Directive** (June 2019): to make corporate bankruptcy procedures more efficient (harmonized conditions, priority to prevention). [see next slide]
Empower investors	**Retail investment strategy**: to improve retail investor decision-making by ensuring that they are treated fairly and duly protected. **FASTER** (directive proposal): to avoid double taxation, simplifying and streamlining refund procedures that discourage cross-border investment within and into the EU.

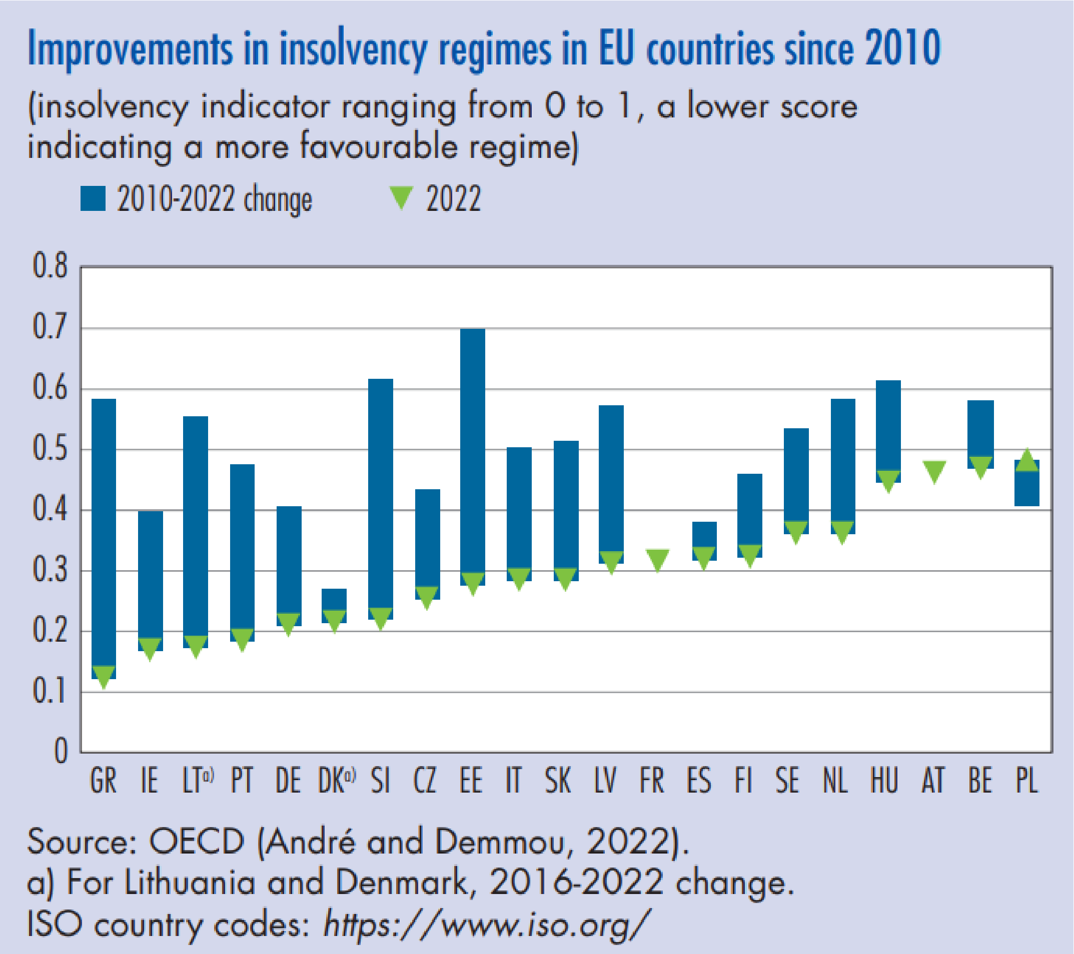
ACTIONS SINCE 2015: INSOLVENCY PROCEDURES

Directive of June 2019 on restructuring and insolvency

- Emphasis on **early restructuring** mechanisms and out-of-court procedures.
- **Classes of affected creditors**, with cross-class cram-down (a plan may be adopted despite negative vote of one or more classes, if a majority of the classes votes in favour of its adoption, provided that at least one of them is a class of secured creditors).

New Commission proposal in December 2022

- A common regime for revocation proceedings during the suspect period.
- Opening of a preventive procedure before value diminishes (“likelihood of insolvency”).
- Negotiated sale of a company prior to the start of a procedure (“pre-pack”).
- The EU Council (2024) and the ECB (2024) have called for further harmonization of corporate insolvency law. But **no agreement has been reached yet on the 2022 proposal.**



Source: Gossé, Jamet, Lamy and Massengo (2024).

SUSTAINABLE FINANCE

Sustainable finance Package 2021

- **EU Taxonomy**: defines which economic activities contribute most to meeting the EU’s environmental objectives.
- **Corporate Sustainability Reporting Directive (CSRD)**: disclosures and reporting for both companies and investors, to ensure proper transparency for all stakeholders.
- **MiFID II**: intermediaries offering investment advice or a portfolio management service are obliged since 2022 to collect their clients' sustainability preferences before offering them a financial investment.

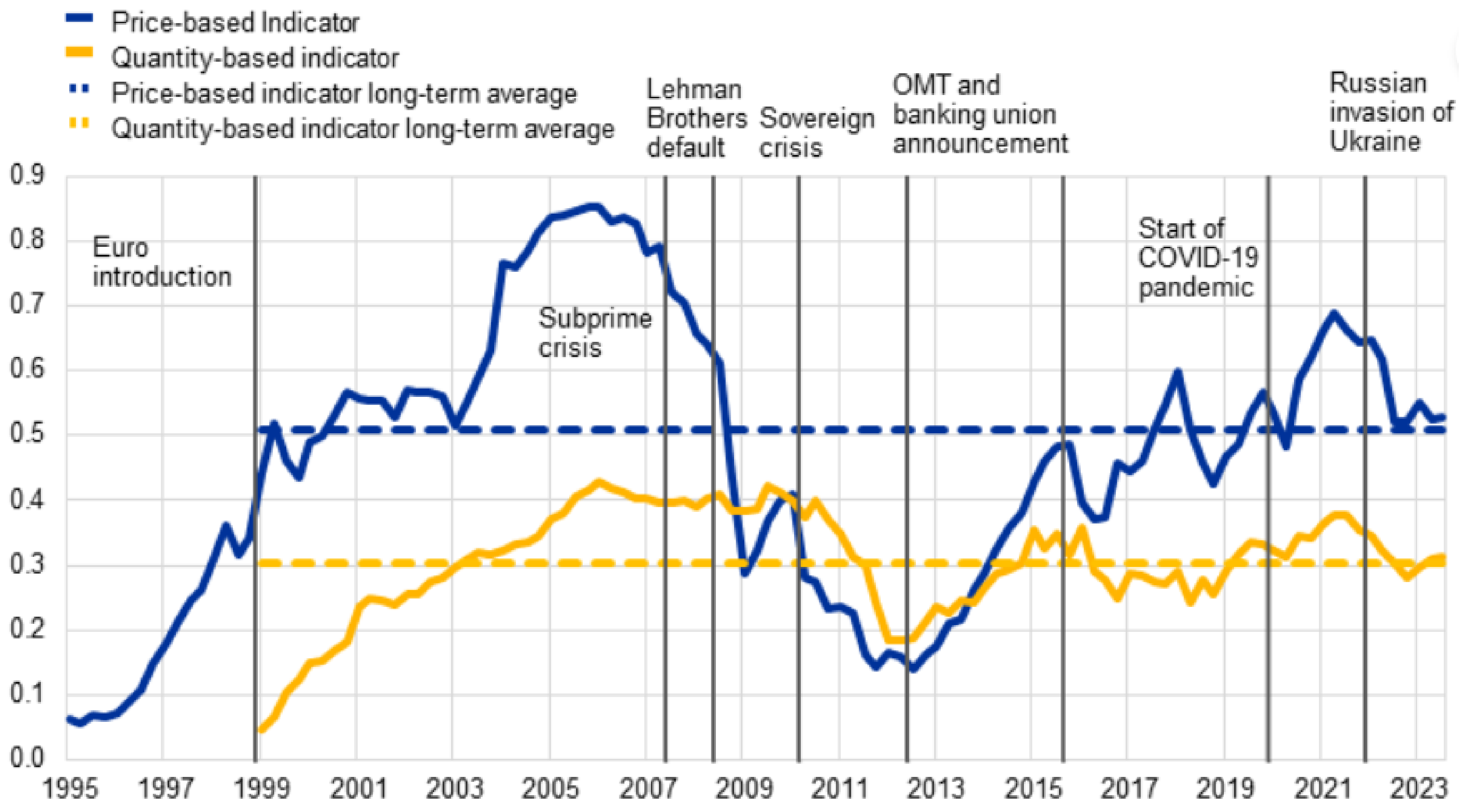
New sustainable finance package 2023

- **EU Taxonomy**: includes economic activities making a substantial contribution to non-climate environmental objectives (protection of water and marine resources, circular economy, pollution prevention biodiversity and ecosystems).
- **Regulation of ESG ratings providers**: e.g.. they must disclose information on data sources, methodologies, and assumptions used in their activities and products.

However, EU capital markets remain fragmented

ECB price-based and quantity-based financial integration composite indicators

(quarterly data; price-based indicator: Q1 1995-Q4 2023; quantity-based indicator: Q1 1999-Q3 2023)



Note: The indicators are bounded between zero (full fragmentation) and one (full integration).

Source : [ECB (2024)]

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FRAGMENTATION IN PRACTICE (1): THE CASE OF A RETAIL INVESTOR

I am an investor and I want to invest cross-border. What potential deterrents?

- Lack of standardized **information**.
- Risk of **double taxation** through withholding taxes (lengthy refund procedures).
- Heterogeneous **insolvency laws**.

Some progress has been made

- European Single Access Point (ESAP) and a standardized Key Information Document.
- Directive on harmonization of insolvency law (EU Commission, June 2019).
- FASTER proposal: fast-track procedure to speed up tax refunds.

…but some challenges remain

- Difficult to obtain an overview of investment funds (including foreign ones) and to compare them.
- Absence of an European business code.
- Transposition of FASTER directive optional for small member states.

FRAGMENTATION IN PRACTICE (2): THE CASE OF AN INVESTMENT FUND

I am an investment fund and I want to sell the same savings product across the EU. What potential deterrents?

- Heterogeneous requirements and regulation to market the product: **27 different jurisdictions**!
- You need **to be authorized twice** by the National Competent Authority (NCA): to operate in another EU country and then to sell your product.

Some progress has been made

- UCITS and AIFM* directives and their successive revisions.

  → **EU passport** for a large class of funds: if you comply with a common set of rules, you can operate and sell your product in another Member State by simply notifying that country (without having to apply for new authorizations).

…but some challenges remain

- Specific requirements of national authorities regarding the **prospectus**.
- A single rulebook but **prudential supervision** largely left to national authorities.

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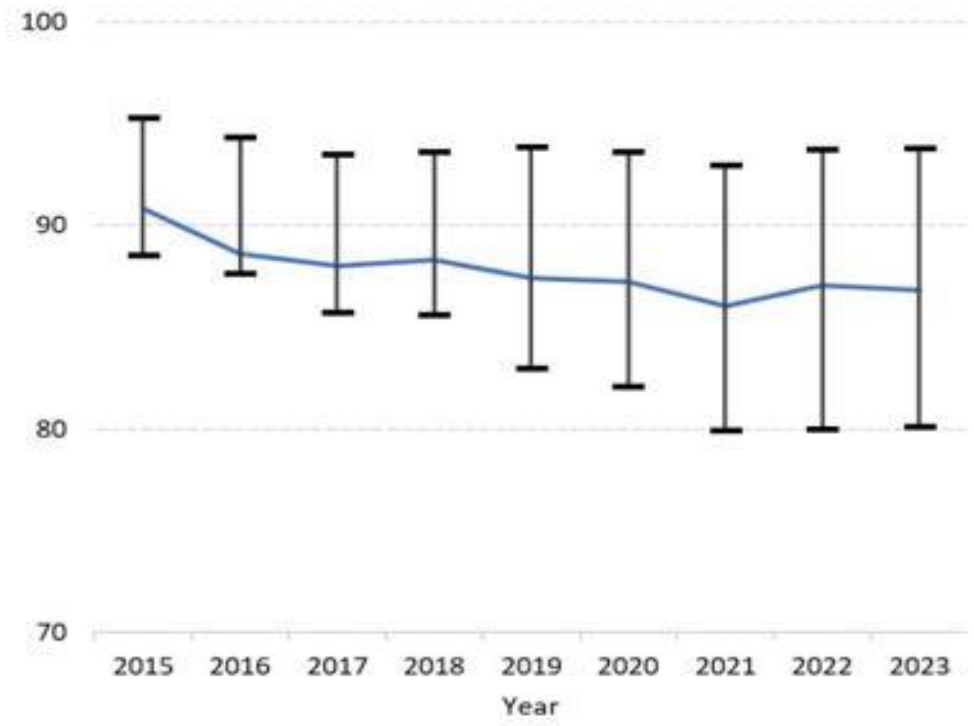
*UCITS: Undertakings for Collective Investments in Transferable Securities
AIFM: Alternative Investment Fund Managers

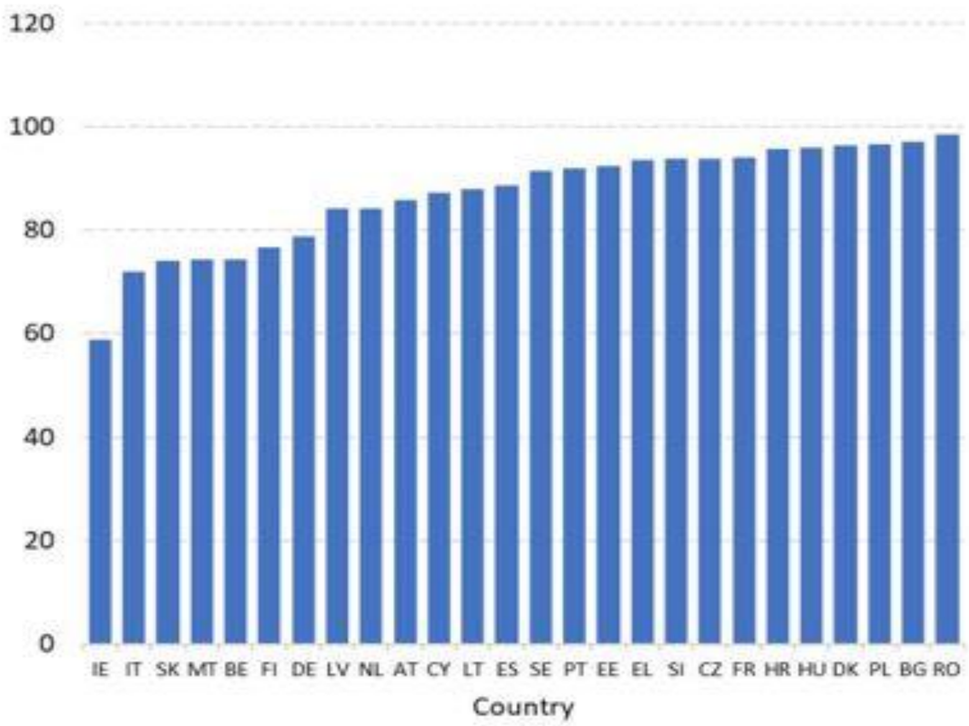
CONSEQUENCE: EQUITY HOME BIAS REMAINS PREVALENT

Holdings of equity from other Member States

EU average home bias, highest and lowest quartile of MS, 2015-2023



Home bias across EU Member States, 2023



Source: [European Commission, 2024]

Note: The home bias is measured as the difference in pp between the relative weight of domestic equity in the portfolio of country *i* and the relative weight of country *i* in the total world market portfolio. The larger is this overweighed in the domestic investment portfolio, the higher the bias.

Reading (left graph): in 2023, the average home bias across Member States was 87pp: share of domestic equity in domestic portfolio =95%; share of domestic equity in world equity =8%. Difference=87pp.

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3. A TENTATIVE ROADMAP

PROPOSALS SUPPORTED BY THE BDF - AND HOW THEY COMPARE TO OTHERS'

	Securitization	Venture capital	Market infrastructures	Supervision
BdF	More **attractive** EU **prudential** framework **EU issuance platform** for large-scale **green securitization**	**Public-private** partnerships **Harmonization** of capital + tax rules **Incentives** for funds to **invest X-border** under **EIB** aegis	A "**European unified ledger**" to reap the benefits of tokenization	**More supervisory** power to the **ESMA**, at least over **systemic cross-border** entities (see C. Lagarde call for a "European SEC")
Draghi	↓ Capital requirements Securitization platform backed by an EU-level guarantee	Using EIB to mobilize public-private funds Dedicated funding schemes	Consolidation of CCPs and CSDs	Similar to the SEC in the US ESMA becomes the single European regulator
Letta	Simpler transparency & due diligence requirements	EU wide scheme allowing private small savers to invest in alternative funds for VC	Consolidation of CCPs and CSDs	Similar to the SSM for banks ESMA directly supervises major entities
Noyer	↓ Capital requirements Securitization platform backed by an EU-level guarantee		Convergence of securities law to foster consolidation of CSDs TARGET2 Securities becomes an EU CSD	ESMA focuses on two sectors: market infrastructures and asset management

Failing to unify supervision would make SIU non-credible

Inefficiencies/costs related to fragmented supervision

- **Regulatory arbitrage** across jurisdictions.
- **Distrust** in national supervisors leading to measures to protect local markets.
- Huge **compliance** costs → ↓ competitiveness of European firms, obstacles to scaling up.

Reshaping market supervision

- **Various schemes** are possible: SEC, SSM, competition authorities.
- We need some form of "phasing in" of direct supervision and a **stronger role for ESMA.**
- Yet, we should **avoid to increase the burden on small entities.**
- Address vested interests of some member states → **Single supervision does not necessary mean centralized supervision** or the disappearance of national authorities.

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RELYING ON REGULATED NBFI AS A COMPLEMENT TO BANKS

Growing role of NBFIs makes markets deeper and more liquid

- ↑ the share of global financial assets held by NBFIs: from 43% 2008 to 50 % in 2021 (see FSB).
- NBFIs **more prone to hold riskier assets** when financial conditions are loose (IMF GFSR, April 2023).
- Non banks (trading firms, MMFs, hedge funds, OE funds) **complement liquidity provision** by "dealer banks", for both debt and equity markets (see Aramonte, Schrimpf & Shin, 2022), *in good times*.

→ ***Regulate liquidity and leverage, reduce pro-cyclicality of margin calls***

Deeper markets help reduce informational asymmetries and transaction costs (in *normal* times)

- Market infrastructures (CCPs) **reduce opaqueness** and **share counterparty risk.**
- "Resilient" NBFIs (trading firms, pension, sovereign, and private equity funds) help to **embed information in prices** and **share risks across market actors** (Adrian & Jones, 2018).
- More developed equity markets help **improve the exit options for venture capital** (e.g. 2/3 of exits are through IPO or M&A, see Gompers et al, 2020).

→ ***Growing NBFIs must be viewed as an opportunity for SIU, albeit with systemic implications***

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Improving market infrastructures through a unified/shared ledger

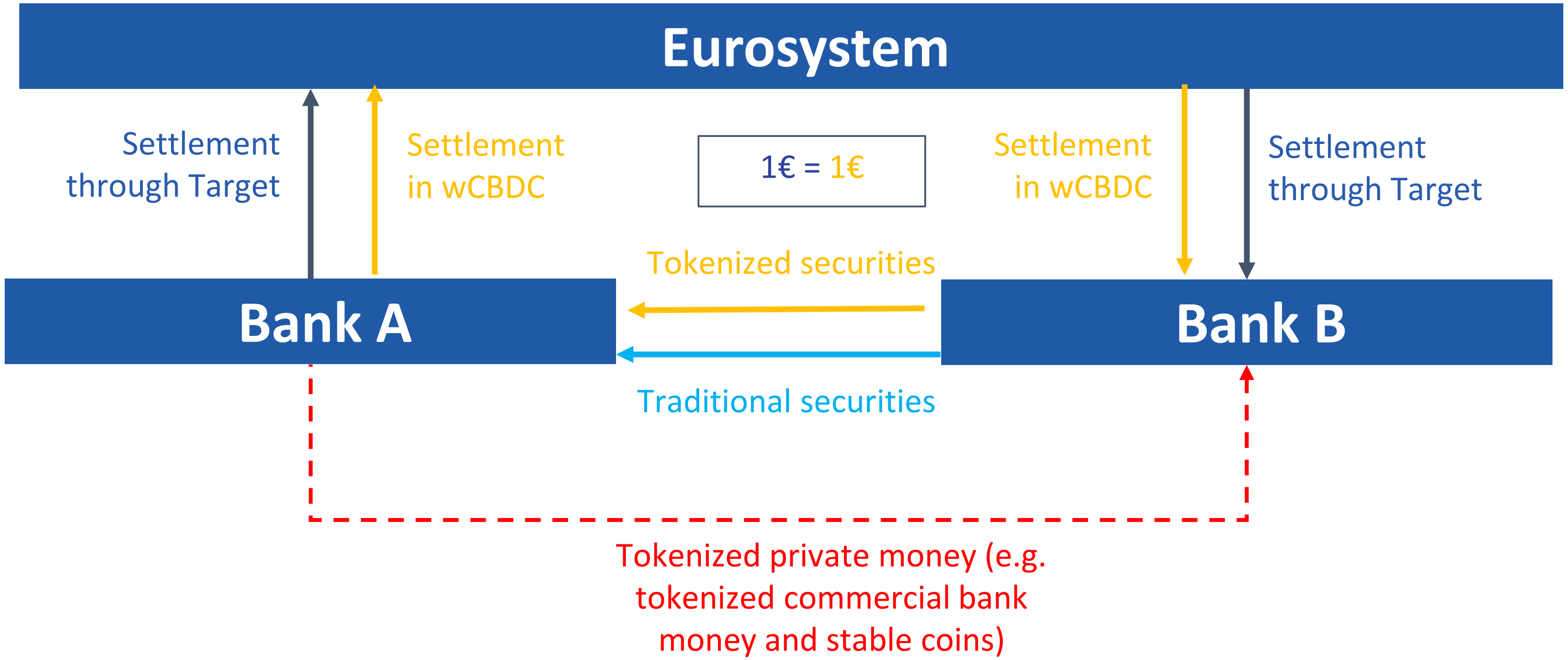
Existing infrastructure

- **T2-T2S:** a common platform on which securities and cash can be simultaneously transferred (delivery versus payment)
- **Limitations**: for securities stored in (multiple) CSDs; no integration with CCPs; operational risks, credit risks, and costs; challenge of speeding up settlement (T+1).

A European shared ledger

- **A shared DLT platform** where wCBDC, tokenised deposits and financial instruments coexist as tokens, under a single European governance framework. Possible phase-in, building on T2 et T2S.
- Automation and streamlining of payments and securities processes → **Reduced settlement risks and operational costs.**
- Different legislations carried on the same infrastructure→ **lower barriers for mid-size and innovative companies to issue/exchange financial securities (incl. cross-border)** + enhanced regulatory compliance. **Leap-frogging market fragmentation.**

Wholesale CBDC



Shared ledger:

- Issuance, negotiation, clearing, settlement-delivery, custody on the same ledger.
- Cutting costs while securing transactions.
- Ensuring unicity of settlement currency.

MULTIPLE USE CASES

Commercial paper

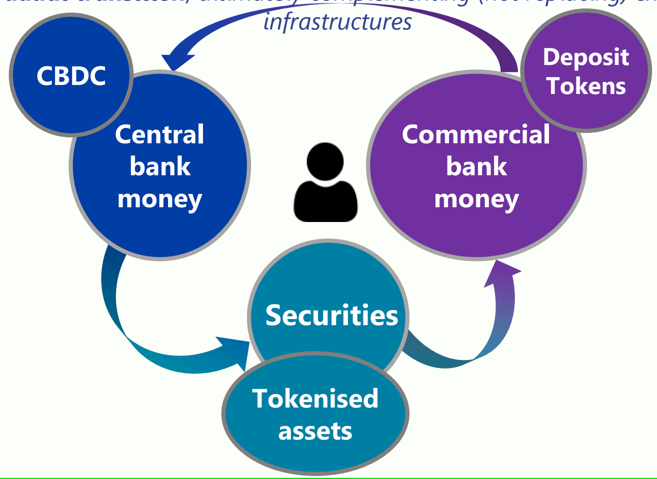
- Automation and digitalisation can **streamline issuance, verification, and compliance processes**, reducing manual errors and delays
- Real-time reporting, and DLTs can **enhance transparency, security, and cash flow management**
  - ➢ Faster, more efficient processing while ensuring better risk management and cost savings

ETF

- To reach investors across Europe, ETFs issuers cross-list on multiple exchanges, **leading to realignments to transfer shares from the seller's CSD to the buyer's CSD**. These realignments represent a sticking point for the transition of ETFs to T+1
- Differences in settlement cycles also lead to increased costs - and long-term, **lower profitability ratios**
  - ➢ A shared ledger **suppresses the need for many reconciliations** especially for multi-listed securities

EUROPEAN SHARED LEDGER

*a **gradual transition**, ultimately complementing (not replacing) existing infrastructures*



Environmental, social, and governance (ESG) finance

- Shared ledger allows to **track and visualise the impact of investments on the real economy** and therefore also on the climate transition
- An **end-to-end traceability** mechanism between the use of the funds and the end investor enables investments to be better targeted

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CONCLUSION

Phasing-in rather than big bang

- ✓ Regulatory and tax harmonization are not a *sine qua non* condition for SIU
- ✓ Relying on existing institutions and frameworks
  - Phasing-in **single supervision**
  - Complementing T2-T2S with **shared ledger**

Embark a majority of member states

- ✓ **Positive externalities**
  - More complete financial markets in EU → lengthening the **planning horizon** for borrowers + **diversifying** and better remunerating **assets** for investors.
  - Scaling-up the funding + more efficient channelling of savings towards innovation + double transition → **closing the productivity gap** in EU.
- ✓ **Incumbent advantage** when the market scales up.

NBFI regulation is part of the SIU roadmap

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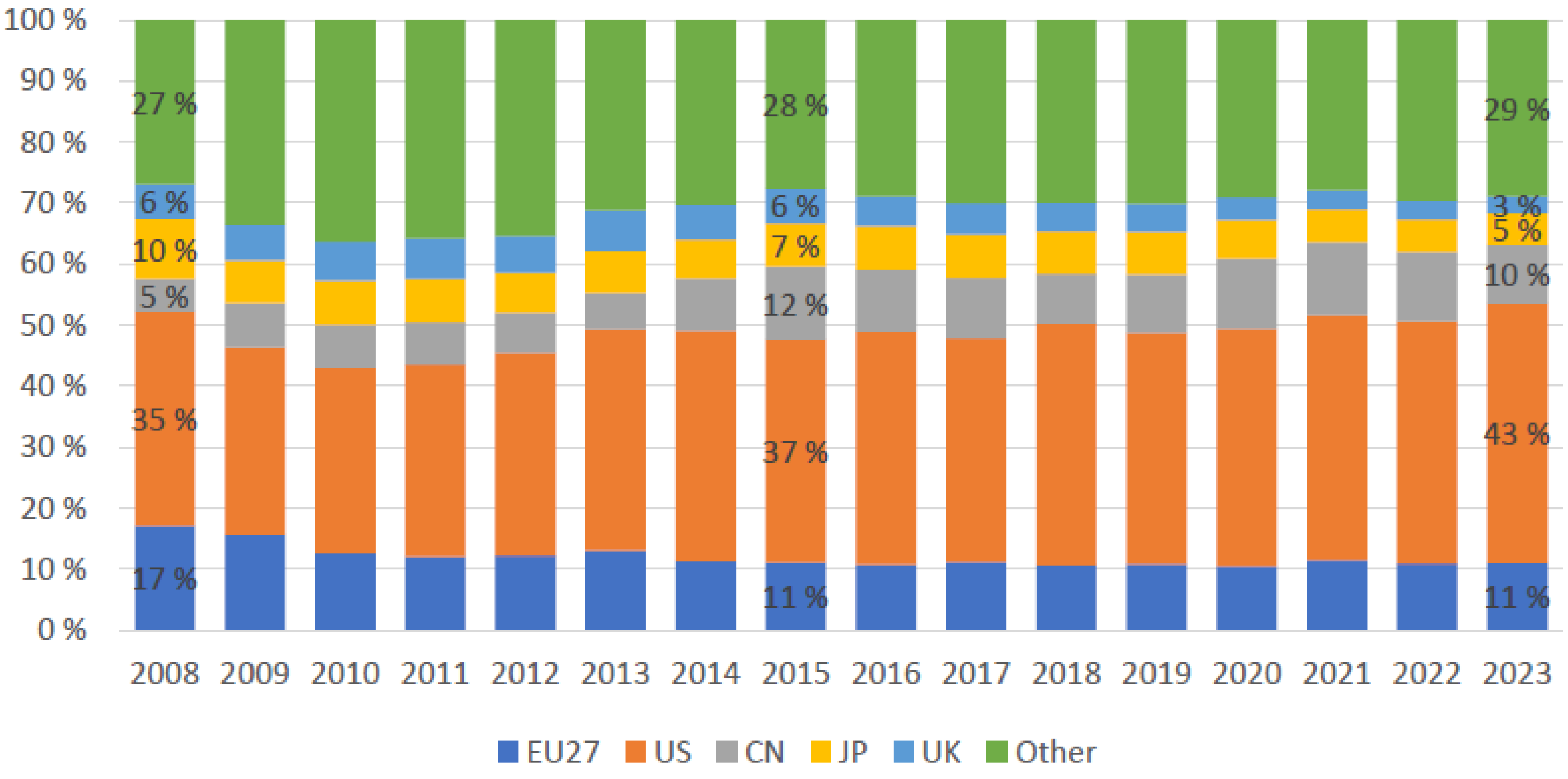
APPENDIX

EU'S SHARE IN GLOBAL EQUITY MARKET HAS DECLINED SINCE 2008

Global listed equity market capitalization (share of total, 2008-2023)



Source: CEPS, 2024.

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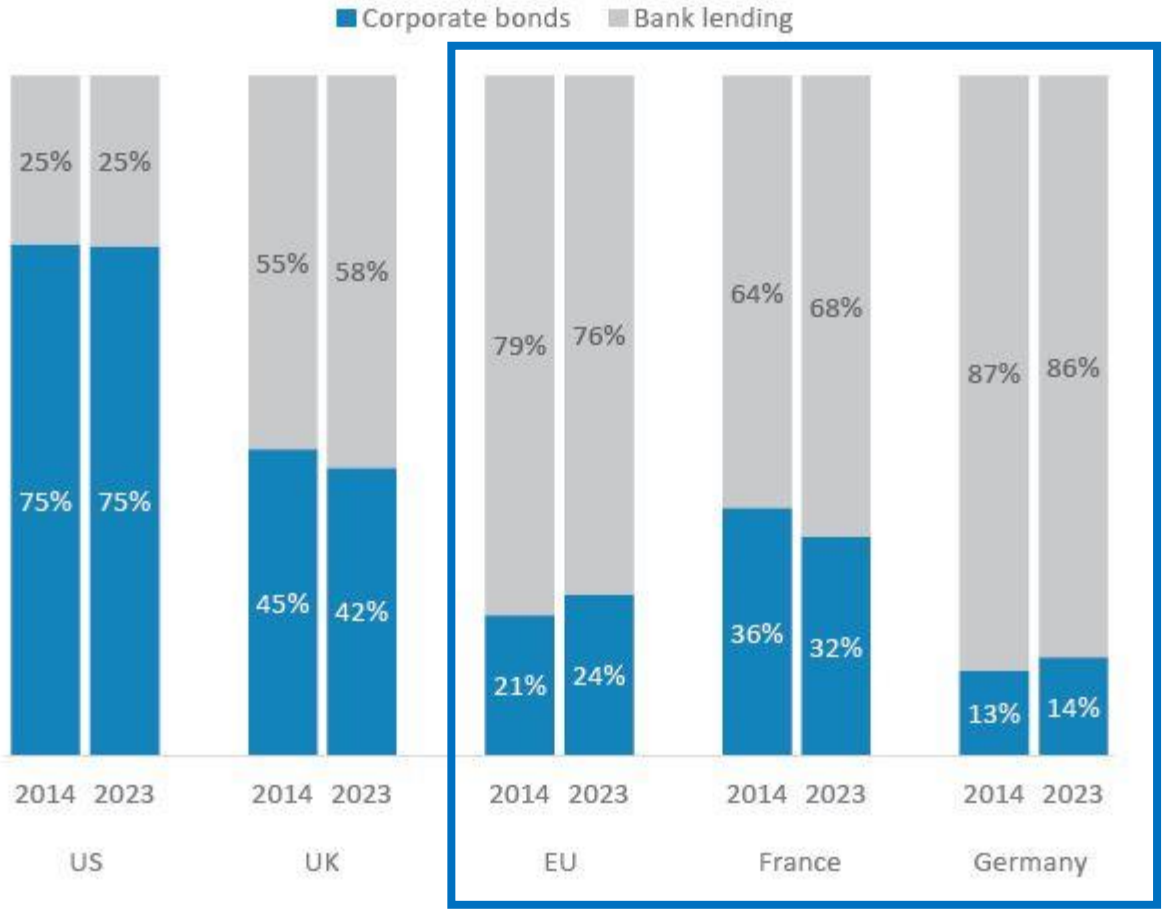
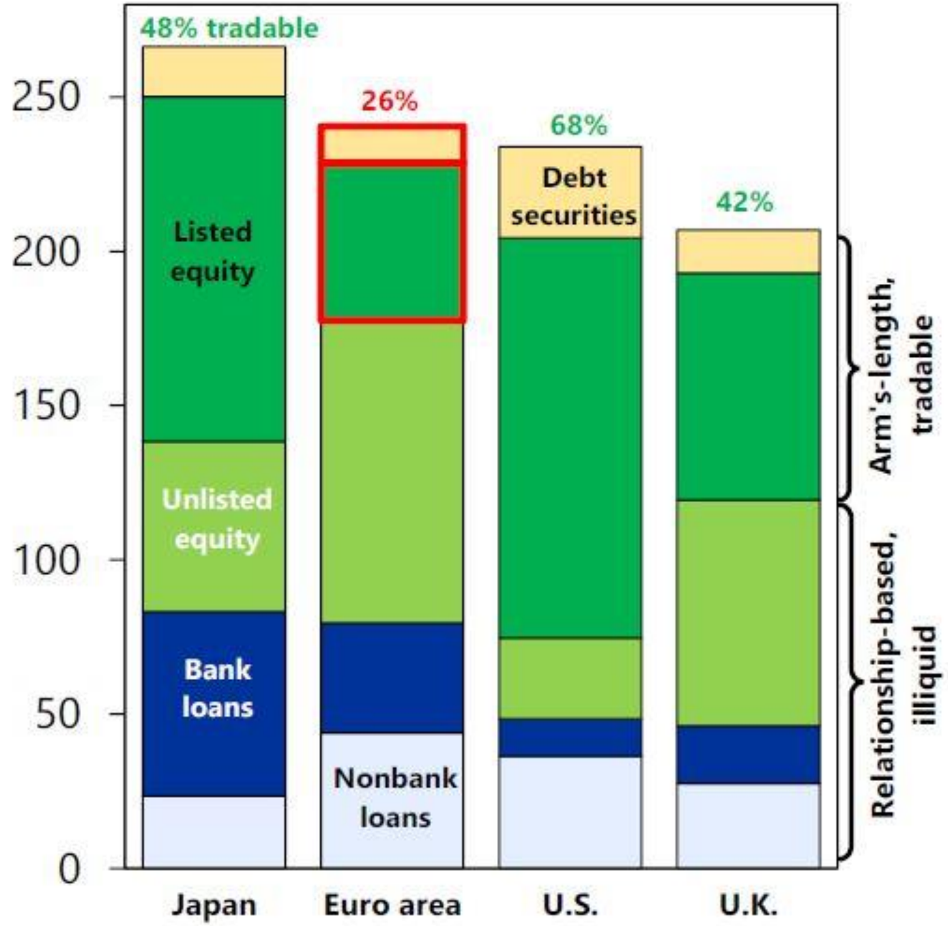
MARKET-BASED FINANCE REMAINS LIMITED IN THE EURO AREA

Banking vs market debt in firms' financing



Source: New Financial 2024

NFC funding structure, 2022 (% of GDP)



Source: IMF, 2024

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Overview of key CMU proposals in Letta, Draghi and Noyer reports

Proposal	Letta report	Draghi report	Noyer report
Securitisation			
Simpler transparency & due diligence requirements	✓	✓	✓
Lower capital requirements		✓	✓
Broader liquidity buffer eligibility (LCR)			✓
Relax prudential framework for insurers			✓
Public securitisation platform		✓	✓
Green securitisation	✓		
Supervision			
Stronger role for ESMA	✓	✓	✓
"Pathways" towards SSM-style model	✓		
European SEC		✓	
Opt-in into central supervision			✓
Executive board for ESMA			✓
Add European appointees to Board of Supervisors	✓	✓	
Market Infrastructure			
Consolidation of CCPs and CSDs	✓	✓	
Convergence of securities law as path to foster			✓
Allow TARGET2 Securities to become an EU CSD			✓
Pensions and Savings			
Introduction of common EU savings product	✓		
EU label for national savings product			✓
Incentives for pillar 2 pension schemes	✓	✓	✓
Harmonisation of Business Law			
European Business Code & European Company Statute	✓		
EU-wide legal statute for innovative start-ups		✓	

Source: EU Parliament (2024), *How to achieve CMU, after all?*

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LEARNING BY DOING – EUROSYSTEM EXPLORATORY WORK (2024)

Announcement of exploratory work (April 2023)

Call for expressions of interest (Dec. 2023)

Wave 1 (May 2024)

Wave 2 (July 2024)

Selection of solution? (2025)

Preparation phase (March 2023 – May 2024)

- Dialogue with the market to refine the scope of work
- Non-binding questionnaire and survey *(Oct. 2023)*
- Call for expressions of interest (*Dec. 2023*)
- Gov. Council approval of framework *(Feb. 2024)*

Exploratory phase (May 2024 – November 2024)

- Trials and proof-of-concept (PoC) experiments
- **3 solutions** to be tested
  1. **FULL DLT INTEROPERABILITY** (CBDC)
  2. **TIPS HASH LINK**
  3. **TRIGGER**

Project phase? (2025 –)

- Conclusion of exploratory phase within Gov. Council
- Comparative analysis of the 3 solutions
- Choice and launch of go-live project?

European pilot regime

Regulatory exemptions to test DLT in market and post-trade activities

A SHARED LEDGER TO FOSTER THE SAVINGS AND INVESTMENTS UNION

Statement by the ECB Governing Council
March 2024

- *The Eurosystem will continue to explore, together with financial market stakeholders, the potential use of new technologies for issuance, trading and settlement, fostering tokenisation and possibly a "European unified ledger". This will help to promote a digital capital markets union and thereby strengthen the efficiency of European financial markets while avoiding a re-fragmentation of elements that have been harmonised and integrated.*
- *The Eurosystem will support the development and integration of pan-European financial market infrastructures to provide European financial markets with a single pool of euro liquidity in central bank money guaranteeing safety, efficiency and integration at the core, through the use of TARGET Services, and the pooling of financial transactions on payments, securities and collateral.*
- *The Eurosystem will continue to catalyse and coordinate market efforts to implement a single pan-European rulebook for securities settlement and collateral management as well as to support the harmonisation of debt issuance procedures and the implementation of these harmonised procedures, with the goal of creating a genuine single securities market in Europe.*
- *The Eurosystem will also strongly support and monitor industry efforts to build-up further central clearing capacity within the EU*

Keynote speech by Piero Cipollone, Member of the Executive Board of the ECB
October 2024

- *Central banks should play a proactive role in this transformation for two main reasons. First, it is vitally important to maintain, if not increase, the use of central bank money as the settlement asset in wholesale markets. The second reason is to promote robust, stable and integrated European capital markets. Therefore, our aim is to facilitate the provision of central bank money settlement for wholesale transactions of DLT assets, thereby using the financial industry's adoption of DLT to address existing shortcomings associated with the fragmentation of European capital markets.*
- *One way to achieve this would be to move towards a European ledger.*
- *A European ledger could bring together token versions of central bank money, commercial bank money and other digital assets on a shared, programmable platform. In essence, this would see T2S evolving into a DLT-based, single financial market infrastructure for Europe. While central banks would provide the platform, or the "rails" so to speak, market participants would supply the content, or the "trains". However, further consideration would have to be given to the specifics of this platform, including the scope of services, governance structure, operational procedures and the potential implications for existing infrastructure and assets.*

Digital euro: Beatrice sells a jacket to Alice

Payment by bank transfer, cash or digital euro