DEVELOPING EUROPEAN CAPITAL MARKETS TO FINANCE THE FUTURE

Proposals for a Savings and Investments Union

April 2024

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List of expert committee members

- **Christian Noyer**, Honorary Governor, Banque de France (Chairman)
- **Delphine d'Amarzit**, CEO and member of the manaagement board, Euronext Paris
- **Nicolas Calcoen**, Deputy CEO, Amundi
- **Frédéric de Courtois**, Deputy CEO, Axa
- **Mohamed Kallala,** Global Head of Natixis Corporate & Investment Banking and member of the management committee, Natixis
- **Bertrand de Mazières**, Special Adviser to the President of the European Investment Bank (EIB)
- **Robert Ophèle**, former Chairman of the French financial markets authority (AMF) and current Chairman of the French accounting standards board (ANC)
- **Anne Pointet**, Deputy CEO, BNP Paribas Wealth Management;

Rapporteurs: Sébastien Piednoir and Florian Surre

English translation from French: Translation Center of the Economy and Finance Ministry

Executive summary

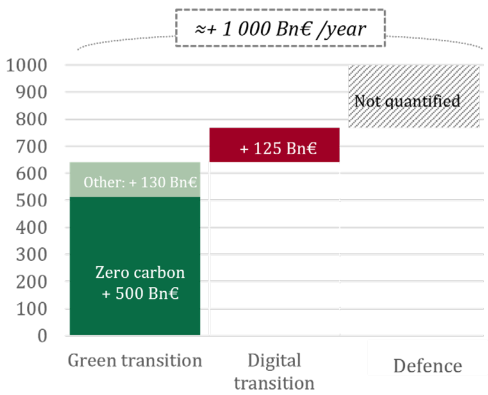
On January 8, 2024, Minister Bruno Le Maire entrusted a committee of experts[1] chaired by Christian Noyer with the mission of formulating concrete proposals to revitalise the Capital Markets Union (CMU). *Bringing together experts from both the private and public sectors, the committee conducted extensive consultations across Europe. The main conclusions of this work are a stark assessment of urgency (1) and four transformative recommendations (2 to 5).*

1. Confronted with massive financing needs, Europe can no longer defer the deepening of its capital markets.

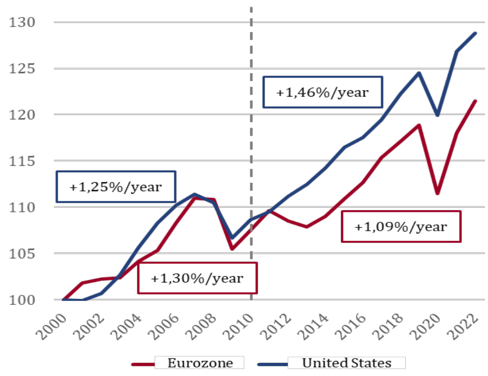
Indeed, Europe will need to invest massively by 2030, with additional financing needs approaching **€1 trillion each year**. The green transition alone will necessitate annual additional investments of nearly €700 billion, while the digital transition could require as much as €125 billion, and other massive needs are emerging in the defence domain.

Substantial additional investments are all the more needed to close **the widening economic gap with the United States.** Since the global financial crisis, Eurozone growth has lagged, primarily due to a chronic underinvestment in physical capital and innovation.

Additional investment needs by 2030



Evolution of GDP per capita in the United States and the Eurozone

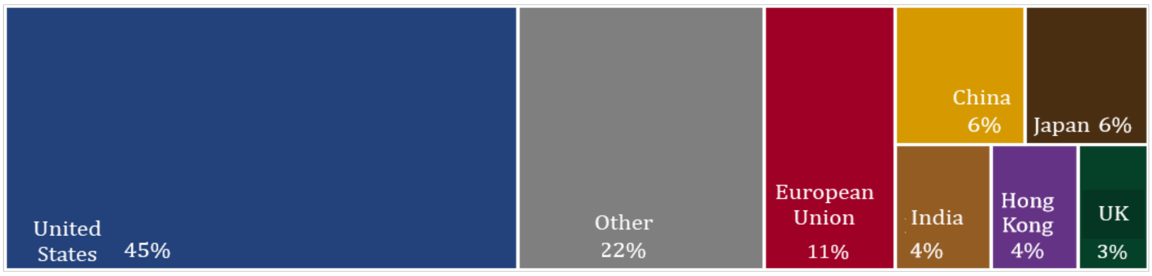


However, **neither public budgets nor banks' balance sheets will be able to meet these investment needs**. The banking channel, already dominant in Europe, is even contracting amidst mounting capital constraints.

1 This committee was composed of Robert Ophèle, former Chair of the Autorité des Marchés Financiers (AMF) and current Chair of the French Accounting Standards Authority (ANC), Delphine d'Amarzit, Chair and CEO of Euronext Paris and member of the management board of Euronext, Nicolas Calcoen, Deputy CEO of Amundi, Anne Pointet, Deputy CEO of BNP Paribas Wealth Management, Frédéric de Courtois, Deputy CEO of AXA, Bertrand de Mazières, Senior Advisor to the President of the European Investment Bank (EIB), Mohamed Kallala, Global Head of Natixis CIB. Analysis and recommendations were built by consensus. Therefore, each view expressed in this report is not necessarily representing the positions of all individual members and of their employers.

Thus, **the underdevelopment of European capital markets is becoming increasingly untenable**. This untapped potential stems from a weaker investor base and a fragmented structure. To align with other major economies, the depth of Europe's equity markets would need to expand by 60%. European equity markets are also less liquid, especially on the small caps segment whose turnover is approximately twice higher in the US. Beyond equities, the European lag extends to bonds and private markets. As a result, European companies face higher capital costs and may consider turning to the United States for fundraising. At the same time, European financial actors see their market shares shrinking not only internationally but also within Europe, to the benefit of non-EU players. This trend poses risks to European strategic autonomy.

Global market capitalization in 2022



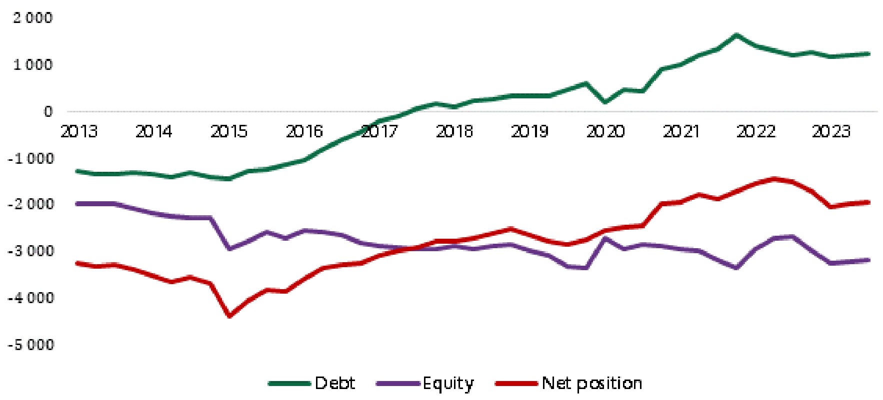
In this context, **a new approach is necessary to achieve a quick and full implementation of the Capital Markets Union (CMU)**. The intense legislative activity of recent years has introduced useful measures but has not halted the underlying trend. The most transformative reforms have encountered significant political obstacles. To overcome them, it is proposed to focus on four key measures.

2. Developing European long-term savings products, invested predominantly in the EU economy, is the first essential step to increase flows towards European capital markets: without a massive investor base, deep capital markets cannot emerge.

Europe generates **abundant savings**, which should be an asset for the financing of its economy. Household financial savings amount to €35,533 billion, fueled by one of the world's highest savings rates (13.3%).

However, these savings are **poorly allocated**. Europe exports its savings through the acquisition of foreign debt securities and imports the equity funding necessary for the development of its companies. As a result, the rest of the world captures the value created by European companies. This misallocation undermines the returns provided to European savers, which are on average lower on debt securities. All the while, the ageing population makes savings returns more necessary than ever.

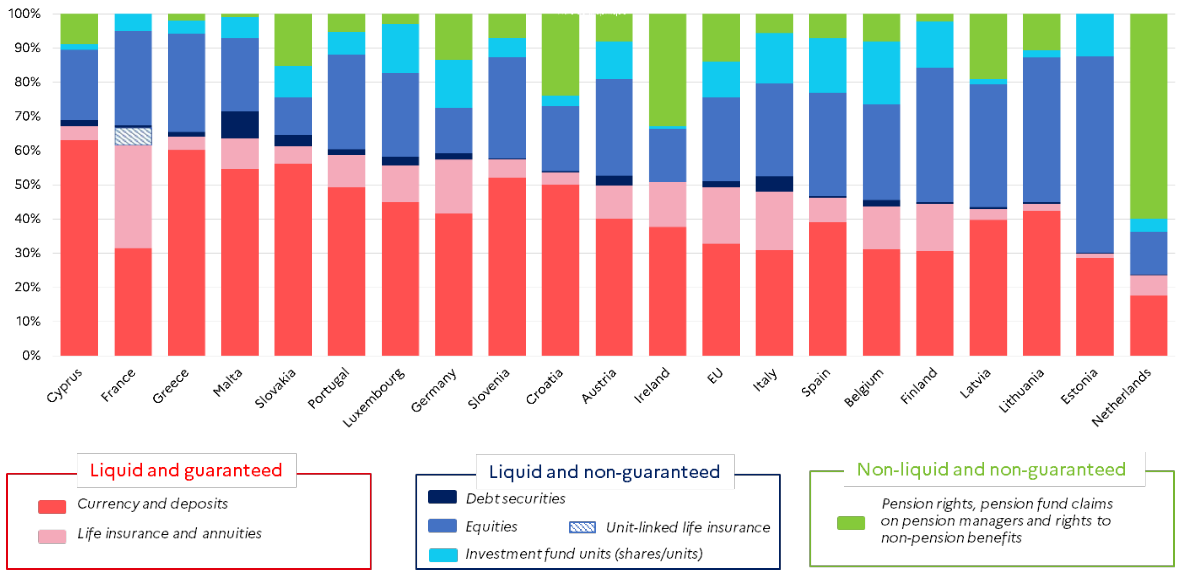
Evolution of the portfolio investment balance of the euro area (€ billion)



This misallocation stems from the savings products and their tax treatment, which too often discourage long-term investment. Products offered to European savers are overly liquid and guaranteed, inevitably constraining the portion of assets that can be allocated to long-term, riskier but more rewarding assets. Bank deposits, savings accounts and guaranteed/liquid life insurance funds represent 47 % of European households' financial holdings.

However, long-term products exist in several countries, such as the PER and the PEA in France, the *Betriebsrente* in Germany, pension funds in the Netherlands, the PIR in Italy, and the ISK in Sweden. Yet, they remain insufficiently widespread across the European Union.

Allocation of households' financial savings in Euro Zone in 2022



It is therefore strongly recommended to **develop long-term savings products.** In terms of method, the failure of the pan-European personal pension product (PEPP), the proliferation of existing products, and the specificity of national frameworks suggest favoring a decentralised approach based on a label. It would be up to each willing Member State to create a new product or adapt existing ones to offer nationally labeled products to their savers. Progress monitoring at political level would give the necessary momentum.

Six fundamental principles should be enshrined in the label criteria: (i) a long term investment horizon with liquidity restricted to retirement or major life events, (ii) exposure to risk with no permanent capital guarantee, (iii) managed allocations by default to build and secure gains over the long run, (iv) a key role assigned to the employer (for auto-enrollment and co-investments), (v) an attractive tax regime legitimated by (vi) a predominant allocation in European assets (e.g. 80% or more). If widely deployed, labeled products could steer approximately €200 billion of long-term investment annually.

From a more general standpoint, it is recommended **to reserve a favorable tax treatment only to products that aim to predominantly channel financing towards the European economy.**

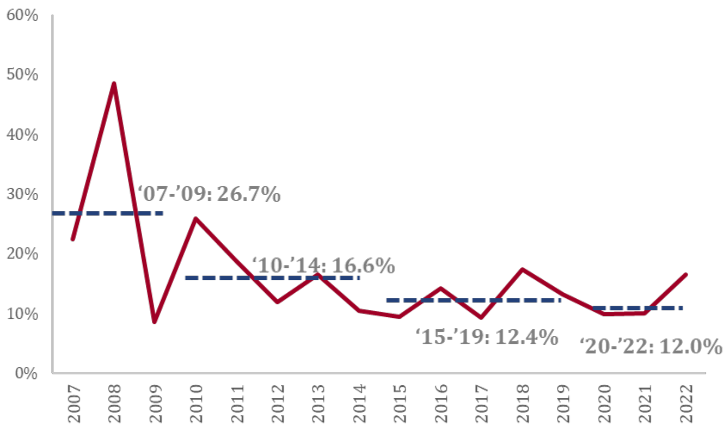
3. The second key proposal is to finally revitalise the securitisation market, to back the lending capacities of European banks by deep capital markets.

Securitisation is **an essential tool to finance the economy**, as it enables the efficient allocation of risk to investors best suited to bear it. Like covered bonds, securitisation can serve a refinancing function. However, unlike covered bonds, it can also serve a risk distribution function, which allows a higher volume of loans for a constant capital. Thus, an increasingly broad political consensus is emerging to recognize the pivotal role that securitisation is meant to play, as evidenced by the convergent statements of the Eurogroup and the ECB Governing Council in March 2024.

Contrary to what **persistent stigma** might suggest, securitised assets issued in Europe have demonstrated **resilience over the long term**. The 2008 crisis stemmed from poor origination practices of mortgage loans in the United States, not from issues affecting securitisation in Europe. In fact, default rates observed in Europe have remained very low.

Despite this track record, **the securitisation market has collapsed in Europe,** particularly the segment of publicly placed issuances. Between 2007 and 2022, total annual issuance volumes of securitised assets dropped from €407 billion to €157 billion, a decrease of 61%. Moreover, the share of these publicly placed issuances experienced an even more rapid decline (-80%), indicating a drying up of liquidity in the market. In contrast, the American market and other international markets have resumed a growth trajectory.

Annual issuances of securitised assets in Europe as a proportion of annual non-agency issuances in the United States (2007-2022)



This decline can largely be explained by the regulatory and prudential framework implemented in Europe. The abundant liquidity provided by central banks over the 2010s may have reduced the need for securitisation, but this phenomenon is also observed in other jurisdictions that have not experienced such a decline. Covered bonds did not eliminate the need for securitisation either, as both tools are complementary. In reality, Europe has implemented a much more restrictive framework than other jurisdictions, especially the United States. While it has wisely prohibited potentially harmful securitisation practices (such as re-securitisation, securitisation without retention, etc.), it has maintained excessive prudential penalties and regulatory burdens, calibrated on practices that are no longer relevant.

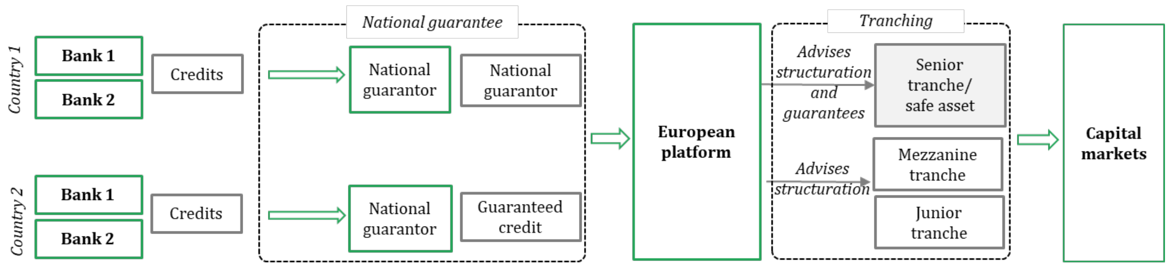
In this context, it is imperative to **quickly correct the regulatory and prudential framework for securitisation**. The first priority should be to restore the investor base by correcting the prudential framework applicable to insurers and by extending eligibility to liquidity buffers for banks (LCR). The second priority is to simplify transparency rules to facilitate both the issuance and acquisition of securitised assets, particularly through a lighter content and better delineation of the scope of ESMA's disclosure templates. Finally, the banking prudential framework must be adjusted (particularly rebalancing the p-factor), even if this implies deviating from Basel rules, as other major economies, namely the US, already do and will continue to do. All these regulatory and prudential measures are now well identified and mostly consensual. The only missing element is a rapid implementation schedule.

In addition to these regulatory and prudential measures, **a European platform for securitisation** could be a powerful tool for deepening capital markets. The United States, Canada, and Japan have long implemented platforms for issuing or guaranteeing mortgage securitisations. Italy also operates a system dedicated to non-performing loans (GACS).

In Europe, such a platform would foster the emergence of a reference securitisation market, deep and liquid. On the demand side, a common platform would meet a need for standardisation, massification and transparency. On the supply side, the platform would offer cost sharing for structuring, to the benefit of smaller banks. Beyond the securitisation market, this platform would create a new common safe asset, enhancing the efficiency and depth of European markets.

The guarantee provided by the platform should be structured to **exclude any transfers between Member States and commitments of budgetary resources**. The guarantee would be priced proportionally to the risk taken by the guarantor. It is also recommended to target a homogeneous and low-risk asset class, such as residential loans, relying if necessary on national guarantee mechanisms. The platform would be created by the EU or a group of willing Member States.

Proposal for a common securitisation platform



After a period of ramp-up, this platform could enable **an increase in lending capacity to businesses by 25% (≈€1,500 billon).** The reallocation of bank capital in favor of loans to the real economy would be ensured by the monitoring of simple indicators, in exchange for access to the platform.

4. The third main proposal is to move towards an integrated supervision for capital market activities, in order to build a true single market and better ensure financial stability.

A true single market cannot tolerate a fragmented supervision. The current supervisory architecture hinders the efficiency of investor and financial stability protection. It also leads to disproportionate compliance costs and ultimately weighs on the competitiveness of European financial actors. It also fosters a form of distrust and, in some cases, additional protection measures towards actors or products supervised by non-domestic authorities.

A **real single rule book, coherently implemented across the EU, is thus essential** to prevent the fragmentation which currently hinders cross-border operations. Significant efforts towards regulatory harmonisation have been made but ESMA has only been given limited powers, incomparable to those of the SEC in the United States or even the SSM in the banking sector. As a consequence, a number of European financial institutions (e.g. asset managers and trading venues) are currently supervised as individual entities without regard to their affiliation to a European group. Therefore, they often face numerous and redundant obligations from various national authorities, while they could, if recognised as belonging to an EU group and supervised accordingly, achieve substantial scalability and enhanced competitiveness.

To move forward, reform of the governance and functioning of ESMA is essential. It should be a prerequisite before allowing it to transition from the status of "supervisor of supervisors" to that of a true direct supervisor. Inspired by the most recent supervisory set-up (AMLA), it is proposed to create an executive board composed of a small number of permanent members, in order to increase agility in supervision decision-making. For some supervisory activities, joint supervisory teams (JSTs) could leverage on existing expertise at national level.

Thus reformed, ESMA should be entrusted with larger supervisory mandates, through mandatory and voluntary schemes.

First of all, for the most important cross-border and systemic clearinghouses (CCPs) and central securities depositories (CSDs), as well as for large and cross-border trading venues, a supervision at EU-level should be mandatory.

For asset managers of European scale, the recognition as EU groups would go along with an integrated supervision. By default, this integrated supervision should take the form of mandatory supervisory colleges, gathering the relevant national authorities under the leadership of ESMA. European asset managers should also be offered the right to opt-in for a direct ESMA supervision. If efficiently implemented, this opt-in should allow for a less fragmented supervision, to the benefit of EU players' competitiveness. This opt-in would take the form of a 28th regime in which authorisation and supervision are directly entrusted to ESMA and conducted via JSTs, under an integrated framework. The opt-in would also be accessible to products. For investment funds, the opt-in would allow cross border marketing without any intervention from national authorities (including marketing documentation). In parallel, asset managers should also be able to keep other investment funds under a national regime. The opt-in should also be opened for financial markets infrastructures not placed under mandatory EU level supervision.

In addition to these supervisory mandates, real "no-action letter" powers should be conferred to ESMA when certain rules appear clearly inapplicable in light of market developments or financial stability concerns. An additional mandate in favor of competitiveness could also strengthen the efficiency and proportionality of ESMA's interventions.

5. Finally and on a more prospective note, the committee recommends considering ambitious measures to address the fragmentation of settlement systems.

The post-market infrastructure landscape is more fragmented in Europe than in the United States, primarily due to the multiplicity of central securities depositories (CSDs - one in the United States and 28 in Europe). CSDs remain primarily national, due to sovereignty reasons (sovereign issuers' preference for nationally supervised CSDs), non-harmonisation of securities law, and vertical integration of market infrastructures.

This fragmentation directly affects **transaction costs** borne by European investors. According to available data, the cost of settlement varies greatly among European CSDs. Fragmentation also translates into higher custody costs, discouraging cross-border investments. Average costs in Europe seem also higher than in the United States, making our markets less attractive to international investors.

Despite its contribution to the facilitation of central bank money settlement of financial transactions, the European settlement platform **Target-2 Securities (T2S)** has not fully resolved the problem of settlement fragmentation in the European Union. Launched by the Eurosystem in 2015, it has not become a node of interoperability for cross-border transactions, but rather a tool for outsourcing certain technical tasks, mainly used for national purposes.

To address this fragmentation, it is recommended to work on convergence in national securities laws, fostering potential consolidation of CSDs. Additionally, two cumulative reforms of T2S should be pursued. **First, T2S' objective of European integration should be reprioritised** by fostering its efficiency and attractivity for market participants and potentially extending its remit to additional CSD functions. Longer-term work could be initiated to enable T2S to support the settlement of financial instruments on DLT (blockchain).

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Together, these four measures promise a scaling up of European capital markets. While the urgency of action can no longer be disputed, this committee hopes that the nascent political momentum in favour of a Savings and Investment Union will swiftly enable all stakeholders to precise, adopt, and implement these transformative measures.

On 8 January 2024, Minister Bruno Le Maire entrusted a committee of experts chaired by Christian Noyer with the mission of formulating concrete proposals to revitalise the Capital Markets Union (CMU). *Bringing together experts from both the private and public sectors, the committee conducted extensive consultations across Europe. The main conclusions of this work are a stark assessment of urgency (1) and four transformative recommendations (2 to 5).*

1. Confronted with massive financing needs, Europe can no longer defer the deepening of its capital markets

1.1. Europe will need to invest massively in the coming years to finance the dual transition and close a widening economic gap with the United States

Between now and 2030, Europe will need to invest close to €700 billion each year just to meet its environmental targets.

The European Union (EU) has set an ambitious target of reducing its greenhouse gas emissions by 55% by 2030 (the "Fit for 55" package). The European Commission estimates that achieving a pace of decarbonisation consistent with this target will require annual investment of €1,241 billion between 2021 and 2030[2] (see Figure 1). This implies additional EU investment of €477 million per year when compared with the average for the previous decade – an increase of 62%. These investment needs will span every sector of the European economy. Although transport will continue to account for more than half of the total, the energy sector will see the sharpest rise in investment needs (up 127%).

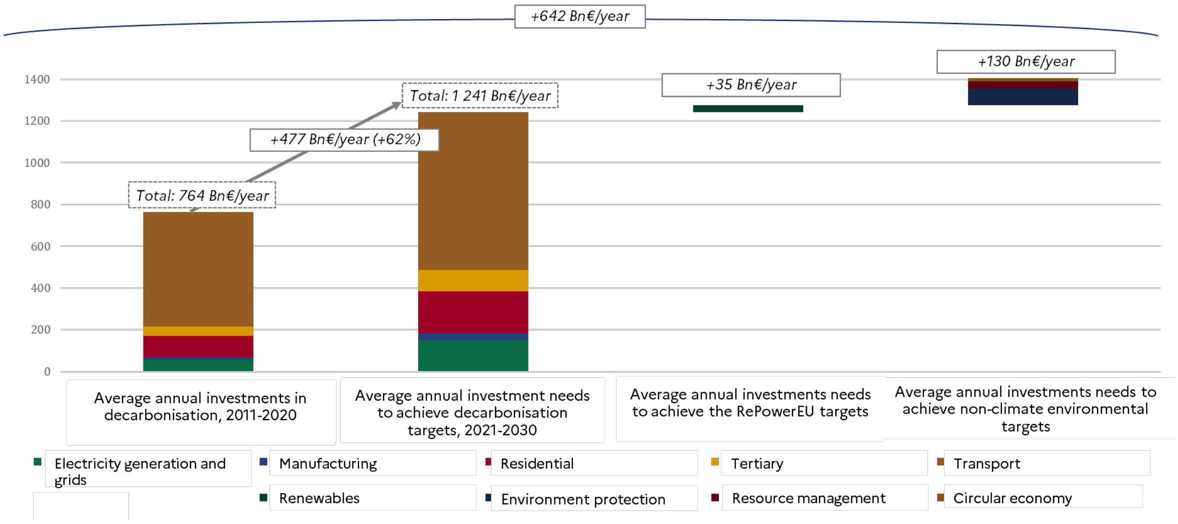
Moreover, maintaining the EU's strategic autonomy in the transition to net-zero will necessitate additional investments in electricity generation and in other key industrial sectors. Additional financing needs for the REPowerEU plan stand at an estimated €35 billion per year. In its proposals for the Net-Zero Industry Act, the Commission estimated that increasing Europe's manufacturing capacity and market share for eight strategic net-zero technologies[3] would necessitate total annual investments of €13 billion.

As well as decarbonising its economy, Europe will need to address other environmental challenges such as protecting biodiversity, tackling pollution and transitioning to a circular economy. According to the Commission, the additional investment needs associated with these challenges will amount to €130 billion per year in the 2030s. In total, Europe will need to increase investment by at least €642 billion per year in order to achieve a successful green transition.

2 Commission Staff Working Document, Investment Needs Assessment and Funding Availibilities to Strengthen EU's Net-Zero Technology Manufacturing Capacity, March 2023 (link).

3 Solar power, wind power, batteries, heat pumps and geothermal energy technologies, electrolysers, biofuels, carbon capture and storage, and grid technologies (link).

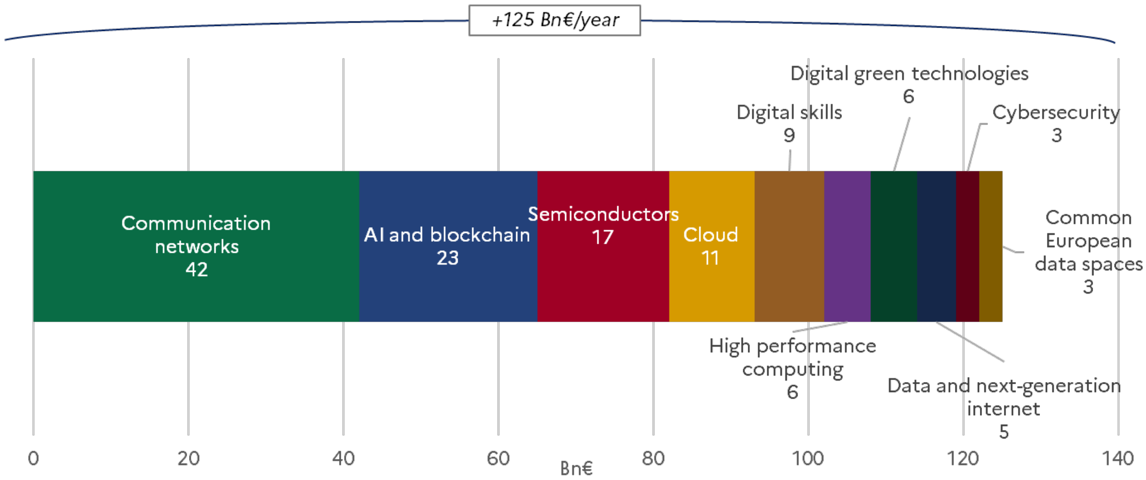
Figure 1: EU green transition investment gaps



Source: European Commission, 2023 (link)

Beyond these environmental needs, Europe will also need to invest in the digital transition. In 2020, the Commission estimated that the EU would need to invest an additional €125 billion per year in order to close its investment gap with China and the United States across a basket of key digital technologies (see Figure 2).

Figure 2: EU digital transition investment gaps



Source: European Commission, 2020 (link)

The outbreak of war on Europe's doorstep also necessitates substantial investment in the European Defence Industrial and Technological Base. From 1999 to 2021, EU defence spending increased by just 20%, compared with 66% for the United States, 292% for Russia and 592% for China[4]. EU Member States have committed to a significant increase in defence spending since the Russian invasion of Ukraine. But this public investment cannot happen unless the entire defence industry is scaled up. In 2022, this sector, which is composed of prime contractors and an extensive ecosystem

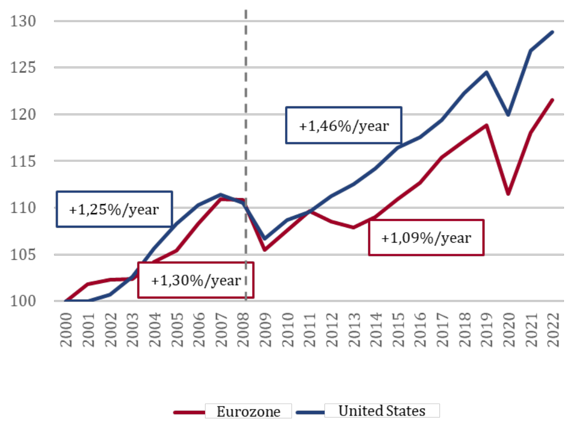
4 Joint Communication to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions on the Defence Investment Gaps Analysis and Way Forward, May 2022 (link).

of small and medium-sized enterprises, recorded annual turnover of €84 billion and supported 315,000 indirect jobs.[5] Boosting production-chain capacity and resilience will necessitate significant private-sector investment, particularly in the form of equity financing[6].

Beyond these sectoral needs, chronic under-investment in innovation and physical capital is widening the growth gap between Europe and the United States.

Since the financial crisis, the growth gap between the euro area and the United States has widened (see Figure 3). Between 2000 and 2008, average per-capita GDP growth rates in the United States and the euro area were similar. Since 2008, however, per-capita GDP has increased by 1.46% per year in the United States, compared with just 1.09% in the euro area. In 2011–2012, the euro area experienced a double-dip recession, partly on account of structural fragilities. But the gap has continued to widen since then, with GDP in the United States holding up better than in Europe during the COVID-19 pandemic.

Figure 3: GDP per capita, United States and euro area (2000–2022, constant 2015 €)



Source: World Bank (link)

The growth gap between the United States and the euro area is expected to persist in the medium term: according to the International Monetary Fund (IMF), the United States economy is forecast to grow by an average of 1.9% per year between now and 2028, while annual euro-area growth will come in at 1.4% over the same period.

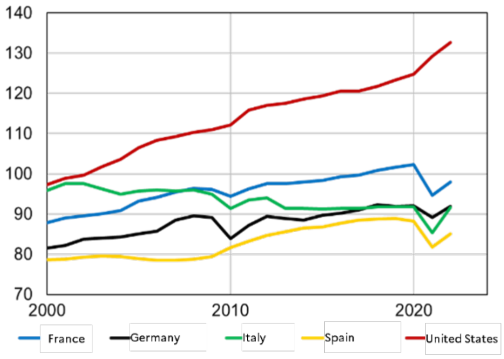
Other than the impact of external shocks, the gap between per-capita GDP growth rates on either side of the Atlantic can largely be attributed to the euro area's productivity deficit with the United States (see Figure 4). According to the Directorate General of the Treasury (*DG Trésor*), slower labour productivity growth (measured as GDP per hour worked) in the euro area than in the United States widened the per-capita GDP growth gap by 0.6 percentage points. By comparison, demographic structure widened the gap by 0.2 points, while labour-market factors[7] narrowed the gap by 0.4 points.

5 Ibid.

6 European Union, Access to equity financing for European defence SMEs, 2023 (link).

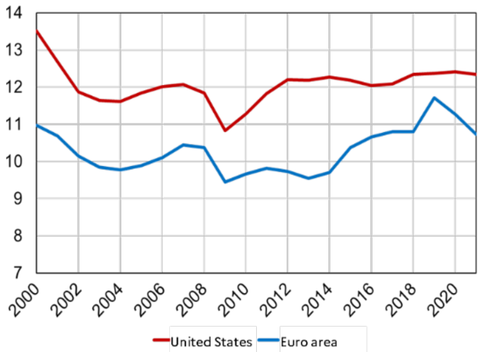
7 Unemployment, activity rate, working life, hours per worker.

Figure 4: Productivity (GDP per worker, thousands of $, PPP)



Source: Direction générale du Trésor, 2023

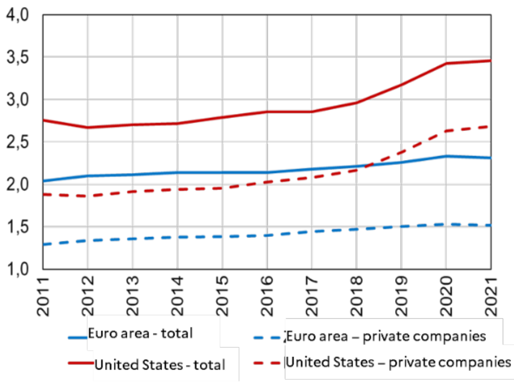
Figure 5: Investment rate[8] (% of GDP)



Source: Direction générale du Trésor, 2023

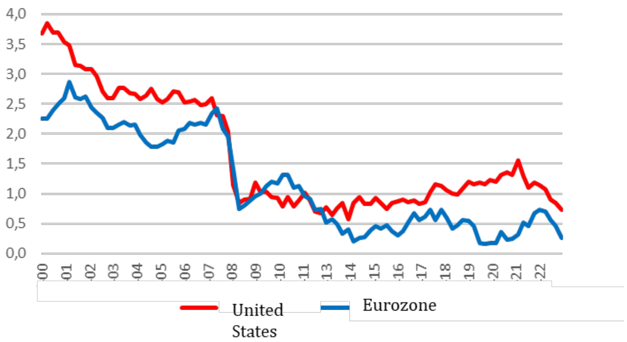
This productivity gap is the result of chronic under-investment in physical capital and innovation. Since 2000, the investment rate has been between 1 and 2 percentage points lower in the euro area than in the United States (see Figure 5). The R&D expenditure trend reveals under-investment in innovation, especially by the private sector (see Figure 6). Meanwhile, the natural rate of interest, which corresponds to the equilibrium price of capital with a zero output gap, indicates that, in the euro area, savings are too high and investment is too low (see Figure 7).

Figure 6: Expenditure on R&D (% of GDP)



Source: Direction générale du Trésor, 2023

Figure 7: Natural rate of interest *r**



Source: Holston, Laubach, Williams, 2023

8 Excluding construction.

1.2. To address these investment challenges, the full mobilization of capital markets will be indispensable

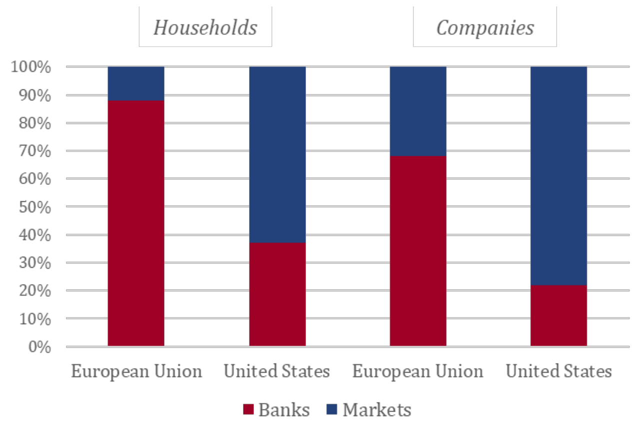
1.2.1. Banks, which already dominate the European financing landscape, will be unable to meet these new needs

The European economy is already mostly financed by banks.

This dominance can clearly be seen in the liabilities of economic agents: in the EU, banks account for 90% of household debt and 70% of business debt. By comparison, these figures are just 40% and 20% respectively in the United States (see Figure 8). Banks therefore meet the vast majority of financing needs in Europe, whereas the markets play a prominent role in the United States. Yet, it is to be noted that this market dominance in the US does not exclude banks from the equation altogether: they act as market makers and originate assets, which are then traded on the markets (securitisation).

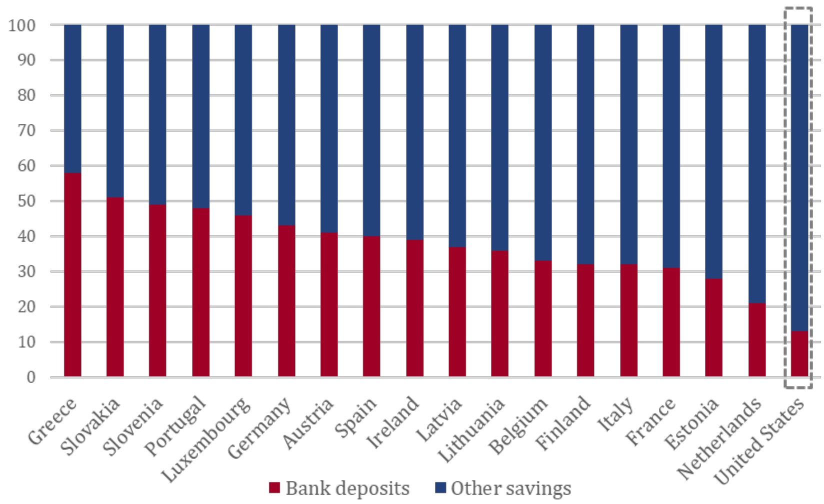
Banks also play a more important role in the assets of economic agents in Europe than in the United States. In 2022, currency and deposits accounted for 13% of household financial assets in the United States, 21% in the Netherlands, and between 28% and 58% in the rest of the euro area (see Figure 9).

Figure 8: Banks and capital markets as a share of household and corporate funding (EU and United States, 2022)



Source: Oliver Wyman, based on data from Eurostat, AFME and SIFMA (link)

Figure 9: Banks and capital markets[9] as a share of household financial assets (euro area and United States, 2022)



Source: OECD (link)

A capital constraint will necessarily limit banks' ability to increase their lending volumes. Since the 2008 financial crisis, European banks have faced significantly higher capital requirements. With increasingly strict rules coming into force, the Common Equity Tier 1 (CET1) ratio rose from 6% in 2011 to 15% in 2021. This upward trend will likely continue in the medium term following the full enactment of the Basel III framework into domestic law, with the standards entering into force progressively in Europe during the 2020s. A central element of the new rules is the output floor, which will limit the ability of banks to use internal models or low-risk mortgage loans as a way to limit their capital charges.

In the majority of cases, European banks have increased their solvency ratio by acting on the equation's denominator. While some of these banks have successfully raised or generated additional capital, most have focused their efforts on reducing the risk-weight of their assets. This observation by the Basel Committee[10] sets Europe apart from the rest of the world, where retained earnings have been the primary contributor to the increase in banks' capital ratios. Thus, unlike their peers, European banks have reduced the availability of higher-risk loans – and, therefore, their contribution to financing the productive economy – rather than raise or generate additional capital.

The low profitability of European banks effectively constrains their ability to generate or raise capital. In 2023, the average return on equity (RoE) of European banks was 7.6%, compared with 9.9% for their US counterparts. This situation can be attributed to multiple factors relating to the macroeconomic climate, banks' business models and the regulatory environment. Among those factors, one reason is that European banks are less able to turn to the capital markets: according to *DG Trésor* calculations, the fact that they securitise fewer of their assets – and, therefore, have a lower balance-sheet velocity – accounts for some 20% of the difference in RoE between European and US banks.[11] This lower RoE is responsible for the constant, long-term decline in European

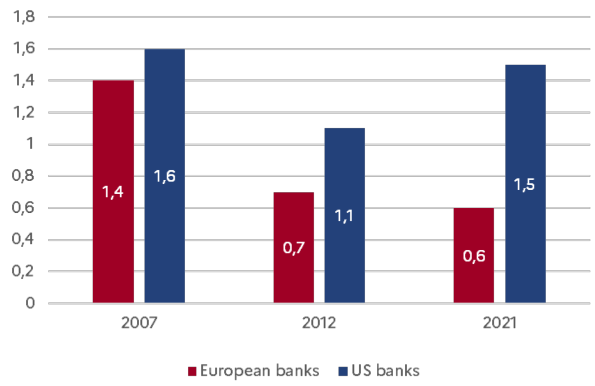
9 "Capital markets" encompasses the following OECD aggregates: "shares and other equity", "securities other than shares", "mutual fund shares", "life insurance reserves" and "pension funds".

10 BCBS, Basel III monitoring report, February 2023 (link – p. 37).

11 Analysis by DG Trésor, 2021.

banks' valuations (see Figure 10) and, ultimately, a higher cost of capital: 8.4% on average, versus 6.5% for US banks.[12]

Figure 10: Price/book value ratio for European and US banks (2007–2021)



Source: Oliver Wyman (link)

Additionally to and independently of the constraints on banks' balance sheets, the low capitalisation of European companies will limit their ability to access bank lending. European companies have a higher debt-to-equity ratio (59%) than their US counterparts (50%)[13]. In order to finance the investments needed for the green and digital transition, European companies will have no option but to turn to equity financing, which can only come from the capital markets.

1.2.2. The European capital markets are still vastly under-exploited as a source of financing

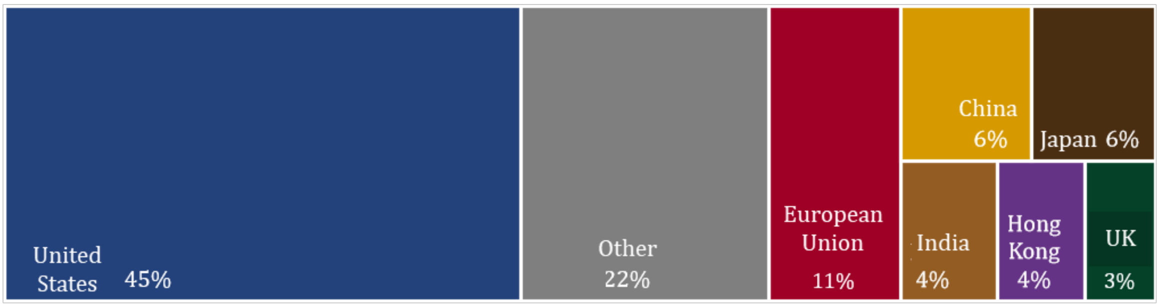
European capital markets remain under-developed, largely owing to a narrow investor base and a high degree of fragmentation. The causes of this untapped potential are explored in more detail in sections 2 to 5 of this report. The present section merely describes the situation. At this point, it suffices to say that the main reason for the state of Europe's capital markets is the lack of a large, long-term investor base (see section 2). The fragmentation of European capital markets, both in terms of supervision (see section 4) and infrastructure (see section 5), also acts as a barrier to both market integration and the competitiveness of European financial actors. Other, more specific factors also come into play, such as the regulatory and prudential framework for securitisation (see section 3).

The under-development of European markets is particularly evident in the equity markets : the EU's equity markets account for 11.4% of the global market capitalisation (see Figure 11), whereas the EU's share in global GDP (at constant prices) is 17.5%. To align with global averages, the depth of Europe's equity markets would need to expand by 60% from current levels.

12 Oliver Wyman, The EU Banking Regulatory Framework and its Impact on Banks and the Economy, 2023 (link).

13 Eurofi, based on data from BIS (link).

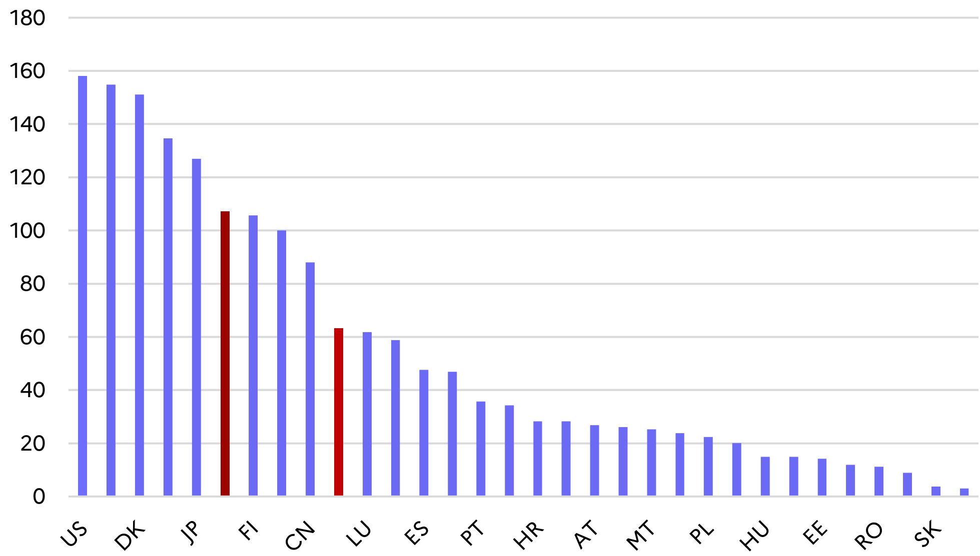
Figure 11: Global market capitalisation in 2022



Source: SIFMA (link)

However, significant disparities can be observed (see Figure 12). At the end of 2022, the market capitalization of the European Union's equity markets accounted for 62% of the area's GDP, but this proportion was significantly higher in some Member States (Sweden, Denmark, Netherlands, France, Finland).

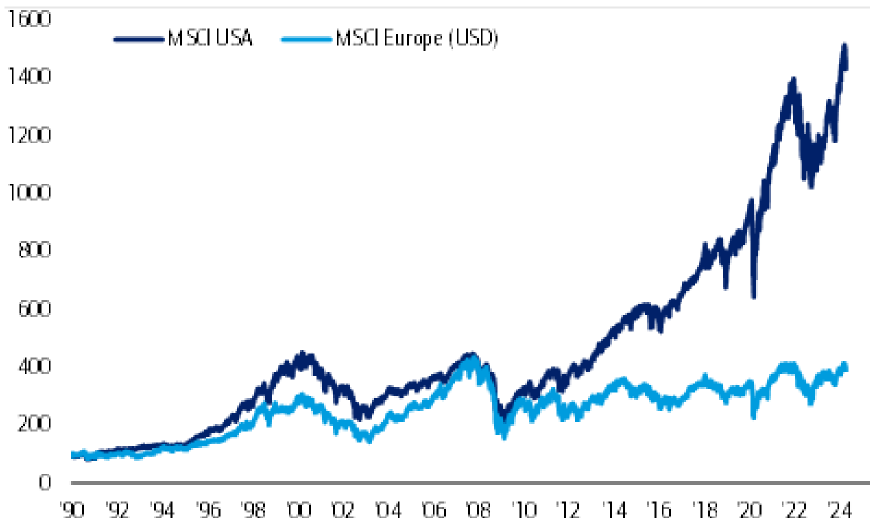
Figure 12: Stock market capitalization as GDP % in selected economies



Source: ECMI, op. cit.

The marginalisation risk facing European equity markets stems from widening gap since the 2008 financial crisis. At the time, the EU's equity markets represented 17.1% of the global market capitalization But the US equity markets have experienced significantly more buoyant growth than their European counterparts since 2008.

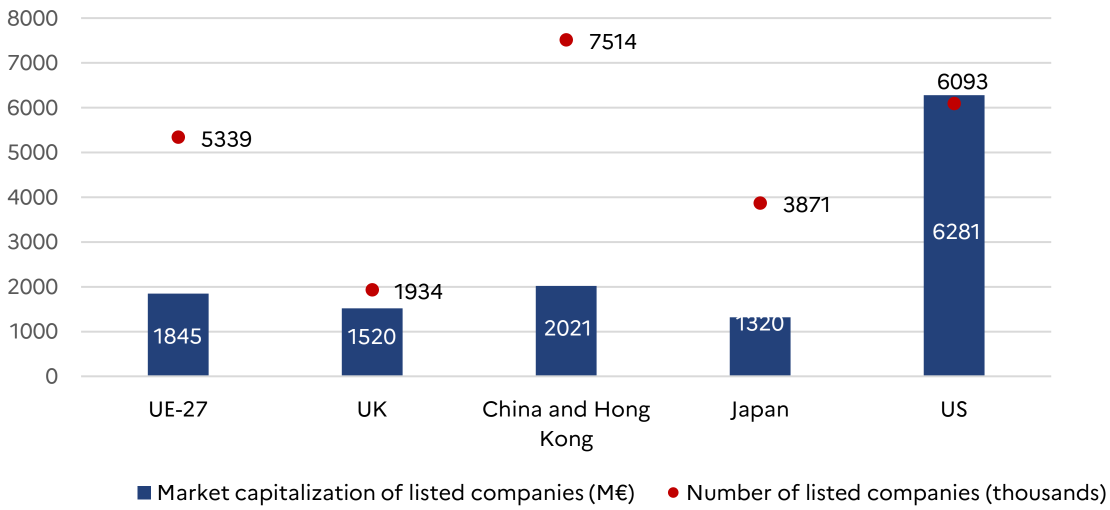
Figure 13: evolution of MSCI USA and MSCI Europe USD indices since 1990



Source: Bank of America

Today, the EU lags a long way behind the United States in terms of total market capitalization, with a ratio of close to 1:4. Yet there is only a little difference in the number of listed companies in both markets: in 2022, there were 5,339 publicly traded companies in the EU, versus 6,093 in the United States.[14] On average, listed companies in the EU are smaller and valued lower than in the United States: at end-2022, the price-to-earnings (P/E) ratio for the 600 largest companies in the EU by market capitalisation was 17, versus 28 in the United States. As a result, in 2022, EU listed companies had an average market capitalization of €1.85 billion, compared with €6.28 billion for their US counterparts. However, it is important to note the impact of US 'mega caps' on these averages.

Figure 14: Average market capitalisation (€ million) and number of listed companies (thousands), end-2022



Source: ECMI, op. cit.

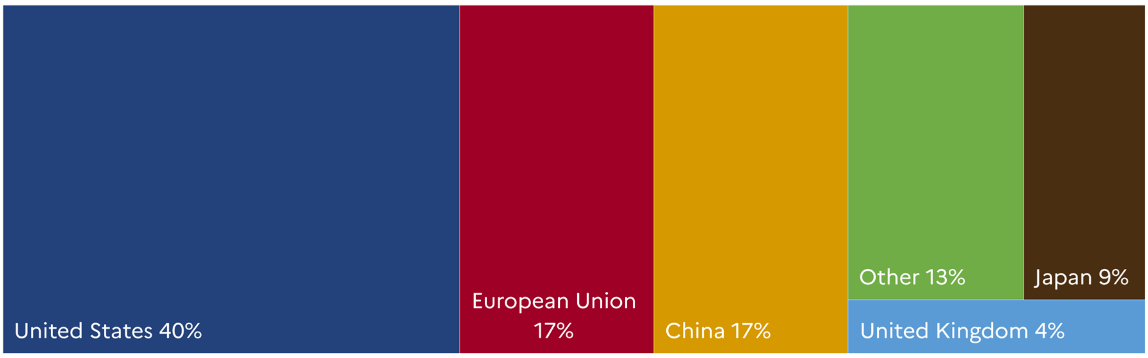
14 Despite this figure falling by 15% between 2009 and 2019.

The EU's equity markets are also considered as less liquid compared to the US markets. This gap, however, should be analysed under a differentiated approach by segment due to the effects of size that can skew the analysis, and the impact of the proportion of free float. In 2023, the gap is not particularly noticeable in the 1-5 billion euros capitalization segment (-9% in float velocity vs. the US) and is even positive in the 5 to 200 billion euros segment (+6%). On the other hand, it is more pronounced for small caps (-41% in the 1 to 2 billion segment, -13% in the 2 to 3 billion euros segment) and for mega-caps (over 200 billion euros), where the impact of individual cases however predominates. However, the liquidity of small caps is key, as they ensure the renewal of the market's listed companies base. This is where the presence of domestic investors is particularly crucial, and they are lacking in European capital markets, while the main ones manage to attract international investors.

Another lesson from this segment analysis is the relatively unfavourable_situation, by contrast, of European companies[15] listed in the United States: European companies with a market capitalization of between 1 and 5 billion euros that have been listed on Nasdaq since 2018 are less liquid than equivalent-sized American companies (velocity of 1.6 versus 2.8),[16], but also than their counterparts listed on European markets[17] (2.5). Simply being listed in the United States is therefore not enough to ensure liquidity for European issuers, which underscores the importance for companies to be able to address their natural trading pool.

The EU's bond market also appears to be substantially less well-developed than its US counterpart: in 2022, the current supply of listed debt securities in the EU equated to 130% of the region's GDP, compared with 200% in the United States. Although this difference is significant, it is smaller than the gap between the equity markets on either side of the Atlantic: in 2022, the size of the EU bond market was "only" half that of the US bond market, at €21 trillion, whereas the US equity market was close to four times the size of its EU counterpart.

Figure 15: Global bond market size in 2022



Source: BNP Paribas

15 According to the criterion of headquarters

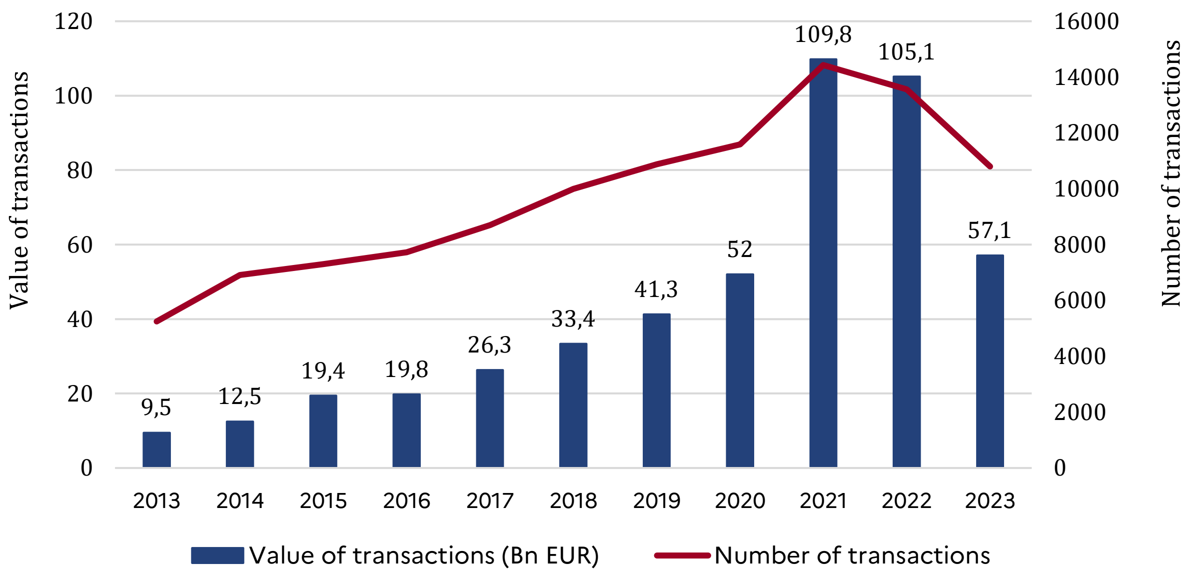
16 Velocity of 1.6 versus 2.8

17 Velocity of 2.5

Beyond the listed equity and bond markets, the EU's unlisted segments pale in comparison with their US counterparts. In the venture capital segment, for instance, total annual investments averaged €23.3 billion between 2013 and 2022 in the EU, compared with €149.2 billion in the United States[18] – a ratio of 1:6. This gap can largely be attributed to the limited number of large venture capital funds in the EU: although there are "only" four times as many such funds in the €200–500 million bracket in the United States than in the EU, the US has 14 times as many funds in the €1 billion-plus bracket.[19]

Despite this significant size difference between the EU and the United States, the European venture capital market has experienced strong growth in the past decade, with a five-fold increase in transaction values between 2013 and 2023. This growth came in spite of a 45.7% decline in the value of transactions on Europe's venture capital market between 2022 and 2023, which was the result of a weakening macroeconomic climate.

Figure 16: Value and number of transactions on the European venture capital market



Source: Pitchbook (link)

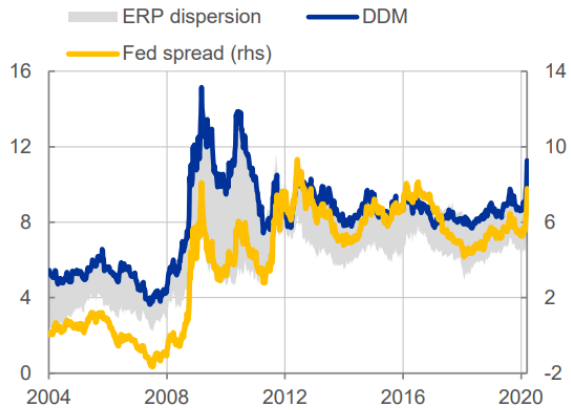
The shallow depth of the European markets directly affects the cost of capital and the supply of financing for European companies. The fact that the EU's capital markets are under-developed, with the exception of certain countries, means that European companies have a more limited access to non-bank financing that their US competitors, across all channels, and the financing options that are available to them have a higher cost on average.

18 Source: AFME (link).

19 Source: EIF (link).

The comparatively lower valuations found on the European equity markets increase the cost of equity for companies that want to raise capital through initial public offerings (IPOs) or secondary market offerings. This is evidenced by the equity risk premium (ERP), which has remained at historically high levels in the euro area since 2008. There are several factors behind this development: the limited participation by certain types of investors (including pension funds), and the impact of regulatory changes introduced since 2008.

Figure 17: Estimates of the euro area equity risk premium[20]



Source: ECB (link).

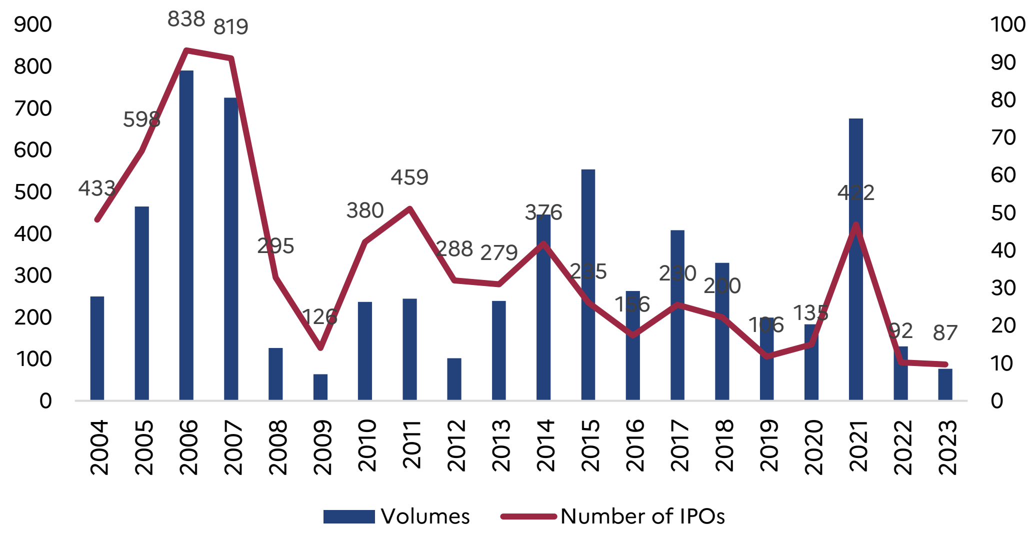
As a result, the number of European companies turning to equity markets is on the decline. This can be seen in the sharp fall in both the volume and value of IPOs over the past decade – with the notable exception of 2021, which reflected globally buoyant equity-market conditions, due to a post-health crisis catch-up that has also positively impacted other financing levers.

The rising cost of raising funds on the equity markets is not, however, the only reason for this structural decline in European IPOs. Other, non-regional-specific factors are also at play, including an increasingly abundant and lower-cost supply of financing in the unlisted segment, excessive regulatory constraints that disincentivise companies from going public, and the perception that the equities market is excessively volatile, and hence disadvantageous in the models of certain types of investors subject to prudential constraints...

The major obstacle in the unlisted equity markets has less to do with valuations or the risk premiums investors expect than with the limited supply of late-stage capital. This type of investment comes at a crucial stage for innovative companies, which need to raise significant funds to scale up their business following a successful early stage and make the shift from start-up to scale-up.

20 The grey area indicates the ERP dispersion for euro-area equities based on a number of models, including the Gordon growth model, the H-model and the Dividend Discount Model (DDM).

Figure 18: Volume and value (€ billion) of IPOs in Europe between 2004 and 2023



Source: PwC annual reports

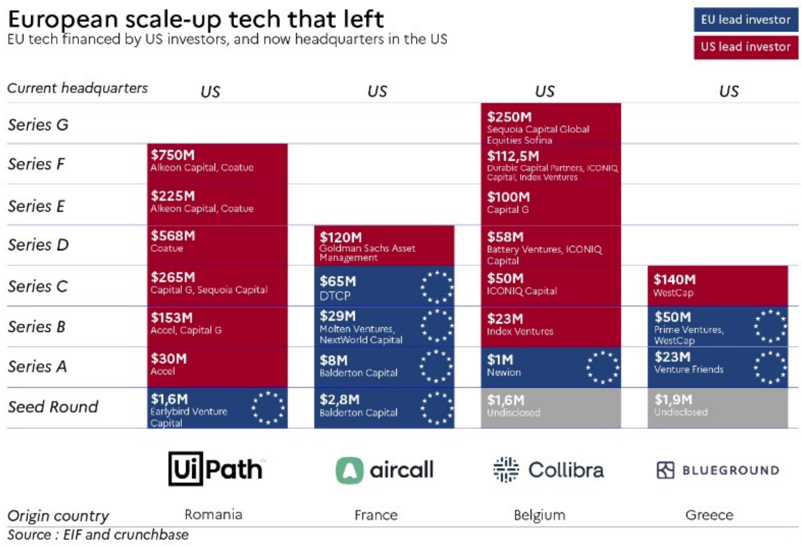
In this context, European companies are increasingly turning to the United States for fund-raising and, ultimately, for IPOs. This break in the financing continuum is a clearly identified weakness – one that was made clear in *Financing the Fourth Industrial Revolution*, a report by Philippe Tibi published in July 2019. It can drive late-stage European start-ups to look outside Europe for fund-raising, since European growth capital funds are often unable to participate in funding rounds worth more than €30 million.

In 2021, on average, 53% of the investors in funding rounds of between €10 million and €50 million were European. This proportion fell to 36% for amounts of between €50 million and €100 million, and to just 24% for rounds of over €100 million.[21]

This contribution from non-European – typically American – investors is of course welcome and opens up more fund-raising opportunities for European companies. But it frequently causes European companies with strong non-European backing to gradually shift their centre of gravity towards the United States, with some even moving their headquarters across the Atlantic and choosing to float on the New York Stock Exchange or the Nasdaq exchange rather than in Europe. A number of high-potential French start-ups chosen to set up in the US in recent years: Algolia (SaaS), Dataiku (data analysis), Datadog (cloud infrastructure monitoring), Kiriba (cash management) and beyond aerospace (hydrogen-powered aircraft). This phenomenon can also be observed in the rest of the European Union.

21 Source: Banque de France (link).

Figure 19: Examples of European companies that raised funds from US venture capital funds and are now headquartered in the United States



Source: EIF (link)

As a result, many innovative companies that were founded in Europe and relied on the continent's innovation and R&D ecosystem to achieve strong early-stage growth ultimately broke some or all of their ties with Europe. Yet these firms continue exporting services to the EU, and those that successfully float in the United States end up importing capital from European investors keen to invest in the buoyant US equity markets.

Moreover, in many cases, European companies that choose to raise funds from US investors are under-valued and lack access to liquidity when compared to US companies operating on the domestic market. This observation further highlights the need to deepen domestic equity markets in order to support the growth of European companies.

Beyond these general observations, there are significant disparities between domestic markets, suggesting that there is room for upward convergence. Member states can be divided into four groups:

- Denmark, Finland, the Netherlands and Sweden are generally considered to have the deepest, most comprehensive and most dynamic financial centres. Their capital markets are well-developed and focused on financing their domestic economies: in these four countries alone, total retirement savings amount to €3 trillion – almost two-thirds of the EU-wide total despite these countries accounting for just 12% of the bloc's GDP.[22] Conversely, the volume of savings held in demand deposit accounts is particularly low.
- The second group includes Member States that have specialised in a particular market segment. These countries have capitalised on the freedom to provide services and on the EU passporting system, even though their domestic financial markets are considered to be as deep as those in the first group (the Nordic countries). This group includes Luxembourg and Ireland, which have carved out a

22 Source: New Financial

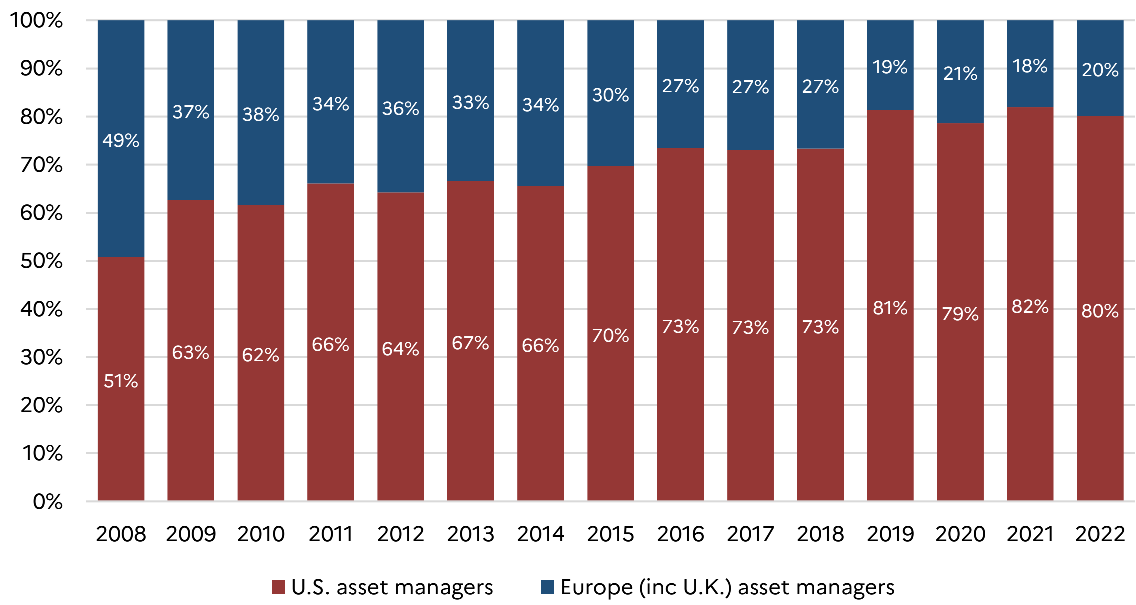
niche in managing and administering cross-border funds, and Cyprus and Malta, which have cornered the retail brokerage market ;

- The third group consists of countries with historically relatively well-developed capital markets, but where banks dominate the financing landscape. This group includes Germany, Austria, Belgium, Spain, Italy and Portugal. France appears to occupy a particular position: its capital markets are among the deepest and most liquid in Europe, and it boasts a diverse ecosystem of financial institutions. But a relatively low share of its households' savings is allocated to equity investments;
- The fourth group comprises central and eastern European countries where the capital markets have developed more recently and still play a relatively marginal role in financing the economy.

1.2.3. At the same time, European financial actors are becoming marginalised on the global stage, and are even losing ground in their own market

In asset management, European firms are losing market share to their American competitors. Over ten years (from 2013 to 2023), their market share has risen from 30% to more than 42% among the top 30 players, figures that contrast sharply with the market share of European players in the United States, which has stagnated at 2%[23]. This disparity highlights the differing levels of market openness between the two regions. On a global scale, the market share of European asset managers among the top 20 global players has fallen from 48% in 2008 to 20% in 2022.

Figure 20: Total assets managed by the world's 20 largest asset managers, by domicile



Source: Thinking Ahead Institute

European corporate and investment banks are also seeing their market shares steadily eroded over time under competition from their US counterparts. Globally, between 2012 and 2022, the share of corporate and investment banking income accounted for

23 Source : Broadridge, Novembre / décembre 2023

by US banks increased from 53% to 64%. Over the same period, this share in the Europe, Middle East and Africa (EMEA) region jumped from 39% to 51%. Consequently, in 2022, only three of the ten largest banks by corporate and investment banking income in the EMEA region were European.

US corporate and investment banks owe a large part of their success to a deep, integrated and more profitable domestic market with a stronger focus on corporate and investment banking. On average, between 2020 and 2022 and on a like-for-like volume basis, commissions on mergers, acquisitions, and equity and bond issuances were between 1.3 and 1.7 higher in the United States than in the EMEA region.

The relative strength of US firms is also predicated on the protective attitude adopted by the country's regulatory authorities. In his annual letter to JP Morgan Chase shareholders, Jamie Dimon described the US government as a "silent partner" [24]. Essentially, the US market is less open to Europeans than vice versa.

A similar, albeit less pronounced trend can be seen in the trading platforms segment, with increasing competition from non-continental players focusing on the secondary market and 'blue chips'. For instance, the American firm Cboe Europe had a market share of 24% in the volumes of European equities traded on trading platforms in February 2024, equivalent to the volumes traded on Euronext's primary markets[25].

Similarly, American brokers have also taken an increasingly dominant role in transactions at the expense of European banks and local brokers. This shift can degrade the ecosystem that benefitted small and mid-cap companies, as global players focus on larger capitalizations

While international financial institutions have a welcome role to play in intermediating transactions on Europe's capital markets, over-dependence on non-European firms runs counter to the EU's strategic autonomy objectives. The fact that non-European banks pulled out from the EMEA syndicated lending market at the height of the COVID-19 pandemic highlights the importance of having large domestic firms operating across the various capital-market segments.

1.3. A new approach is mandated to support the scale-up of Europe's capital markets

The intense legislative activity of the past decade has not delivered the desired results, and there is a risk that a certain "fatigue" with the idea of the Capital Markets Union could set in.

The majority of the measures set out in the 2015 and 2020 action plans have been implemented. Some corrective measures have proved particularly important, such as the extension of the simple, transparent and standardised (STS) framework to apply to synthetic securitisation, which spurred post-pandemic growth in this segment. Other structural measures adopted in recent years will have a significant impact in the medium term: these include the relaunch of European Long-Term Investment Funds

24 Jamie Dimon, *Dear Fellow Shareholders*, February 2024 (link).

25 It should be noted that the observed fields are not the same, with Euronext remaining largely dominant, and thus the reference market, for securities listed on the primary markets it operates, while MTFs (Multilateral Trading Facilities) operate on their own selection of listed securities from European markets of their choice

(ELTIF 2.0) and the creation of the European Single Access Point (ESAP) for financial and non-financial information.

However, the most transformative measures have encountered political obstacles and struggled to gain traction on account of their complexity. The proposed pan-European Personal Pension Product (PEPP) was hobbled by unrealistic limits on distribution costs, which led to Member States failing to agree on an appropriate tax regime (see section 2). And despite ambitious Commission proposals, the 2017 review of the European supervisory authorities resulted in only very limited reforms (see section 4).

These obstacles stem in part from a lack of clarity in political framing. Proposals for capital-market deepening and integration were framed as measures aimed at strengthening risk-sharing and financial-system resilience, but too little emphasis was placed on their importance for the financing of European companies. The chosen approach – successive revisions of existing directives and regulations – perpetuated a climate of uncertainty around the end goals, making it difficult to rally political support behind the proposals. Now, ten years later and with Europe's markets lagging behind the United States, a new approach is mandated.

The relaunch of the Capital Markets Union will hinge on a limited number of transformative reforms. This is precisely the approach recommended in this report, which sets out four key measures, each addressing a major obstacle to Europe's capital markets playing a decisive role in financing the European economy:

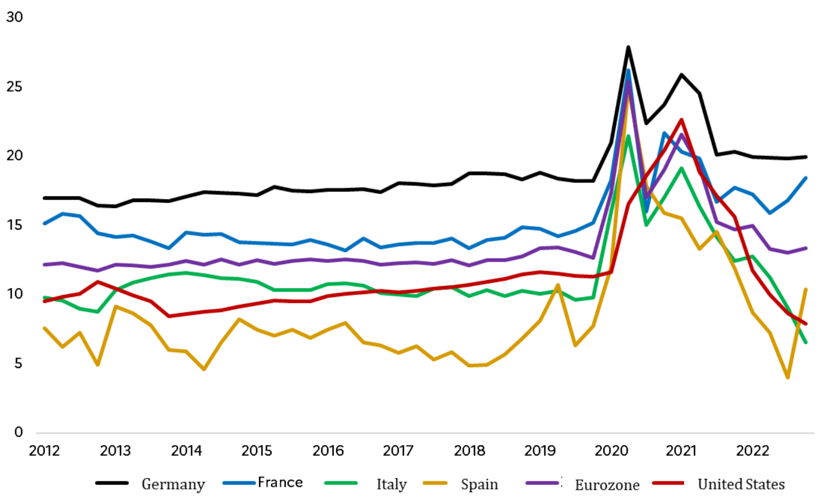
- A European long-term savings product is the first essential step to increase flows towards European capital markets: without a massive investor base, deep capital markets cannot emerge;
- The securitisation market needs to be revitalised in order to back the lending capacities of European banks by deep capital markets. This ambitious effort would involve quickly correcting the regulatory and prudential framework, and exploring the option of a common platform;
- A move towards an integrated supervision of European financial markets will prove decisive in both scaling up European actors and maintaining financial stability in an integrated market;
- Market infrastructure needs to be better integrated: the report recommends ambitious measures to address the fragmentation of settlement in the EU.

2. Long-term savings products are needed to better channel European households' abundant savings towards the European economy

2.1. Europe generates abundant savings, but these savings are poorly allocated and do not appreciate enough

European households have abundant savings, which should be an asset for the deepening of Europe's capital markets and the financing of its strategic priorities. The euro area has a particularly high level of household savings when compared with other major developed economies (see Figure 21): in Q4 2022, savings averaged 13.3% of gross disposable household income in Europe[26], compared with 7.9% in the United States[27]. This rate stands at 20% in Germany, 18.5% in France, 10.4% in Spain and 6.6% in Italy.

Figure 21: Household savings rate (% of gross disposable household income)



Source: Banque de France

EU household financial savings amounted to €35,533 billion in 2022 – almost double the EU's GDP. Two-thirds of this amount was concentrated in five Member States (Germany, France, Italy, the Netherlands and Spain)[28].

However, it should be noted that this total is lower than the amount of household savings in the United States, where the savings rate masks the real picture of high savings coupled with high debt[29]. In 2022, US household savings amounted to more than €106 trillion, or more than four times GDP[30]. This contrast reflects a different approach to the liquidity constraint: in the euro area, households build up a buffer of

26 Banque de France (link).

27 Banque de France (link).

28 Eurostat (link).

29 According to the Banque de France, in Q3 2023, US household debt amounted to 99.9% of gross disposable income, compared with 54.5% in the euro area.

30 Federal Reserve (link).

liquid savings to keep their budget balanced throughout the economic cycle, whereas US households take out short-term loans to meet their immediate needs and lock away their savings in longer-term products.

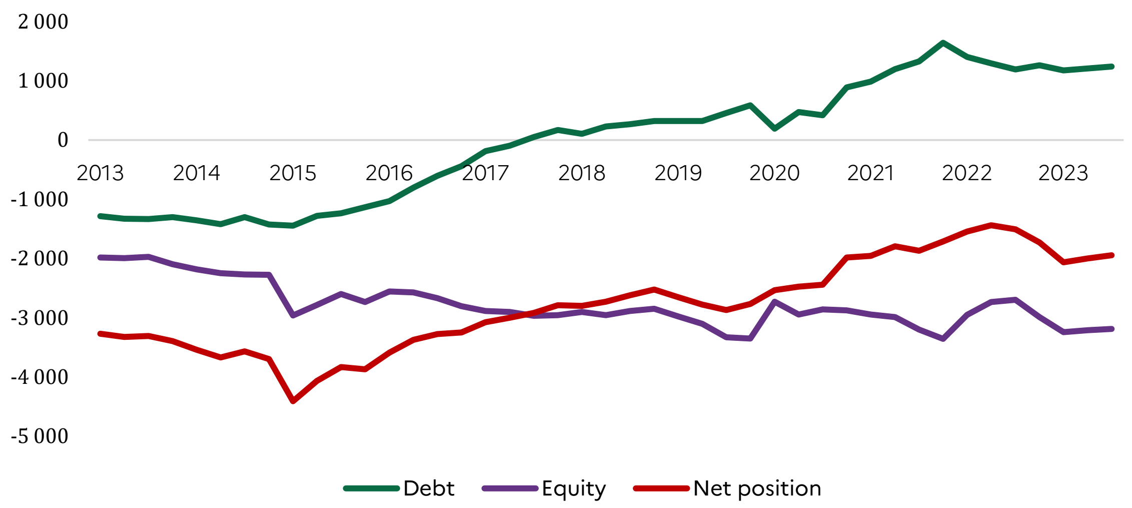
But European households' savings are not efficiently allocated to the financing of Europe's economy, and a large share is even exported to the rest of the world. The majority of European household savings are allocated to fixed income products, especially sovereign bonds. These products alone cannot finance the long-term investments necessitated by the green and digital transition of the European economy.

Most tellingly, Europe exports a significant share of its savings through the acquisition of foreign fixed income products and imports equity financing necessary for the long-term development of its companies. Consequently, although the euro area displayed in Q3 2023 a portfolio investment deficit of €1,945 billion, this headline figure masked a dual imbalance (see Figure 22):

- A surplus of €1,242 billion in terms of debt security investments: euro-area residents held €6,038 billion in non-euro-area-issued debt securities, while non-residents held €4,796 billion in euro-area-issued debt securities.
- A deficit of €3,188 billion in terms of equity investments:[31] euro-area residents held €5,724 billion in non-euro-area-issued equities, while non-residents held €8,912 billion in euro-area-issued equities.

Indeed, Europe exported an increasing amount of its savings over the last ten years. The portfolio investment deficit shrunk by €1,359 billion over the course of a decade, as the volume of non-euro-area-issued debt securities held by euro-area residents increased sharply (up €2,784 billion) while the volume of euro-area-issued debt securities held by non-residents remained relatively unchanged (up €209 billion). At the same time, the volume of euro-area-issued equities held by non-euro-area residents increased at a faster pace (up €4,673 billion) than the volume of non-euro-area-issued equities held by residents (up €3,457 billion).

Figure 22: Portfolio investment balance of the euro area (€ billion)



Source: ECB (link); Expert committee calculations

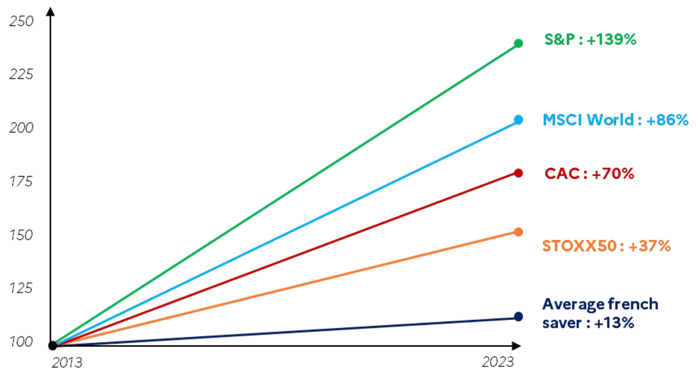
31 ECB (link); Expert committee calculations.

As a result of this shift, close to 20% of euro-area residents' savings are now invested in debt securities issued elsewhere in the world, which comes at the expense of Europe's funding needs. These needs are partially met by foreign capital, which in turn captures the value created by European companies. This simple macroeconomic observation testifies to the sheer extent to which European savings are misallocated, and to the cost of this misallocation for the continent's competitiveness, for its ability to meet the challenges of the green and digital transitions, and for its strategic autonomy.

Beyond its collective cost, the misallocation of savings carries individual costs borne by European savers through lower returns. Allocating savings to liquid, low-risk products carries a cost, depriving European savers of the returns that long-term investors can achieve on the financial markets.

For instance, between 2012 and 2021, the average annual return on unit-linked life insurance products in France was 4.6%, compared with 2% for euro-denominated life insurance funds and 1% for *Livret A* savings accounts, both of which are backed by capital guarantees[32]. By way of an example, a financial portfolio reflecting the average stock of the most common savings products in France (see Figure 23) significantly underperformed the main European and global equity indices over the ten years.

Figure 23: Returns on selected financial investments (2013–2023)

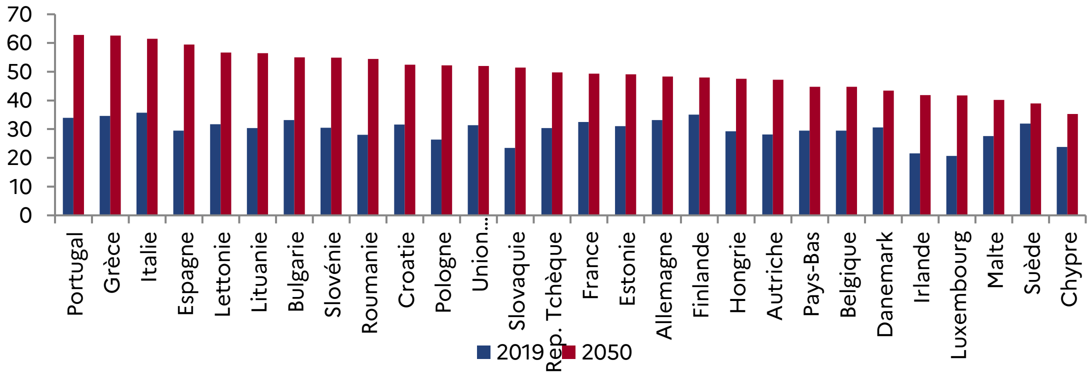


Source: Expert committee

At the same time, Europe's ageing population makes savings returns more necessary than ever. The average old-age dependency ratio in the EU is set to rise from 31% at present to 52% by 2050, with sharp increases across all Member States. While each country will strike its own balance between pay-as-you-go and funded pension systems, the sheer scale of the need means that none of them will be able to overlook savings in the long term. The returns produced by these savings will prove decisive in Europe's ability to navigate the macroeconomic consequences of its demographic shift.

32 DG Trésor calculations.

Figure 24: Old-age dependency ratio (ratio of the number of people aged 65 and over to those aged 15–64 years)[33]



Source: Eurostat

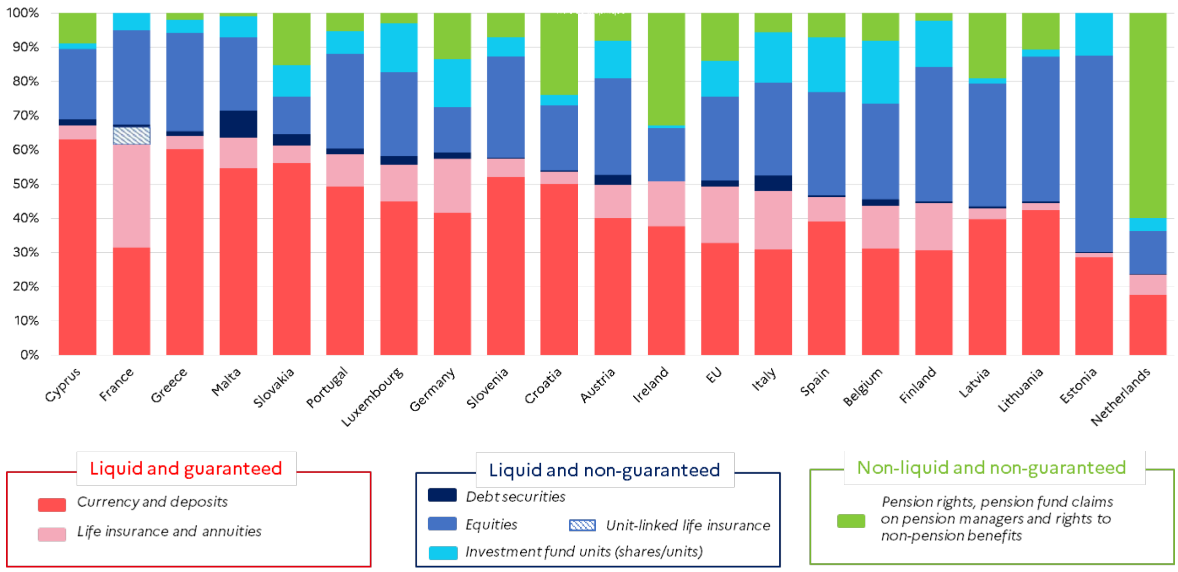
2.2. This misallocation stems from the savings products and their tax framework, which too often discourage long-term investment

Product characteristics and fiscal incentives determine how savings are allocated. For the financial intermediary managing a given product, the risk and liquidity characteristics offered to savers are liability-side constraints. These constraints inevitably carry over onto the assets side, since the intermediary does not have an unlimited capacity to pool risk and liquidity. By offering mainly liquid and guaranteed products, banks and insurance companies find it harder to invest savings in equities and other high-risk, long-term assets, even though such investments are necessary to support European innovation and growth. This effect is compounded by the prudential treatment, especially under Solvency 2, of volatility when it is measurable, namely for listed equities. Paradoxically, illiquid assets benefit from better prudential treatment than listed ones.

Yet the lion's share of European savings is invested in liquid and guaranteed products, constraining the portion of assets that can be allocated to equity investments, especially listed stocks. While bank deposits, savings accounts and euro-denominated funds can be allocated to medium-to-long-term and relatively safe debt financing, they are of limited use for equity financing. Despite this, these products represent between 23% and 63% of household financial holdings across different EU Member States (see Figure 25).

33 How to read this chart: in France, the old-age dependency ratio (i.e. the number of people aged 65 and over to those aged 15–64 years) is expected to rise from 33% in 2019 to 49% in 2050.

Figure 25: Allocation of households' financial savings in the euro area in 2022



Source: Expert committee, based on Eurostat data

Bank savings accounts are the most common type of liquid and guaranteed product. On average, demand deposits accounted for 31% of European households' financial savings in 2022, with this figure rising as high as 39% in Germany and 38% in Spain[34]. Despite being short-term in nature, some of these savings products are regulated and attract extensive tax subsidies. In France, for instance, 15% of all financial savings are held in regulated savings accounts (see below). Italy also offers postal savings accounts, which are administered by the *Cassa Depositi e Prestiti*, distributed by *Poste Italiane* and backed by government guarantees. Deposits can be withdrawn at any time, but the interest offered is extremely low, at just 0.001%. While these savings accounts carry no fees, the interest earned is subject to a 26% tax.

Many life insurance products also offer a high degree of liquidity and capital guarantees, although their exact features vary from country to country. Some examples are given below:

- In France, life insurance policies can be cashed out, in the form of an annuity or in capital, at any time, with favourable rules on the taxation of gains after eight years and on inheritance tax before the age of 70. The portion of any policy invested in euro-denominated funds remains backed by a capital guarantee at all times. There are no constraints on the allocation of life insurance assets in France, other than a recently introduced requirement to list labelled units of account and to include a minimum amount of unlisted assets in actively managed policies;
- In Germany, unlike in France, life insurance is not conceived as a medium-term financial investment[35] but rather as a retirement savings product, with preferential taxation arrangements on payout[36]. Guaranteed capital and maximum-rate policies are the most common. Annuity policies

34 Eurostat (link).

35 In France, the average holding time of a life insurance policy is 12.6 years (link).

36 For a capital payout, tax is only due on 50% of the income revenue (at the income revenue rate of 25%) if: (i) the policy is taken out for 12 years or more, and (ii) the policyholder is aged 60 or over at the time of the payout. For an annuity payout, only the "income revenue" portion is subject to tax, on a monthly basis, at the standard rate of income tax.

(*Rentenversicherungen*) remain the most popular type in this category, which includes *Riester* and *Rürup* policies that offer additional benefits: contributions are tax-deductible and may be topped up by the government under certain conditions. There are no particular rules on the allocation of life insurance assets in Germany;

- In Spain, although the lion's share of savings is held in bank deposits, there are also life insurance-style savings products that offer an annuity (*Plan Individual de Ahoro Sistematico*) or a capital payout (*Plan de Ahoro a Largo Plazo*). These products carry a minimum waiting period of five years and the gains are tax-exempt.

In the EU, some 47% of household financial savings are held in liquid and guaranteed products (bank deposits and life insurance products, even though a share of life-insurance assets are invested in non-guaranteed units of account). This figure is as high as 61% in France and 54% in Germany. By comparison, deposits and life insurance products account for just 14% of households' financial savings in the United States.[37]

European savers nevertheless have access to long-term savings products, although these are more widespread in some countries than in others. In some countries, a higher share of savings is allocated to long-term investments. In 2022, equities and fund shares accounted for 33% of European households' financial savings, and as much as 44% in Spain and 40% in Italy. The Netherlands is a notable outlier among EU Member States, as 58% of its household financial savings are held in pension funds. In the United States, more than half of household financial savings are invested in equities and fund shares.[38]

Retirement savings products are, by nature, long-term investment vehicles that help finance the economy and offer attractive returns for savers. However, they are considerably more common in some EU members states than in others, owing largely to differences in the respective pension systems. Some examples are given below:

- In France, assets held in a retirement savings plan (*Plan d'Épargne Retraite*, or PER) cannot be accessed until retirement, other than in exceptional circumstances. The PER offers two preferential taxation options: tax-deductible contributions, or tax exemption on payouts (in the form of an annuity or capital). Beyond voluntary contributions, the company retirement savings plan can be topped up with the employee's performance-based bonuses and profit-sharing earnings, as well as with employee contributions. The key particularity is that PER assets are actively managed by default: the savings are allocated in such as a way as to gradually reduce financial risks as the saver moves closer to retirement. This approach helps to meet long-term financing needs while offering something close to a capital guarantee upon maturity. There are two types of PER: individual and collective (company or mandatory PER). The scheme has gained positive momentum since its was reformed under the Business Growth and Transformation Act of 22 May 2019 (the "PACTE Act"). There are no constraints on the allocation of PER assets, other than for the collective PER, where there is a requirement to list socially responsible funds labelled against non-financial criteria, and the option for the employer to benefit from a reduced taxation if a share of PER assets are invested in SMEs;

37 Federal Reserve (link).

38 Federal Reserve (link), Congressional Research Service (link), Investment Company Institute (link); *DG Trésor* calculations.

- Savings products similar to the French PER exist in other Member States: Germany has the *Betriebsrente* (a collective savings plan); Spain has the *Plan de Pensiones Individual* and the *Plan de Previsión Asegurados* (individual plans), and the *Planes de Pensiones de Empleo* (collective plan); and Italy has the *Piani Individuali Pensionistici*. The Netherlands stands out from other euro area member countries for its high uptake of pension funds, with 90% of the population being affiliated to such a scheme[39]. Life insurance products are also available: these are actively managed, pay out in the form of an annuity, and offer preferential taxation under the third pillar of the Dutch pension system (individual pension products).

Employee savings schemes are a long-standing cornerstone of France's value-sharing model but enjoy limited popularity in other EU Member States. These schemes allow employees to build up a long-term savings pot with support from their employer. The assets are invested in higher-risk asset classes and offer competitive costs and returns. In France, funds invested in a company savings plan (*Plan d'Épargne d'Entreprise*, or PEE) are locked away for five years by default, but there are various conditions under which they can be accessed. Contributions in the form of performance-related bonuses and profit-sharing earnings are tax-exempt, as are employer contributions, and there is no tax to be paid on gains from these contributions. Employees can also make voluntary contributions to a PEE, although these are not tax-exempt. There are no constraints on the allocation of PEE assets, other than a requirement to list socially responsible funds. While the French employee savings model is unique within the EU, there are similar schemes in other Member States. Under the scheme in Germany, employees make regular contributions and receive a government top-up; the funds are locked away for seven years but there is no tax advantage[40]. Other examples include the *Planes de Ahorro Salarial* in Spain and the *Piano di Risparmio Aziendale* in Italy.

Brokerage accounts are also a common savings option in the EU. These represent a particularly useful equity investment vehicle, and benefit from preferential tax treatment in some Member States:

- In France, the equity savings plan (*Plan d'Épargne en Actions*, or PEA) is a type of brokerage account that lets savers invest exclusively in European corporate stocks and shares in collective investment schemes that invest 75% of their assets in Europe. Savers are allowed to invest in a single PEA, with contributions capped at €150,000. Gains are tax-exempt after a period of five years, but any withdrawals before this point will result in the closure of the PEA, except in limited circumstances. Another option is the PEA-PME, which is reserved for investments in SMEs that meet certain thresholds[41]. In this case, savers' contributions are capped at €225,000. Otherwise, these products are governed by the same conditions as the PEA.
- A product similar to the French PEA is available in Italy. Known as the *Piani Individuali di Risparmio* (PIR), it was introduced in 2017 to channel private savings towards long-term business investment needs. Savers can invest in a single PIR, with contributions capped at €200,000. Gains are fully tax-exempt, and inheritance tax is reduced after five years. However, the asset allocation rules that

39 DG Trésor.

40 BaFin (link).

41 Companies must meet the following criteria: (i) fewer than 5,000 employees, and (ii) annual turnover of up to €1.5 billion or a balance-sheet total of no more than €2 billion. Listed companies must have had a market capitalisation of less than €1 billion in at least one of the previous four financial years.

apply to the PIR are stricter than the rules for the French PEA: (i) at least 70% of PIR assets must be allocated to financial securities issued by European companies with a permanent establishment in Italy; (ii) no more than 10% of the assets can be allocated to securities from a single issuer; (iii) 17.5% of the total value of the PIR must be invested in SMEs; and (iv) 3.5% of the total value of the PIR must be invested in small enterprises.

- In Sweden, a significant share of household savings is invested in equities, owing in part to the nature of the country's pension system. Savers also have access to an investment savings account (*Investeringssparkonto*, or ISK), which offers particularly advantageous conditions – more than one-third of the population has one of these accounts[42] – while supporting long-term investment. There are no limits on the number of ISKs an individual can hold, or on the amount of contributions they can make, and deposits are guaranteed by the government up to a limit of €90,000. The ISK offers genuine flexibility, with no lock-in period or time restrictions on transactions, including withdrawals. In addition, the ISK is subject to a simple, flat-rate annual tax on the value of the assets; in 2023, the applicable tax rate was 0.882%[43].

This overview of the European situation contrasts sharply with the picture in the United States, where long-term investments prevail (see Figure 26). In the United States, retirement savings products are extremely popular, accounting for close to 36% of households' financial savings[44]. Looking specifically at collective savings products, some 90% of public-sector employees are enrolled in defined-benefit plans, while 69% of private-sector workers are members of defined-contribution schemes.[45] All of these products benefit from favorable tax treatments: contributions are tax-deductible up to an annual cap, with income tax only levied on benefits received during retirement. However, any pension benefits taken before the age of 59.5 years are subject to tax penalties. Companies can enrol their employees in these schemes automatically, although staff have the right to opt out if they choose to do so.

Beyond these company-provided schemes, savers can also opt to invest in Individual Retirement Accounts (IRAs). These plans, which account for 30% of US retirement savings, are offered on an individual basis by banks, insurance companies and other financial institutions. They carry similar tax advantages as company-provided plans, with the added flexibility that savers can withdraw their funds early under a range of circumstances. The growth of these pension funds has increased both the depth and

42 DG Trésor.

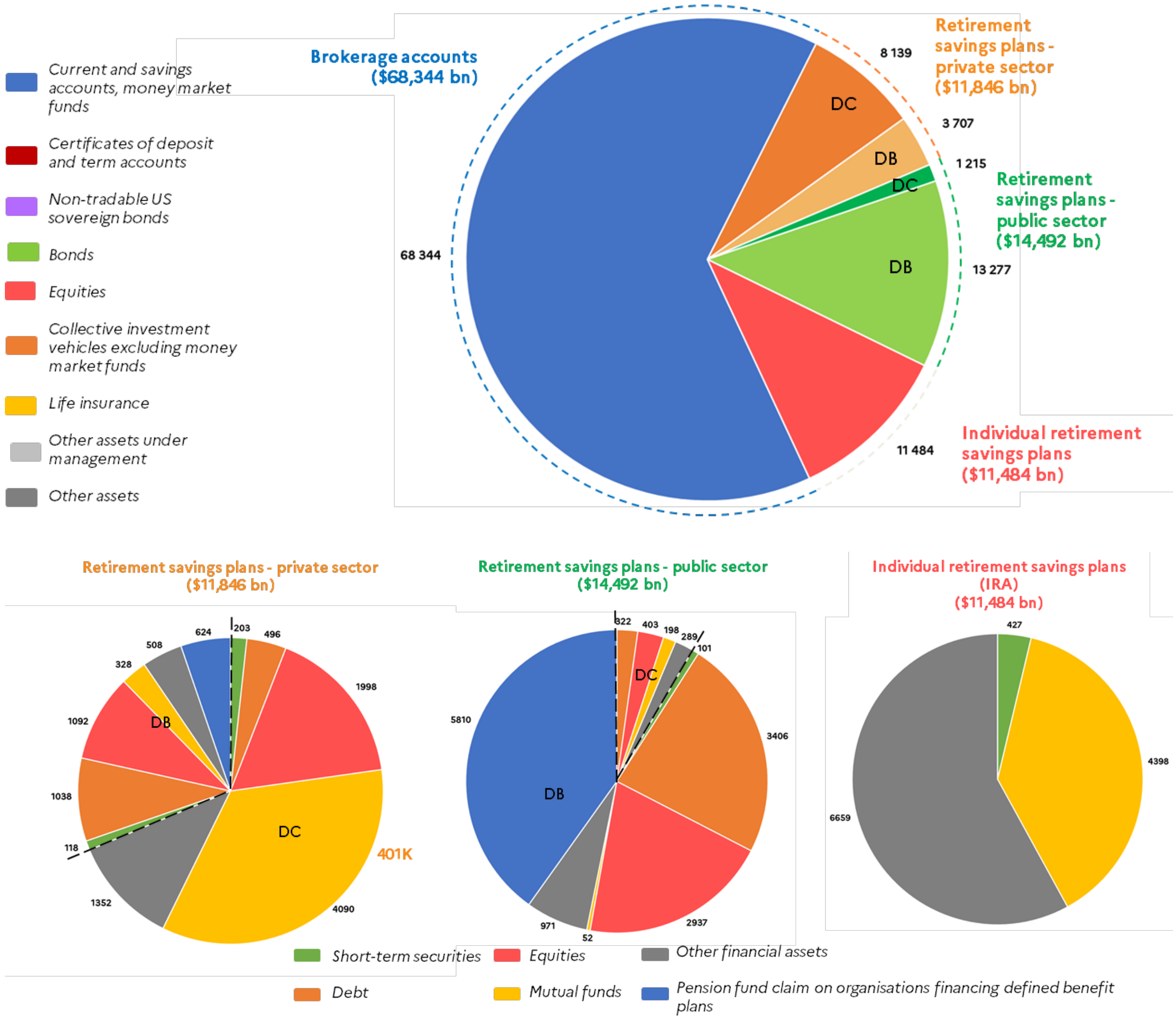
43 The value of the assets is taxed at 30% of the government borrowing rate (1.94%) plus 1%, which gives an effective tax rate on ISK assets of 0.882% in 2023.

44 Federal Reserve (link), Congressional Research Service (link), Investment Company Institute (link); DG Trésor calculations.

45 In a defined-benefit plan, pension benefits are calculated using a single formula generally based on the employee's final salary and length of service. Under these schemes, companies are required to pay their employees a predefined pension throughout retirement, meaning that employers bear the investment risk. Conversely, under defined-contribution schemes, the benefits depend on both the amount the employee contributed and the performance of the assets in which these contributions are invested. Employees have a certain degree of freedom to choose how to invest their assets, with options including a predetermined selection of equities, bonds and fund shares. In this case, the investment risk rests with employees. The 401(k) is the most popular plan in the private sector.

liquidity of the United States' capital markets and helped extend the average maturity of US household savings[46].

Figure 26: Allocation of households' financial savings in the United States (2022)[47]



Source: Expert committee

Generally speaking, the situation in France is indicative of the problems besetting European savings. France has a vast array of savings products, including a number of liquid and guaranteed options, which are chiefly invested in fixed income products. In 2022, these accounted for 59% of French household savings[48].

France stands out first and foremost for the share of savings invested in regulated products, which represent 15% of household savings (€871 billion) and include the following products: the *Livret A* savings account (€356 billion), the home-ownership savings plan (*Plan d'Épargne Logement*, PEL – €283 billion) and the social and sustainable development savings account (*Livret de Développement Durable et Solidaire*, LDDS –

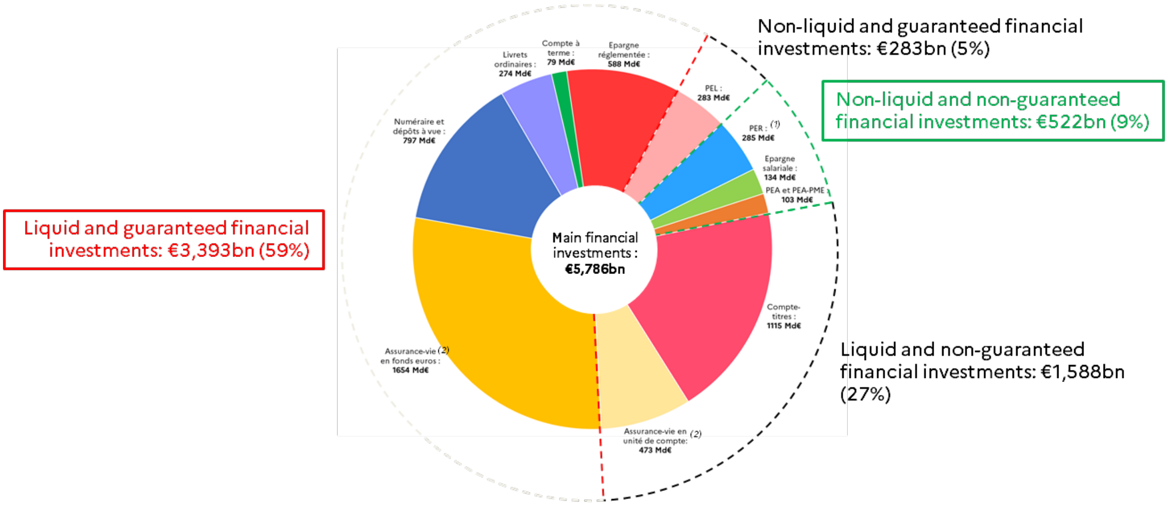
46 Aux origines de la désintermédiation bancaire américaine, BNP Paribas (January 2016).

47 The top-right chart represents total US household savings, broken down as follows: securities accounts (top-left), private collective retirement savings accounts (bottom-left), public collective retirement savings accounts (bottom-centre) and individual retirement savings accounts (bottom-right).

48 DG Trésor.

€134 billion)[49]. The majority of these products are fully tax-exempt, backed by government guarantees and have sufficiently high caps to meet the savings needs of most households – less than 8% of savers reach the *Livret A* limit[50]. The combined cap for French regulated products for an individual saver (€96,150) exceeds the gross financial assets of 80% of French households, rising to 95% for couples with two children[51]. Although these regulated products offer low long-term returns, they are the most popular retirement savings option for French households, suggesting they are seen as more than mere precautionary savings vehicles[52].

Figure 27: Allocation of households' financial savings in France in 2022



Source: Expert committee

More than one-third (€315 billion) of the funds invested in regulated savings products are administered centrally by the *Caisse des Dépôts et Consignations*. These represent the liabilities of the *Fonds d'épargne* which, on the assets side, finance long-term loans for social housing and urban policy to the tune of €174 billion – just over half of the balance sheet of the *Fonds d'épargne*, a share that has declined sharply since 2016. The *Fonds d'épargne* therefore far surpasses its statutory minimum liquidity ratios[53], which suggests that these savings are sub-optimally allocated. The remaining assets in the *Fonds d'épargne* consist primarily of highly liquid financial securities. The rules state that regulated savings that are not administered centrally and remain on banks' balance sheets must be used to finance SMEs, the green transition, and the social and cooperative economy. However, this theoretical requirement does not necessarily play out in practice because of the fungibility of banks' balance sheets.

49 Banque de France (link).

50 Banque de France (link).

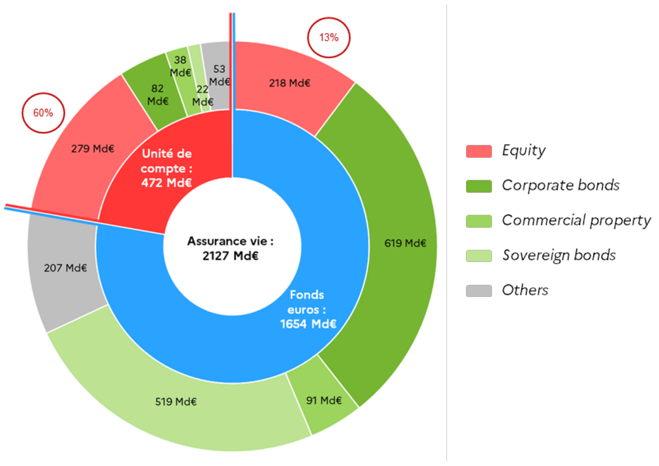
51 INSEE (link).

52 IPSOS survey for Le Cercle des Épargnants (link).

53 Article L. 221-5 of the French Monetary and Financial Code stipulates that the total deposits in Livret A and LDDS savings accounts multiplied by the centralisation rate must be at least equal to 125% of the amount of loans granted for social housing and urban policy (this ratio stood at 184.2% at end-2022). Decree 2013-688 of 30 July 2013 introduced a second loan coverage ratio: the combined total of equity and centralised deposits (for the Livret A, LDDS and Livret d'Épargne Populaire (LEP) savings accounts) must be at least equal to 135% of outstanding loans on the savings fund's balance sheet (this ratio stood at 187.3% at end-2022).

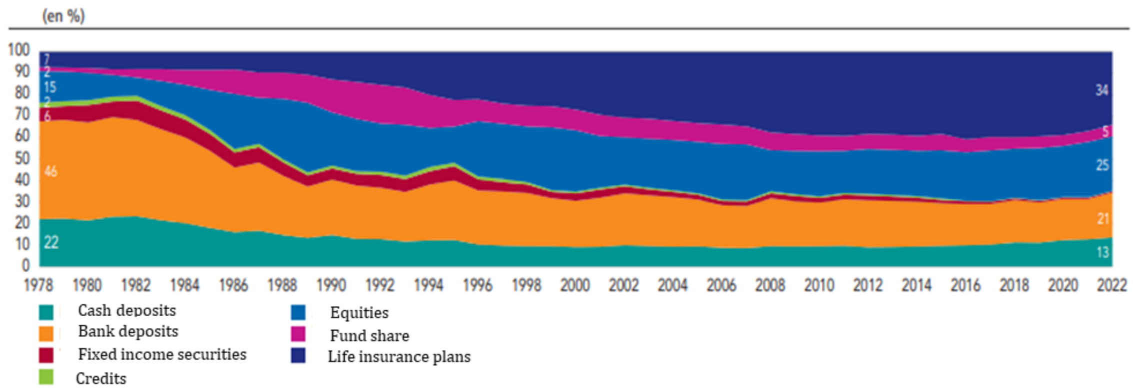
France also stands out for the relatively recent prominence of life insurance products: these account for more than one-third of household financial savings (see Figure 28), with euro-denominated funds backed by capital guarantees representing the lion's share of this amount (see Figure 29)[54]. Given the sheer volume of savings invested in life insurance, these products play a vital role in financing the French and European economies – not least because there is a strong domestic bias in the allocation of life-insurance assets[55], close to 80% of these assets are invested in Europe, and more than half in France. However, less restrictive liquidity and guarantee conditions would allow for greater mobilisation of these assets for equity funding. Less than one-quarter of life-insurance assets are invested in equities, which account for 60% of assets invested in unit-linked plans but just 13% of assets invested in euro-denominated funds.

Figure 28: Allocation of life-insurance assets in France in 2022



Source: Expert committee

Figure 29: Allocation of French households' financial assets



Source: Banque de France

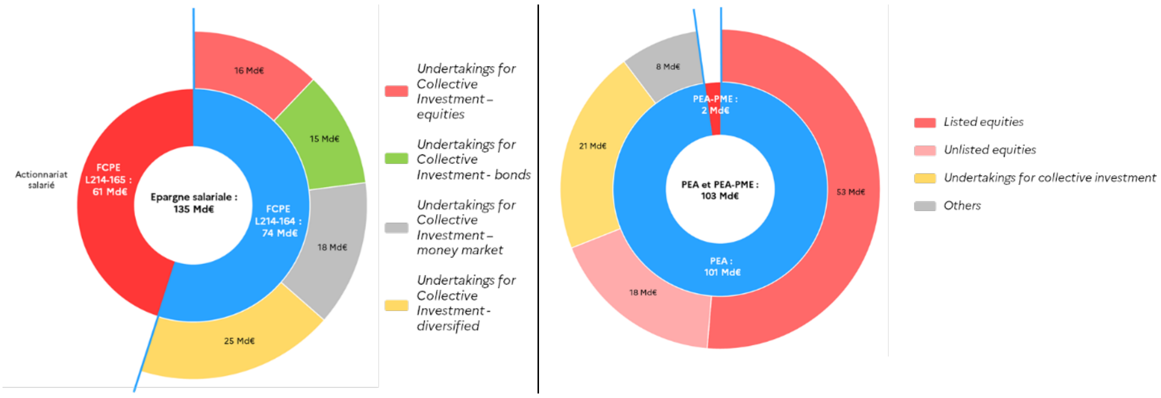
54 France Assureurs (link).

55 France Assureurs (link).

Beyond regulated savings and life insurance, illiquid and non-guaranteed savings products have gained limited traction in France despite their positive impact on for long-term financing. These products – the PER (part of which is nevertheless invested in euro-denominated funds), employee savings, and the PEA and PEA-PME plans – account for just 10% of household financial savings:

- For the PER (€285 billion),[56] 54% of new generation products introduced by the Pacte Act (€44 billion) are invested in equities, of which 6% are invested in SME and mid-sized firm stocks;
- For employee savings (€134 billion[57] – see Figure 230), 57% of the assets (€76.9 billion) are invested in equities;
- For the PEA (€103 billion)[58], 71% of the assets (€74 billion) are invested in equities.

Figure 30: Allocation of employee savings schemes (left) and equity savings accounts (PEA/PEA-PME – right) assets in France in 2022



Source: Expert committee

2.3. It is therefore recommended to build on national best practices to develop long term savings products, predominantly invested in Europe

In terms of method, the failure of the PEPP[59], the proliferation of existing products and the specificity of national frameworks suggest favouring a decentralised approach based on common principles and implemented domestically by willing Member States.

The PEPP was proposed by the European Commission in June 2017 and entered into application in March 2022. The project highlighted the major obstacles to launching a new, standardised EU savings product through the ordinary legislative procedure. The aim of the proposal was laudable: to introduce a new product that would bypass disparate domestic rules and promote competition for the benefit of savers while helping to channel savings towards long-term financing needs. But the negotiations were beset by political difficulties, especially when it came to taxation and pricing

56 DG Trésor. Data encompassing the three new product types introduced by the 2019 PACTE Act (individual PER, company PER and mandatory PER).

57 AFG (link).

58 Banque de France (link).

59 Regulation (EU) 2019/1238 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product (PEPP) (link).

issues. The existence of divergent tax regimes across Member States required the creation of a complex system of separate national sub-accounts. On top of this, the lack of tax incentives meant that the PEPP was potentially less appealing to savers than existing domestic savings products. Moreover, fees for the PEPP are capped at 1% of the accumulated capital, which gives little incentive for providers to offer the product and automatically restricts the investment universe to the most liquid and lowest-risk financial assets – assets that are of limited use in meeting long-term financing needs. The Commission's initial proposal ultimately resulted in a compromise whose complexity and constraints are restricting uptake of the PEPP.

Given this situation, it would appear more advantageous to take an inter-governmental approach: a new class European savings products could be based on a label, with willing Member States possibly making changes to some of their existing domestic savings products or creating new ones. Rather than attempting to create a unique European savings product, it would be simpler, quicker and at least as efficient to allow willing Member States to apply a European label to domestic savings products that meet the relevant standards, subject to any necessary adaptations.

The question of portability between Member States could be addressed via a transferability system with no tax friction. It is important not to over-estimate the importance of this question, however, since savings will remain first and foremost a domestic affair. However, one possible benefit of a label-based arrangement is that savings could be transferred between labelled products in different Member States with no tax frictions.

Six fundamental principles should be enshrined in the label criteria, in order to effectively channel household savings towards long-term financing.

1. A long term investment horizon: Restricting the liquidity of savings is a necessary step to meet long-term investment needs, especially when it comes to equity investments, which naturally carry a higher risk but play a key role in supporting innovation, competitiveness and growth. However, it is important to maintain a certain degree of liquidity in order to allay savers' fears around access to their savings and to encourage more people – especially younger generations – to invest in this product. Withdrawal upon retirement should be the default position, but some flexibility should be afforded. In addition to offering an annuity[60] or a capital payout at a defined point in time, the product should allow savers to withdraw funds early for major life events. Other than in these specific circumstances, early withdrawals should attract a tax penalty or simply be prohibited altogether.

2. Risk exposure: labelled products should not be backed by a permanent capital guarantee. Offering a full, non-time-bound capital guarantee severely restricts the ability of financial intermediaries to invest in high-risk assets, especially equities – not least if the product is liquid and if savers can easily withdraw their funds at any time. By default, those savings products should be actively managed by investment horizon (see below), with the capital and accumulated interest progressively allocated to less risky assets by the intermediary as the maturity date approaches. This arrangement would make it possible to provide a form of guarantee at maturity alone (i.e. at retirement), but not in the event of early withdrawal.

60 Annuity payments could, in certain cases, extend the duration of savings while providing a guaranteed lifelong income

3. Managed allocations by default to build and secure gains over the long run: labelled savings products should be actively managed by investment horizon in order to achieve optimal allocation throughout their lifetime. Assets would be allocated in accordance with savers' risk profiles, with the allocation strategy shifting gradually towards lower-risk assets as the product's maturity date approaches. This third party active management would ensure that savings are optimally allocated to long-term assets in line with savers' risk appetite. While the default position would be for allocations to be actively managed, savers could opt to play a more direct role by self-managing their savings, allowing them to select their preferred financial securities from a predefined investment universe.

4. For employees, a key role assigned to the employer: labelled products should be offered on a collective, company-provided basis. Companies could enrol their employees in this product automatically, although staff would have the right to opt out if they chose to do so. Employees could also make voluntary contributions, either on a one-off or regular basis, and these could be supplemented by employer contributions. This arrangement, combining automatic enrolment and regular contributions, would make it easier for employees – especially younger staff members and those on lower incomes – to build up a savings pot. It would also promote uptake of the product and provide a larger source of funds for long-term financing. Moreover, collective savings plans are particularly cost- and performance-competitive because they avoid the distribution costs associated with other savings products. Other collective schemes could be devised for workers not in salaried employment (i.e. the self-employed).

5. An attractive tax regime: it is vital for these labelled products to attract preferential tax treatment. This would widen the product's appeal to a broad spectrum of savers and, in turn, generate the resources needed to support long-term investments. Contributions to the product could be tax-deductible up to a certain amount or give rise to a tax credit – a measure that would help build popular support for long-term savings across Europe. The gains generated by the products, including income and capital gains, could alternatively be exempt from tax and social security contributions. In addition, these products could offer an inheritance tax advantage, which would help it to stand out from the many competitive products already available on the market. While arriving at a uniform tax regime across all Member States is a challenging prospect, a compromise solution would be to apply the most favourable domestic regime.

6. A significant European bias in asset allocation: since the goal of these products is to more effectively channel European household savings towards EU investment needs, it seems only logical to set a minimum threshold – of 80% or more – for investment in European assets. On a more general note, **it is recommended that any product offering advantageous tax treatment should carry an obligation to invest in European assets.**

In order to promote broad uptake of this product, one should refrain from imposing more granular asset-allocation requirements. It may, however, prove useful to **link this product to public co-investment initiatives** designed to increase financing flows to specific market segments. Savings placed in this product could, for instance, be invested in funds backed through the **European Tech Champions Initiative (ETCI)**, or in another domestic or European public-private mechanism, such as in the listed SMEs segment[61].

This new European savings product could trigger long-term investment flows worth hundreds of billions of euros. A number of existing savings products in the EU are possible candidates to receive this label, subject to certain adjustments, because they align with the principles outlined above. Potentially eligible schemes include France's collective PER, the *Betriebsrente* in Germany and the *Planes de Pensiones de Empleo* in Spain.

Based on France's employee savings model, which has an enrolment rate of close to 50% and attracts contributions equaled to one monthly income per year on average[62], this new European savings product could capture annual savings inflows of approximately €200 billion. By comparison, total annual household financial investments in the euro area stand at €600 billion[63]

61 On 19 March 2024, for instance, President Macron announced that the Caisse des Dépôts et Consignations would launch a €500 million public investment fund to strengthen the investment ecosystem for listed SMEs and mid-sized firms. Similar initiatives exist in other countries, and these could be extended to other market segments.

62 DARES (link).

63 Eurostat; DG Trésor calculations.

3. Bold and decisive action is essential to revive the securitisation market

3.1. Securitisation is an essential tool for the efficient allocation of risk, which remains largely underexploited in Europe

By distributing risk to investors best equipped to carry it, securitisation increases lending capacities to the real economy. In securitisation, loan portfolios, or the credit risk attached to them, are packaged into marketable securities. An independent special-purpose vehicle (SPV) acquires the portfolio from the originator and records it in assets. The SPV finances the acquisition by issuing securities to investors. The original lender is usually, but not always a bank, non-bank originators playing an essential role in some segments of the market. The asset-backed securities (ABS) are split into different risk categories or tranches according to seniority. The lowest-rated (and highest-risk) junior tranche is first in line to absorb any losses incurred by the underlying assets and also enhances the credit of the senior tranches. In a nutshell, securitisation lets lenders transform illiquid loans characterised by specific risk profiles into homogeneous, liquid financial securities. Tranching by risk generates assets with risk/return profiles suitable for different investor types (pension funds, insurers, investment funds).

In essence, securitisation provides a means for each participant in the credit chain to specialise in what they do best: origination and customer relations for banks or originators, financing for senior investors and carrying risk for the junior investors.

Given the predominance of banks in Europe, securitisation could play an even more significant role in financing the real economy.

An increasingly broad political consensus is emerging on the pivotal role of securitisation as a tool for financing the European economy. In 2020, the High Level Forum on the Capital Markets Union identified the development of securitisation as a top priority[64]. On 7 March 2024, the ECB's Governing Council confirmed the priority in its statement calling for progress to ensure *"… that the EU securitisation market can play a role in transferring risks away from banks to enable them to provide more financing to the real economy, while creating opportunities for capital markets investors"*[65]. Then on 11 March 2024, the Eurogroup also weighed in on the importance of reviving securitisation in Europe[66].

Justifying this approach are the many benefits securitisation can bring for an economy with such far-reaching bank penetration. In fact, for banks, securitisation is both a refinancing and a capital-management tool:

64 Final Report of the High Level Forum on the Capital Markets Union, 2020 (link)

65 Statement by the ECB Governing Council on advancing the Capital Markets Union, 7 March 2024 (link)

66 Statement of the Eurogroup in inclusive format on the future of the Capital Markets Union, 11 March 2024 (link)

- The refinancing function is not its main added value, insofar as banks have other sources of funding, especially deposits and covered bonds[67], but it does provide a means of diversifying these sources. Securitised assets can also serve as collateral for central bank refinancing, a particularly useful function during quantitative easing programmes;
- The other key benefit of securitisation is the ability to deconsolidate the bulk[68] of bank assets and related risk, which means banks can use capital more efficiently. Removing assets from the balance sheet means banks can maintain constant leverage, while increasing loan issuance volumes. Unlike covered bond issuances, securitisation transfers risk away from banks, which frees up resources to meet solvency ratio requirements.

Through both these functions, securitisation can significantly increase banks' lending capacity. This effect is of course not automatic: it depends on demand for corporate credit, itself determined by the macroeconomic climate and access to equity funding. However, if these two conditions are met and untapped demand for credits arises, then securitisation strengthens banks' solvency and liquidity to meet these needs. Above all, redistributing risk is an important tool to manage balance sheet efficiency and velocity, which in turn has the potential to increase lending, both directly and indirectly. Directly, securitisation lets banks lend more while keeping their capital constant. Indirectly, as securitisation techniques increase balance sheet velocity, the return on banks' capital increases, as does their ability to raise more capital. In fact, one fifth of the difference between US and EU banks RoE is due to the higher volume of securitisations in the US in the 2020s[69].

Finally, scaling up securitisation stands because of its almost immediate impact. Faced with the massive and urgent needs to finance the twin green and digital transition, the EU needs to scale up its financing capacity, starting in this decade. Securitisation offers a tool to quickly boost the market's financing capacity using banks' existing tried and tested distribution channels.

Yet, despite these needs and a robust track record, the European securitisation market has never recovered from its collapse starting in 2008.

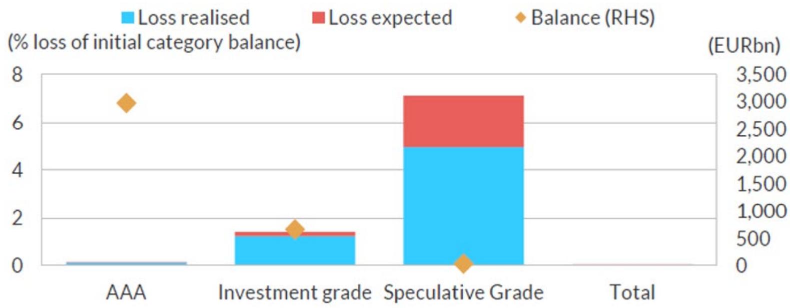
Tightly overseen and supervised, securitised assets issued in Europe have proven resilient over the long term, including during the global financial crisis. Across all securitised asset classes (see Figure 31), losses are concentrated in speculative segments, which account for a tiny share of the exposures.

67 Covered bonds (CBs) are financial instruments, backed by mortgage loans or public-sector debt, issued by credit institutions to access refinancing. They offer investors two layers of security: the issuing bank's signature and the assets provided as collateral – unlike securitised assets where the risk depends solely on the underlying loan portfolio.

68 Banks must retain at least 5% of the exposure and the risk.

69 Analysis by DG Trésor, 2021.

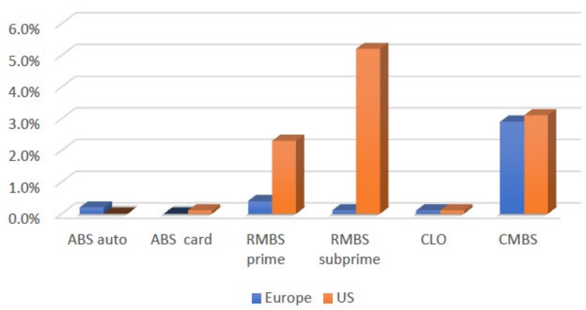
Figure 31: Total losses on securitised assets issued in Europe in the period 2000 – 2020 by credit rating



Source: Fitch Ratings, "Global Structured Finance Losses: 2000-2020 Issuance", March 2021

This performance differs markedly from the US market's, especially in the residential mortgage-backed securities (RMBS) segment. According to S&P Global Ratings[70], defaults across all US RMBS tranches from the global financial crisis to 2015 amounted to 22.97%, as against 0.14% for European RMBS. No losses were incurred on senior tranches of European RMBSs (AAA to AA- at issue), despite the steep increase in unemployment and the severe correction in real estate markets in some Member States at the time. The main lesson from this contrasting performance is that the blame for the financial crisis lies more in failures in loan origination in the US than in the use of securitisation techniques.

Figure 32: One-year average default comparison: US – EU issuances since 1973



Source: Association for Financial Markets in Europe (AFME), according to S&P (link)

Yet, despite this track record, the securitisation market has collapsed in Europe, particularly the segment of publicly placed and physical issuances.[71] Between 2007 and 2022, total annual issuance volumes of securitised assets fell 61% to €157 billion from €407 billion (see Figure 33). Moreover, the share of these issuances that were publicly placed shrank even faster (- 80%), an indicator of liquidity drying up in the market. This pattern of annual issuances is naturally reflected in the compositions of outstanding

70 Cited by Prime Collateralised Securities (PCS), Response to FSB consultation (link)

71 In physical securitisations (also known as 'cash' or 'true sale') the bank sells the loan portfolio to a securitisation vehicle. The loans no longer appear on the originator's balance sheet, enabling them to tap sources of refinancing while also transferring risk. In contrast, in synthetic securitisation, the banks keeps the underlying loans on the balance sheet and only the credit risk is transferred through a hedging agreement. The risk is transferred, but the assets remain on the originator's balance sheet.

assets: these are now dominated by securitisations retained on bank balance sheets[72] (up 34 pp since 2008 to 64%, see Figure 34).

Figure 33: Annual securitisation issuance in Europe (2008-2023)

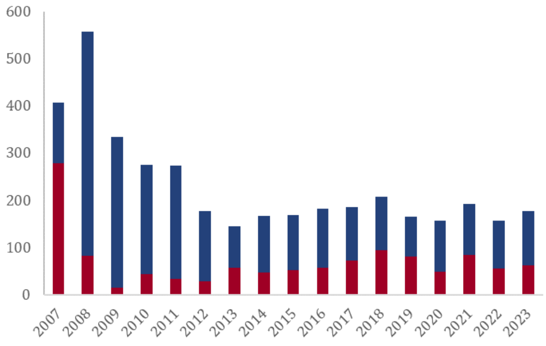
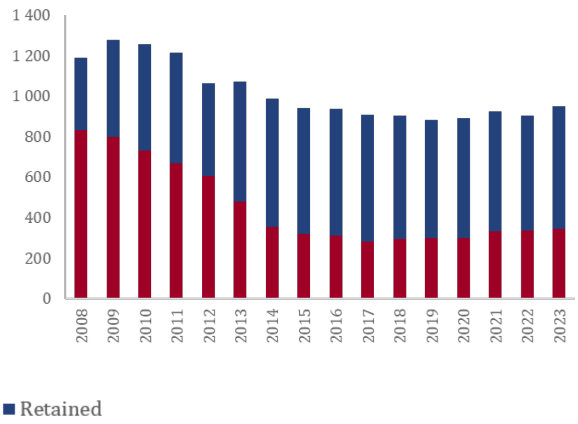


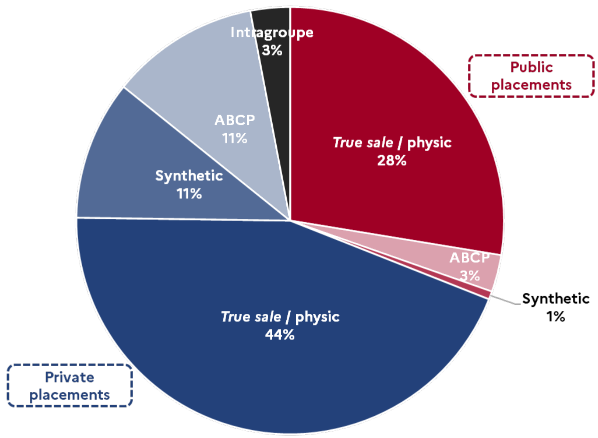
Figure 34: Total European outstanding ABS (2008-2023)



Source: AFME (link)

<u>A private segment is undoubtedly growing alongside this shrinking public market, but not on the scale required to meet the financing needs of the EU</u> (see Figure 35). Private placement transactions account for 66% of total volume versus 31% for public transactions. Synthetic securitisations have also grown rapidly within the private segment, driven by lower structuring costs due to their bilateral nature[73].

Figure 35: Composition of public and private securitisation issuances in Europe (2021)



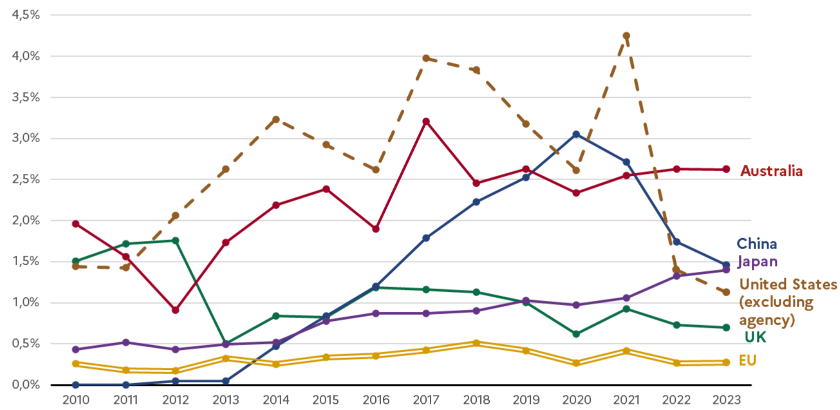
Source: Joint Committee advice on the review of the securitisation prudential framework, 2022 (link)

72 This type of securitisation does not produce a consolidation effect. Their purpose is to generate assets eligible for use as collateral.

73 ECB, A new high for significant risk transfer securitisations, 2023 (link)

Other comparable jurisdictions have not seen a similar long-term collapse in the public securitisation market. European issuances in 2023 amounted to 0.3% of European GDP, compared with 2.6% in Australia, 1.4% in Japan and 0.7% in the UK (see Figure 36).[74] Were volumes to approach those observed in other countries, the European securitisation market could increase by a factor of between 2 and 9.

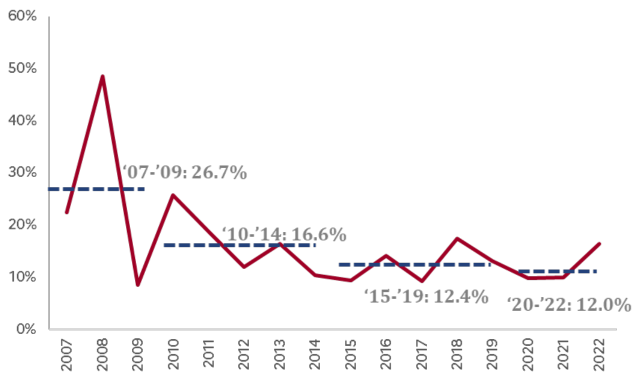
Figure 36: Annual issuances of securitised assets as a % of GDP in six jurisdictions (2010-2023)



Source: AFME , 2023 (link)

Most importantly, the gap with the United States is widening, even when we exclude the share of the market covered by public guarantee schemes (see section 3.3). Between 2020 and 2022, issuances in Europe amounted to 12% of US issuances, compared to 27% in the period between 2007 to 2009 (see Figure 37).

Figure 37: Annual issuance of securitised assets in Europe as a proportion of annual non-agency issuance in the United States (2007-2022)



Source: AFME (link)

74 It is worth noting that the recent decline in U.S. volumes is primarily attributed to the impact of rising interest rates on loan origination (leveraged loans fell by 17%, commercial real estate loans by 43% and residential mortgages by 36% in 2023 vs. 2022). Yet, this drop notwithstanding, US volumes are still almost three times higher than European volumes as a percentage of GDP.

3.2. The first priority is to quickly adjust the regulatory and prudential framework for securitisation

The decline in the European securitisation market is largely due to regulatory and prudential factors.

Of course, macroeconomic factors have not helped promote the growth of securitisation: abundant liquidity pumped into the economy by the central bank over the 2010 decade meant securitisation was less advantageous for banks, while low interest rates limited the return on securitised assets. But such macroeconomic considerations were not unique to Europe. They affected other countries too, without causing securitisation volumes to slump (see above).

Others see the explanation for the moribund European market in the vigour of the covered bonds market. But securitisation and covered bonds are complementary rather than alternative instruments. While both are refinancing tools, securitisation covers more loan types and is the only technique that transfers risk from the bank to other investors. European Banking Authority (EBA) data[75] put the cumulative outstanding volume of securitisations in the US at quadruple the combined size of the European securitisation and covered bonds markets. We can conclude therefore that the growth of the securitisation market in the EU in no way implies a reduction of the covered bonds market.

It is indeed the regulatory and prudential specificity of Europe that explains the underdevelopment of its securitisation market. The difference between the US and European frameworks is particularly sharp (see Table 1). Generally speaking, the US has not implemented Basel III rules in this area and, going on recent political developments, this situation is unlikely to change in the near future. Overall, capital charges are lower for both US bank and insurance investors. Transaction structuring, reporting and due diligence rules are also looser in the United States.

75 Joint Committee advice on the review of the securitisation prudential framework, 2022 (link)

Table 1: Securitisation regulatory and prudential framework: comparison between the EU and US (non-exhaustive)

		European Union	United States
Prudential treatment for banks	Solvency (p-factor)[76]	Standard approach: - Non-Simple, Transparent and Standardised (STS): 1 - STS: 0.5 Internal model: minimum of 0.3	Standard approach: 0.5 Internal model Implicitly close to zero
	Liquidity (liquidity coverage ratio (LCR) eligibility)	Senior STS: HQLA level 2b (25-35% discount) Non-STS: non-eligible	Agency MBS: HQLA 2a (15% discount)
Prudential treatment for insurers		High capital requirements: higher charge for a senior tranche than for a direct exposure to the same pool Poor risk differentiation (no distinction between non-STS tranches)	Moderate charges. Granular risk differentiation: 21-category scale according to tranche rating
Structuring rules	Risk retention	Required	Optional
	Re-securitisation	Prohibited	Allowed
	Reporting and due diligence	Specific obligations	General obligations under securities law

Sixteen years after the great financial crisis, Europe's regulatory response remains incomplete and therefore disproportionate to the risks associated with securitisation. Responding to what was essentially a US phenomenon, Europe's first reaction was to increase capital charges on securitised assets, to preserve financial stability. Banks' capital requirements were increased by 105%[77]. A principle of capital non-neutrality was introduced in banking and insurance regulations to take account of agency and model risk specific to securitisation[78]. Stringent reporting and due diligence requirements were also imposed on market participants.

76 DG FISMA, Non-paper on the review of the securitisation prudential framework, February 2023

77 Joint Committee advice on the review of the securitisation prudential framework, 2022 (link)

78 Model and agency risks arise from information asymmetry and the potential for a mismatch between the best interests of originators and investors in a securitisation transaction. More specifically, the investor, unlike the originator, may have limited knowledge and understanding of the underlying portfolio and the assumptions underpinning how credit risk is allocated. The factors used to correct for non-neutrality imply that a higher capital charge applies to an investment in securitisation tranches than to a direct investment in the underlying assets.

However, since the calibration of these constraints, the securitization market has evolved. Numerous measures implemented since the crisis have effectively contributed to the disappearance of harmful market practices. Those useful measures include, among others, the risk retention requirement and the prohibition of re-securitization, which should be preserved in the case of a securitization framework reform.

Initiatives aimed at adapting the framework and strengthening proportionality have been launched since then, but they fell short. In 2021, as part of its post-COVID stimulus package, the Commission introduced a new simple, transparent and standardised ("STS") labelling regime for synthetic securitisations and amended the treatment of non-performing loan securitisations. In the updates to the banking package in 2023, the Commission granted a temporary derogation to reduce the impact of the future output floor, but with no improvement relative to existing law.

In this context, the top priority must be to restore the securitisation market investor base by adjusting the prudential framework that applies to insurers. Insurers make up the bulk of institutional assets but have withdrawn from the market. According to the European Insurance and Occupational Pensions Authority (EIOPA)[79], in 2022, a mere 12% of insurers invested in securitised products for €18 billion in total[80]. Insurers' absence from the market creates a vicious circle where lack of insurer demand dampens activity, which in turn makes it less attractive for all investors, including insurers.

No prudential reform can radically transform insurers' asset allocation in the short run. Insurers base their allocation decisions on a range of factors, including the macroeconomic environment, risk/return comparisons between asset classes and deep seated investment practices. But if European insurers are to be encouraged back into the securitisation market, it is essential to recalibrate prudential treatment of these assets to ensure shocks are strictly proportionate to the risks. Two types of measures are required:

- Reduce capital charges: this is particularly vital for non-senior STS tranches and the highest rated non-STS assets, whose performance history show that they are over-capitalised relative to their risk[81];
- Allow a more granular risk assessment: possibly by segmenting the non-STS category into two sub-categories (senior/junior) and by creating a new mezzanine tranche for STS securitisations.

79 Source: EIOPA questionnaire (2022).

80 Compared with €9205 billion in assets held by insurers covered by Solvency 2 (including €3133 billion in bonds, €108 billion in direct real estate, and €335 billion in loans and mortgage loans). This is in sharp contrast with the US, where securitised loans account for 23% of insurers' bond portfolios.

81 AFME, ABS and covered bonds risk and Solvency II capital charges, 2022 (link). See also, EIOPA, joint committee advice on the review of the securitisation prudential framework (insurance), 2022 (link), and in particular the Table below (p. 24 – capital charges for duration of 10 years):

	Credit quality step 1	Credit quality step 2	Credit quality step 3
Covered bonds	7%	-	-
Bonds/loans	8,5 %	20%	58,5%
Senior STS	9.5%	22.5%	73.5%
Non-senior STS	26.5%	63%	100%
Non-STS	100%	100%	100%

In banking, eligibility of securitisations to liquidity buffers (LCR) must be increased to broaden the investor base. Senior STS tranches, currently classed as 2b, should be upgraded to 2a, while senior non-STS should become eligible at level 2b, with discounts comparable to those that apply to covered bonds with an equivalent rating.

The second priority is to simplify the transparency rules to facilitate issuance and acquisition of securitised assets.

Regarding reporting, it is necessary to streamline the content and better define the scope of application of ESMA's disclosure templates:

- For private placements, characterised by investors' close involvement in structuring the product, standardised templates are ill-suited to investors' specific information needs. Private securitisation, however, should not evade all transparency measures, at the risk of jeopardising liquidity in the market as a whole. Exempting private securitisation from reporting requirements would require a strict definition of its scope[82] and a new rule for recording these transactions in a public repository;
- For public placements, the templates should be simplified and aligned with the reporting already required by investors, rating agencies and the ECB.

Turning to due diligence obligations, breaking down practices and rules by market segment, nature and risk duration would be advisable (private market, public market, short-term transactions, synthetic transactions). What is more, the current rules do not distinguish between transactions with EU and non-EU originators. Originators outside the EU should not be required to produce ESMA reports.

Rather than revising the STS label criteria, it would be better not to restrict support measures to the labelled market segment. Numerous and complex, the criteria mainly boil down to a formal statement of broadly shared practices. They could be simplified, but a thorough overhaul might destabilise the market. A better approach would be to avoid targeting securitisation support measures exclusively at STS transactions, especially as regards prudential requirements. Some asset classes that help finance the economy may never be eligible for STS classification, primarily because they are not granular enough (loans to corporates and infrastructure projects for instance).

Adjustments are needed to the banking prudential framework, even if this means deviating from Basel rules. The committee recommends two measures:

- Recalibrating the p-factor: halving the p-factor for the standard model and setting it at a minimum of 0.1 for internal models would foster alignment with the current US framework and, most importantly, take into consideration the measures already put in place to reduce agency risk;
- Reducing the RW floors applicable to senior tranches: these floors have a significant impact, because banks frequently retain senior tranches and place risk with non-bank investors. Following on from the proposals tabled by the EBA and the Commission during the CRR trilogue in February 2023, these floors should be reduced to pre-2017 levels.

82 Under the current definition, a private securitisation is simply one for which no prospectus is published. The Committee is in favour of a more substantial definition guaranteeing the specific or "tailored" nature of the transaction.

These two measures constitute deviations from Basel rules, which are likely to be seen as a major political obstacle. However, it will be imperative to overcome them, otherwise no real progress will be achieved in the short term.. So far, the Basel Committee has refused to include securitisation in its work programme. Attempted progress has been blocked by some jurisdictions on the basis of a poorly calibrated framework that they do not apply. The only way to restore a level playing field and force a rethink of the Basel framework is for the European Union to deviate from the Basel standards.

All these regulatory and prudential measures are now well identified, and many enjoy consensus. The only thing missing is a rapid implementation schedule. None of these measures challenge the key principles of the securitisation framework introduced in response to the financial crisis. Instead, they are targeted adjustments. Rapid progress seems possible in the insurance sector since the Solvency II Directive was revised at the end of 2023, giving the Commission a clear mandate to reassess the prudential treatment of securitised products. But progress seems less certain and the timeline longer for other areas: end-2027 is the date set for a new legislative proposal in the banking sector, while a review of the securitisation regulation has yet to be announced. If the pace does not pick up, the market will remain moribund until at least 2030.

Once the soon-to-be-elected Commission is up and running, the committee recommends announcing an immediate action plan to reform the regulatory and prudential framework, before the end of 2025. The quick-fix approach has proved its worth post-Covid and could be the template for action.

3.3. In addition to these regulatory and prudential measures, a securitisation platform could be a powerful tool to deepen EU capital markets

3.3.1. As in other jurisdictions, a European securitisation platform would meet a key standardisation need

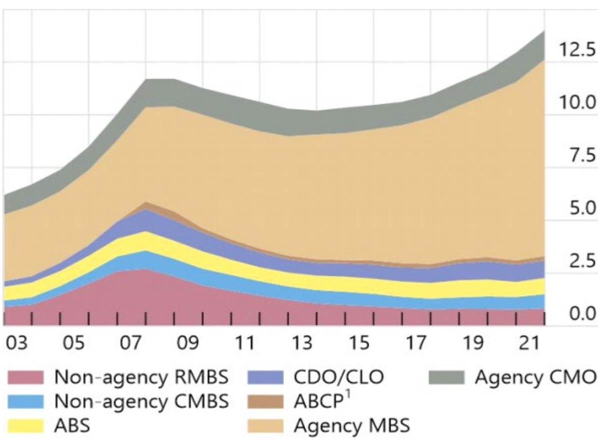
In a number of advanced economies, public platforms play a major role in deepening securitisation markets and capital markets more generally. Platforms for issuing and guaranteeing mortgage-backed securities are long-established in the US, Canada and Japan (see Table 2). They contribute to liquidity in the RMBS market and help deepen capital markets as a key funding channel for the real economy.

Table 2: Main characteristics of MBS platforms in the US, Canada and Japan

	United States (GSEs)	Japan (JHF)[83]	Canada (CMHC)[84]
Eligible debt	Residential mortgages that meet origination criteria + commercial real estate loans + student loans	Residential mortgages that meet origination criteria	Residential mortgages that meet origination criteria
Form of guarantee	Principal and interest payments due at default (prepayment risk). MBS issuances by public trusts (or directly by partner banks for the CMHC)		
	Guarantee fee: 50-60 bp	Over-collateralisation (20%)	Variable guarantee fee
Organisation	Quasi-holding by the State via preferential shares, warrants and conservatorship *Sui generis* prudential regime, $84 billion in equity in Q1 2022	JHF = Japanese public agency (*Zaito* agency), capitalised by the Japanese government	CMHC = Canada Mortgage and Housing Corporation, capitalised by the Canadian government The Canadian Finance Ministry caps the amounts guaranteed on a annual basis.
Volumes	Outstanding: $13,800 billion Annual issuances: $1200 billion (=50% of residential mortgage volumes granted)	Annual issuances: $84 billion in 2017(=10% of residential mortgage volumes granted)	Annual issuances: around $110 billion (22% of annual residential mortgage volumes granted. Target: 40-50%)

In the United States, *government sponsored entities* (GSEs, Fannie Mae and Freddie Mac) have increased their footprint in the securitisation market. Their share of outstanding ABS jumped to 75% from 55%[85] in the period 2008 to 2022 (see Figure 38).

Figure 38: Breakdown of outstanding ABS, US (2003-2021)



Source: FSB, 2023.

Tasked with creating a secondary loan market and providing it with liquidity, government sponsored entities (GSEs) have gradually standardised the mortgage securitisation market: through two channels: (i) by imposing strict origination criteria, they have homogenised the underlying loans; and (ii) by guaranteeing the securitised assets issued based on these loans, they have equalized their credit risk.

A massive, homogeneous asset class ($13,800 billion in outstanding assets) has emerged from this standardisation process. The transaction volume for these MBSs is a whopping $250–300 billion per day, due largely to the very diverse range of investors present in the market: non-bank investors hold 72% of the amounts outstanding and foreign investors 12%[86]. One of the key drivers attracting this broad investor base is the relatively high return[87] on MBSs, despite the very low credit risk. The American government's guarantee is fully funded over a long period by the guarantee fees, without any long term commitment of US budget resources[88].

These international examples point to the potential value of a securitisation platform as a standardisation tool, that could remove obstacles to broadening and deepening European capital markets.

A common platform would foster the emergence of a deep and liquid public securitisation market:

- On the demand side, a common platform would meet the twin need for scale and transparency. Shrinking public issuance weighs on the European securitisation market as a whole (see section 3.2). What is more, the small and fragmented European market holds little appeal for institutional investors. Hence, the platform and its eligibility rules could help achieve convergence in underlying assets, while its structuring role would standardise arrangements. Any residual heterogeneity would be eliminated, from the investor's point of view, by a broad government guarantee;
- On the supply side, the benefit of a platform would be structuring cost sharing, which would benefit smaller banks that do not have the resources to be standalone participants in the securitisation market. Germany in particular has a large number of small and mid-sized banks that would benefit from this type of cost-pooling[89]. The German securitisation federation (TSI) has proposed, with the support of the public bank KfW, to establish a national securitisation platform[90].

In common with all securitisation support measures, such a market would bring in more capital to boost European banks' lending capacity and make them more competitive. In addition, with the introduction of conditionality(3.3), the platform would help ensure that the balance sheet resources released through securitisation are channelled towards EU funding priorities.

83 Source: Japan Housing Finance Agency (link)

84 Source: Canada Mortgage and Housing Corporation (link)

85 Financial stability board, Securitisation exchange group progress note, October 2023

86 Ginnie Mae, Foreign ownership of agency MBS, 2022 (link): in 2021, Foreign holdings of Agency MBS totalled $1,188188 billion, 12% of the total.

87 This is around 150 bp more than Treasuries, and 50 bp more after restatement for prepayment risk

88 Between 2008 and 2019, the Federal government contributed $191.5 billion to GSEs and received $301 billion in preferential dividends.

89 The five largest banks make up only 35% of banking sector assets (source: ECB, link).

90 TSI, Final Report of the "German Securitisation Platform" working group, September 2023 (link)

Widening the lens beyond the securitisation market, a common platform would create a new common safe asset and thus enhance the efficiency and depth of European markets. Safe assets are defined as countercyclical, liquid, highly-rated assets that can weather market volatility. When used as collateral, safe assets lower transaction costs in the financial markets. They typically maintain their value and attract capital to their country of issue. Guaranteed securitised assets broadly rank as safe assets, especially agency MBSs, which are used as collateral in almost one-third of repo transactions in the United States and trade at close to sovereign rates.

The lack of a common pool of European safe assets during the 2010s was a factor in the creation of a "sovereign-bank nexus""" that undermined the sustainability of some Member States' public finances and their ability to finance their economy. Tighter prudential requirements worldwide and central bank policies of buying up government securities made safe assets even scarcer.

As governments put budgets on a sounder footing and monetary policy tightened from 2023 onwards, the eurozone saw an increase in the net supply of safe assets. But, at €782 billion in 2023, net supply of safe assets in the EU is still only one-quarter of net supply in the US (€3,092092 billion) and less than half as a percentage of GDP (6% vs. 12%)[91]. As a consequence, European savings tend to flow to US safe assets (see section 2.1). A common securitisation platform could therefore be useful in exploiting the untapped potential for euro-denominated safe assets issuance.

The core objective of the proposed platform would be to standardise the securitisation market, not to circumvent the regulatory and prudential framework nor to transfer public resources. The proposed platform would complement the existing framework, rather than serve as an alternative to revising it (see 3.2). The platform and its guarantee would not be intended to subsidise origination of certain loans or, more broadly, to transfer public resources. Guarantee pricing must be designed to prevent loss and transfers between stakeholders, including between Member States.

3.3.2. To achieve these objectives the platform must grant a European guarantee of last resort for securitisation of mortgage or SME loans

While not technically imperative, a public guarantee would considerably augment the platform's standardisation impact. Without a public guarantee, generating an immense pool of homogeneous assets would require strict origination rules, which would come up against the problem of inertia in national market practices. Furthermore, a sovereign European guarantee, country risk would persist and need to be controlled through strict portfolio composition rules, which investors would be responsible for verifying. With no incentive from governments, it is also very uncertain how private operators could be encouraged to constitute and join such a platform.

The European guarantee should be structured to exclude transfers between Member States and commitment of budget resources over the length of the economic cycle. This leaves a choice between two different structuring models (see diagram 1):

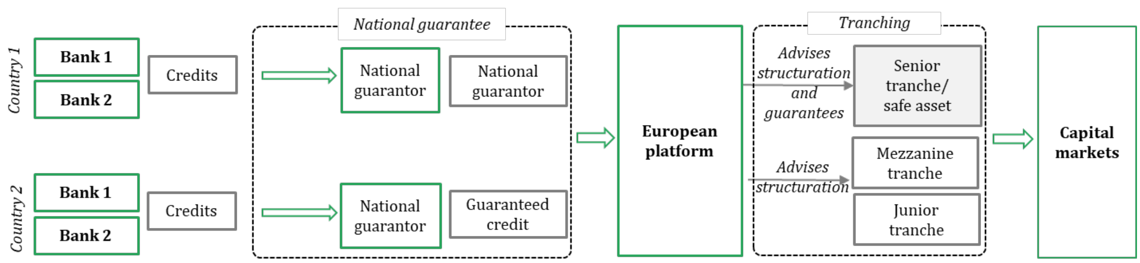
- The guarantee must be priced to cover potential losses, the cost of sovereign capital and the platform's operating costs. Budget resources may be called upon in a crisis, but the overall balance should be positive or neutral over the entire

91 Source: Goldman Sachs Global Investment Research and World Bank, working group calculations

cycle. Pricing can take two forms, which are not mutually exclusive: a guarantee fee paid at regular intervals and a discount on the portfolios of transferred loans (overcollateralization). The discount could be adjusted according to loan portfolio composition and notably the share of different origination markets, to avoid cross-country transfers.

- The assets to be guaranteed by the platform must be low-risk. The guarantee would homogenise risk between originators and allow some markets to qualify for AAA rating, even when the sovereign is rated lower. But it is not intended to cover large potential losses. The committee recommends a national guarantee to back loans sold on the platform. Such guarantees are common in mortgage loan markets, either as private (*Crédit Logement* in France), or state guarantees (NHG in Holland). Only senior tranches would be guaranteed by the platform. Risk would be concentrated in mezzanine and junior tranches, which would be structured by the platform but placed on the market without a public guarantee.

Diagram 1: Proposed structure of the common securitisation platform and of the European public guarantee



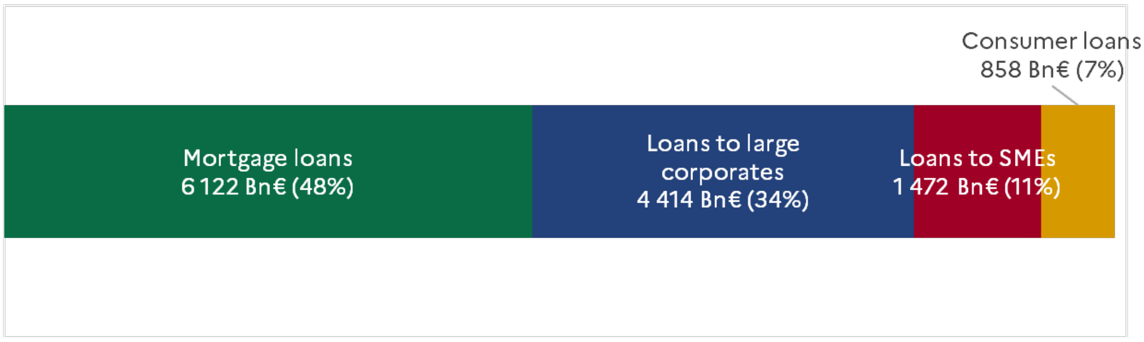
Source: Expert committee

Four constraints suggest targeting this platform towards real estate loans, although loans to SMEs could also be considered:

- To achieve its standardisation objective, the platform should target a massive asset class. An analysis of eurozone bank loan portfolios (see Figure 39) shows the preponderance of residential mortgages. Loans to large corporates predominate in the corporate lending segment;
- The other prerequisite for achieving standardisation is a homogeneous and granular asset class. At this stage, no loan type is perfectly harmonised within the European Union. However there is a degree of convergence in mortgage loans, with an increasing share issued at fixed rates since the global financial crisis. Besides, loans to individuals and, to a lesser extent, loans to SMEs would be the only ones to offer sufficient granularity;
- The objective of zero cost for public finances implies choosing a low-risk asset class, despite a lower capital relief impact for banks. Here too, mortgage lending stands out, as loans are secured by an asset and are often guaranteed at national level. Analysing risk on loans to SMEs to match guarantee pricing to risk level is a more complex task;
- The margin on the loans targeted by the platform must be sufficient to deliver returns to the originator, investors and the platform itself. When it comes to residential mortgages, this margin requirement could trigger a difficult and

politically tricky repricing exercise in some markets where net rates are low or negative[92].

Figure 39: Composition of European banks' loan portfolio



Source: AFME

The guarantee should be carried directly by an agency set up by the European Union or a group of voluntary Member States, so as to avoid capitalisation costs.

The European Investment Bank (EIB) group[93] has been active in the securitisation market since 1996. Its total transaction volume in the period 2013 to 2023 was €43 billion, equating to €2–3 billion per year[94]. Since 2013, these transactions have released an additional €108 billion in lending capacity for the beneficiary financial intermediaries. The EIB has also helped standardise structuring practices and promote securitisation in certain markets. The EIB group could ramp up its securitisation activities in the near future to support specific market segments.

Yet the EIB's transaction volumes are nowhere near what is required for the emergence of a benchmark asset class. Given the prudential rules applicable to the EIB, any significant increase in its securitisation interventions[95] will require a reallocation or an increase in its capital. Furthermore, in line with its mandate, the intervention logic of the EIB is project financing, which implies strong and granular constraints on the origination of new loans by banks and thus limited volumes.

A guarantee provided directly by the EU or voluntary Member States could obviate the need for ex ante capitalisation – which would be prohibitively expensive for the public finances. There are in fact two possible models for structuring public guarantees. In the "funded" model, the guarantee is based on *ex ante* funding from the guarantor. This is the approach adopted by the European Stability Mechanism (ESM), which holds €80.5 billion in fully paid-up capital. In the "unfunded" model, the guarantee commitments are recognised in full in the accounts of the guarantor, but without tying up capital to meet them. If the guarantee is called up, the sovereign must then allocate fiscal resources or issue debt. This is the option preferred by France for its state-backed loans

92 For example, rates in France, Denmark and the Netherlands were less than 2% for new mortgage loans granted in 2022 (source: European Mortgage Federation – link)

93 European Investment Bank (EIB) and its subsidiary the European Investment Fund (IEF), specialising in supporting European micro enterprises and small and medium-sized enterprises (SMEs) through risk financing, guarantees and microfinance.

94 €29 billion in physical transactions and €14 billion in synthetic transactions.

95 The EIB's annual interventions amount to between €80 and €90 billion, while the planned issuance of the proposed securitisation platform would be around €200 billion.

issued during the Covid crises (PGE) and by the US for the GSEs. Fannie Mae and Freddie Mac are indeed under-capitalised relative to their commitments (1%)[96], their business model depends on the counter guarantee of the federal government. Although without precedent in the European Union, the unfunded route is essential to limit the burden on the public finances.

Structured in this way, the guarantee could be carried by an agency set up by the EU or a group of voluntary Member States. One example of EU level action is Next Gen EU, whereas the ESM is an example of the intergovernmental approach. An agency could be tasked with managing the platform and structuring securitisations and guaranteeing the senior tranches, provided that no prudential rules impose to back the guarantee with capital *ex ante*. Where necessary, the agency could call on the EIB's technical expertise.

3.3.3. The impact of such a platform on the financing of the economy, which could be potentially massive, should be monitored over time

The first impact would be to increase the lending capacity of European banks. How this capacity is used should be monitored over time. The committee's consultations found that several institutional investors had appetite for the safe asset class that could be built out of senior guaranteed tranches. The structuration of these products would closely mirror the US agency MBS, which would significantly enhance their appeal. If we take residential mortgages as the target, the common platform could facilitate around €3,000 billion in bank refinancing with capital savings of some €120 billion. The capital reallocation could generate €1,500 billion in new loans to businesses, which amounts to 25 % of total outstanding assets in 2023.

Diagram 2: Common platform's impact on financing the economy[97]

Source: Expert committee

Long-term monitoring of how the released bank capital is actually reallocated to the EU's funding priorities will be essential. In all probability, a granular verification of use of proceeds, such as the review provided in the European Green Bonds standard (EU GBS), would be too onerous and could inhibit scale-up. However, measures to monitor overall corporate loan origination for each bank accessing the platform could be envisaged, and if necessary as part of environmental and green transition indicators.

96 At end-2023, Fannie Mae and Freddie Mac had cumulative equity totalling $126 billion, 0.9% of the $13,800 in Agency MBSs.

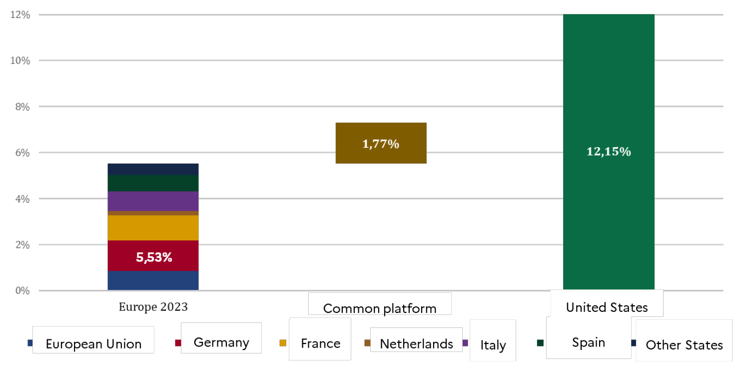
97 Underlying assumption: 50% of residential mortgages would be eligible for the platform. Certain loans will remain ineligible due to the poor quality at origination of the asset used as collateral for the covered bonds (€1346 billion of the €6122 billion in residential mortgages). 25% is the average weighting for residential mortgages and 50% for loans to corporates. The average solvency ratio (CET1) is 16%. The retained share (5% minimum) is not taken into account.

For loan origination, simple indicators could be designed, drawing inspiration from the ones used for TLTRO III[98].

This direct impact on loan production could be boosted by an indirect impact on the profitability of European banks. By increasing balance sheet velocity and reallocating capital to more risky, higher-margin corporate lending, European banks could increase their return on equity. The platform could reduce the profitability gap between EU and US, making it easier for EU banks to raise capital and break from the trend of boosting solvency by derisking assets (see 1.2.1).

Last, the platform could significantly increase the issuance of safe assets, thereby making markets more efficient and consolidating the euro's role in international finance. Setting a target of 50% of mortgage loan production[99], the platform could be instrumental in the issue of some €20052005 billion in safe assets per year, equivalent to 27% of the difference in the volume of safe assets issued in the United States and in Europe (see Figure 40).

Figure 40: Platform's impact on the supply of safe assets in Europe as a percentage of GDP and comparison with the US



Source: Expert committee's calculations based on Goldman Sachs data

98 Banque de France "Paying banks to lend? Evidence from the Eurosystem's TLTRO and Euro Area Credit Registry", Working Paper, 2021 (link)

99 According to the ECB (link), house purchase loan grants in 2023 totalled €509 billion (excluding forbearance)

4. We need to move towards integrated supervision to build a real single market and preserve financial stability

4.1. The fragmentation of supervision burdens European financial actors and savers with considerable costs

4.1.1. Supervision remains, fort the most part, a national prerogative

As part of the legislative work on the Capital Markets Union, considerable efforts have been made to harmonise regulations for the application of a single rulebook. On the legislative front, although the conversion of existing directives into regulations was met with political obstacles, new instruments more frequently took the form of regulations that do not need to be transposed, thereby limiting the risk of different national interpretations.

In this context, the European Securities and Markets Authority (ESMA) plays a key advisory and decision-making role in the production of common standards:

- It influences the content of the European Commission's legislative proposals with its reports and opinions issued upstream of presentation to the Council and the European Parliament;
- It is mandated to produce Level 2 measures (regulatory technical standards (RTS) and delegated acts) and Level 3 measures (guidelines) for Level 1 texts (directives and regulations) to specify details for their implementation where necessary. Although the Commission can oppose the adoption of its texts, as can the European Parliament and the Council, this remains extremely rare in practice. Level 2 and 3 measures play a key role in the application of the EU single rulebook.

However, supervision remains largely a matter for the national authorities with ESMA having only limited powers. It has nothing like the powers of the US Securities and Exchange Commission (SEC) or the Single Supervisory Mechanism (SSM) for the Euro Area banks. ESMA does not conduct any joint supervision of entities covered by market regulation, with the notable exception of the credit rating agencies, and its direct interventions are restricted to a series of specific cases (critical benchmarks, suspension of short selling, etc.).

This situation stems from technical difficulties but primarily from political obstacles. For example, during the review of the European Supervisory Authorities (known as the 'ESA review') which concluded in 2019, the majority of Member States opposed strengthening the powers of ESMA. France, for its part, was in favour of extending ESMA's supervisory powers, in line with some of the European Commission's proposals.

In these circumstances, europeanisation mainly takes the form of a convergence of supervisory practices led by ESMA. Restricted to a role of "coordinator of supervisors", ESMA organises peer review exercises whereby supervisory practices are regularly reviewed for each market regulation area. ESMA also produces guidelines, Q&As, opinions, statements and supervisory briefings. Nevertheless, these convergence efforts face difficulties coordinating 27 supervisory authorities with different priorities and levels of expertise.

In addition to ESMA, colleges of national supervisors have sometimes been set up to oversee actors of clear systemic importance for the EU. For example, each European clearing house (CCP) is overseen by a college of relevant national supervisors (called EMIR colleges). In practice, however, these bodies did not really call into question the supervision exercised at national level. They are only consulted for non-binding opinions regarding certain supervision decisions. Colleges were also put together for the review of the regulation applicable to central securities depositories (CSD), focusing on those of systemic importance in at least two EU Member States. Yet their role is limited to information sharing.

4.1.2. This fragmented supervision compromises the emergence of European financial champions and generates additional costs for savers

The current situation, whereby a single rulebook is defined at European level and then applied by domestic supervisors at national level prevents European financial actors from harnessing the benefits of a single market, which remains largely theoretical in the area of financial services. European groups operating from different jurisdictions within the European Union based on an integrated model remain subject to supervision by a multitude of national competent authorities, more often than not in an uncoordinated manner.

This situation severely limits the benefits that European groups in the financial services sector can reap from the single market. Although they should be able to pool a certain number of functions in house and benefit from large economies of scale like their American competitors who can count on a profitable integrated domestic market, the European financial actors have to justify sufficient substance in each of the jurisdiction where it operates. This is the case in particular with the compliance functions, since maintaining relations with multiple national supervisors calls for considerable compliance team staffing needs in each establishment's jurisdiction and a high volume of sometimes overlapping data to be sent, but in different formats to different national competent authorities.

Moreover, the absence of integrated supervision means that European regulation does not recognise EU groups, which is another source of friction compromising the generation of synergies. For example, non-recognition of EU groups in the asset management sector gives rise to the regulatory handling of intra-EU intra-group delegation practices aligned with the handling of external delegation. This in turn generates additional requirements including the requirement for the delegated company to be able to justify sufficient resources to carry out the tasks delegated to it.

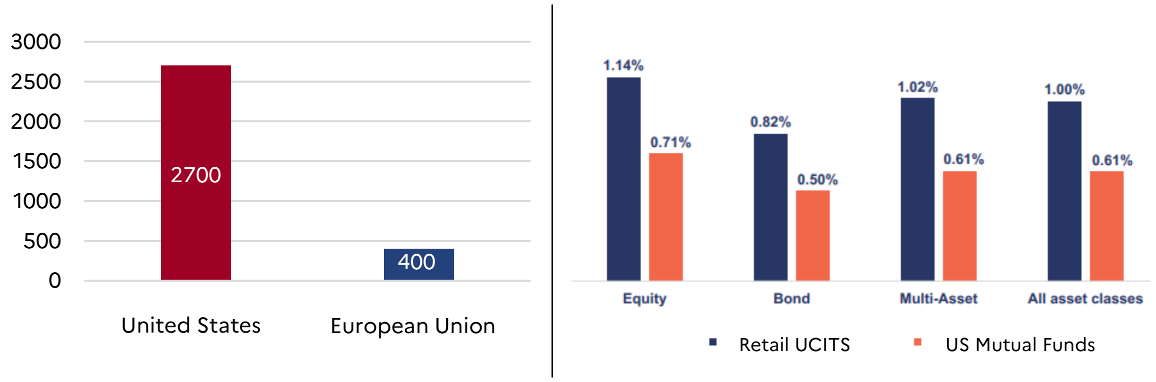
This absence of integrated supervision also affects the market infrastructures operating on the basis of an integrated model, such as Euronext which applies a single rulebook to its seven European regulated markets with harmonised trading rules, but has to bilaterally obtain validation of changes to rules from a number of different national supervisors including France, Belgium and Italy before it can apply these rules on its seven markets, even though the European regulatory framework sets no particular requirement for prior approval of trading rules.

Although these examples may appear incidental, they perfectly illustrate the many elements of cost and complexity that the absence of integrated European supervision brings to bear on European financial actors to the detriment of their competitiveness and their ability to bring together capital supply and demand on the European market.

European financial actors are not the only ones to pay the price for this fragmented supervision, which ultimately affects savers themselves.

For example, in the asset management sector, the absence of supervision continues to compromise cross-border fund distribution and thereby the volume of their assets under management. European funds hence remain nearly seven times smaller than American funds, which is not without its effects on their costs (see Figure 41).

Figure 41: Average size (€M - left) and average cost (%) for investment funds in the United States and the European Union



Source: EFAMA

This situation also raises risks for financial stability by preventing domestic supervisors from having a consolidated picture of the European activity of partially supervised groups, with the exception of certain types of actors for which colleges of supervisors have been set up (see 4.1).

In addition, it deprives of European governance those Member States whose financial stability is directly exposed to the risks posed by non-domestic critical financial infrastructures (certain large cross-border clearing houses and central securities depositaries).

Lastly, this absence of integrated supervision increases the risks of regulatory arbitrage, leading financial actors to set up in Member States considered to have laxer supervisory practices, and can in certain cases trigger a regulatory race to the bottom by Member States concerned to remain attractive, which in turn raises further risks for financial stability. It then fosters a form of distrust of actors and products supervised by non-domestic national authorities. It enables the persistence of different interpretations of common rules, to which Member States sometimes respond with national barriers at the expense of market integration.

4.2. Reform of the governance and running of ESMA is a prerequisite to any extension of its powers

4.2.1. ESMA's governance structure has come under some criticism

ESMA's governance structure is based on a governing duo comprising a Board of Supervisors and a Management Board.

ESMA is currently managed by a duo in the form of a Chair and an Executive Director. The ESMA Chair is appointed by the Council of the European Union following a call for applications and a shortlist of qualified candidates drawn up by the Board of Supervisors (BoS) with the assistance of the European Commission. The ESMA Chair is responsible for preparing the work of the Board of Supervisors by preparing and chairing its meetings. The Chair is assisted by an Executive Director appointed by the BoS after confirmation by the European Parliament. The Executive Director is responsible primarily for the day-to-day running of ESMA and preparing the Management Board's work (work programme, draft budget, etc.).

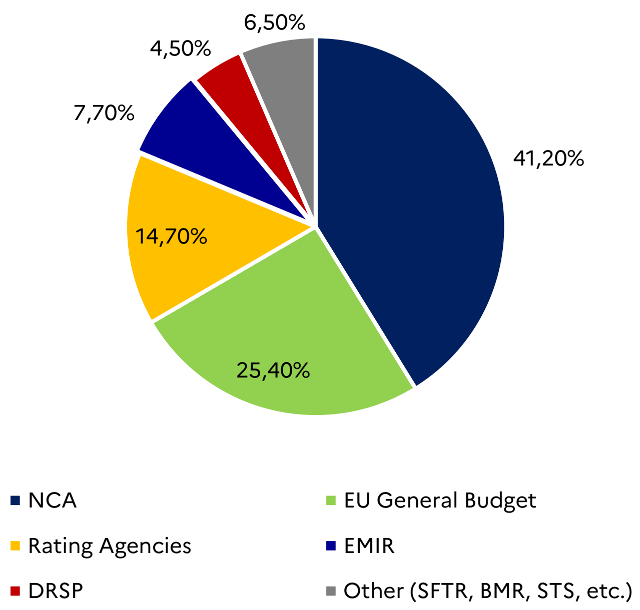
ESMA's policy decision-making body is the Board of Supervisors (BoS). In addition to the ESMA Chair, the Board of Supervisors is composed of (i) each national competent authority (NCA) responsible for the supervision of financial markets in the European Union, (ii) market authorities responsible for the European Economic Area (Iceland, Lichtenstein and Norway), (iii) a representative of the European Commission[100], and (iv) representatives of the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). The Executive Director may also attend meetings, bringing the number of participants up to 35.

ESMA's Management Board comprising the Chair of the Authority and six members of the BoS as well as the Executive Director and a representative of the European Commission, both non-voting members, is responsible for defining ESMA's multiannual work programmes and preparing certain in-house budgetary and human resources decisions.

ESMA is funded primarily by contributions from the national supervisory authorities, which account for approximately 40% of the Authority's annual revenues (see Figure 42). The other revenues come from the General Budget of the EU and contributions from entities over which ESMA exercises direct supervision.

100 Generally the DG FISMA Financial Services Director.

Figure 42: ESMA's 2022 budget revenue



Source: ESMA 2023 Annual Report

However, this governance structure is subject to criticism, particularly because it does not promote agile decision-making and raises doubts about the consideration of political factors in decisions on individual cases. Moreover, it does not allow for the expression of views different from those of the supervisory community within the Board of Supervisors.

The latest significant development with the European financial supervisory framework came with the adoption of the review of the founding regulations for the European supervisory authorities[101] (ESA) in April 2019. The main purpose of this legislative proposal was to significantly extend the coverage of entities and activities placed under ESMA's direct supervision by including data reporting service providers (DRSP)[102], investment funds structured in accordance with certain harmonised European formats[103], and certain types of prospectus regarding issues of "wholesale" debt traded in the regulated markets section and accessible solely to professional investors.

The Commission's proposal also set out to extensively revise the governance of the European supervisory authorities, including ESMA, by replacing the Management Board with a new Executive Board made up of the ESMA Chair and five members independent of the national authorities appointed by the Council of the European Union on a proposal from the European Commission for a term of five years. This Executive Board would have been granted broader responsibilities than the Management Board, tasked in particular with proceedings for breaches of EU law, settlement of disputes between national competent authorities and independent reviews (replacing the peer reviews). This newly created Executive Board would have also been made responsible for

101 EBA for the banking sector, ESMA for the financial markets, EIOPA for the insurance sector and also the European Systemic Risk Board (ESRB).

102 Approved reporting mechanisms, approved publication arrangements and consolidated publication systems.

103 European Long-Term Investment Funds (ELTIF), European Venture Capital Funds (EuVeCa) and European Social Entrepreneurship Funds (EuSEF).

coordinating the activities of the national competent authorities by means of assessed strategic supervisory plans. In the regulatory area, the Executive Board would have been tasked with proposing decisions to the BoS, which would have remained the decision-maker.

However, this Commission proposal was met with resistance from Member States, which were opposed to any transfer of supervisory powers at European level at the expense of their national authorities.

It therefore culminated in April 2019 in the adoption of a text containing a certain number of changes which, although commendable advances, far from meet the objectives initially stated by the European Commission:

- Governance: The powers of the Chair[104] and the Management Board[105] were extended slightly;
- Convergence tools: More transparency in the preparation of Q&As, opinions, guidelines and recommendations by the ESAs, although without making them binding; and peer review committees now systematically chaired by the ESAs rather than national authorities;
- Direct supervisory powers: ESMA was granted the possibility to express its opinion on any action to be taken in suspected cases of market abuse as well as a direct supervision mandate for data reporting services providers of sufficient size and EU and non-EU administrators of critical benchmarks.

4.2.2. The reform of the governance and running of ESMA could usefully be modelled on more recent authorities such as AMLA

In terms of governance, ESMA needs to be made autonomous with respect to the Board of Supervisors (BoS) for individual decisions. For normative decisions of general scope, the role of the BoS could be maintained without a problem. Nevertheless, more agility appears to be necessary with regard to individual decisions.

To this end, the organisation of the Anti-Money Laundering Authority (AMLA) and the Single Resolution Board (SRB) could provide useful inspiration. These two authorities have the particularity of having a stronger central decision-making body in the shape of an Executive Board, comprising the Chair and five other members (including the Vice-Chair at the SRB, sitting as a non-voting member), which is responsible for individual decisions concerning directly supervised entities. This model is also similar to the Board of Governors of the US Federal Reserve System (Fed), which has the authority to take individual decisions in matters of supervision without referring them to the regional Feds.

This structure would make for a more agile decision-making process than formations comprising all the supervisors, since the members of the Executive Board would be permanent members of ESMA. The smaller number of Executive Board members with a broader range of profiles would also support the development of a more consistent

104 Setting the agenda, proposal by the chairs of the peer review committees, establishment of internal committees and coordination groups, representation of the institution before Parliament, etc.

105 The procedure for the re-examination of Management Board decisions by the college of supervisors (BoS) made conditional on the breaking of the procedure of silence by three national authorities, hence giving these decisions more weight.

and robust internal policy, which could give more weight to proposals for ESMA's services in internal work. Lastly, this configuration would theoretically ensure a geographical balance in the representation of the various Member States.

The Executive Board would continue to have knowledge of draft rules submitted for the approval of the BoS, which implies maintaining a representation of the European Commission and European authorities, in smaller numbers (such as two instead of six) for these decisions. The current Management Board and Central Counterparties Supervisory Committee would therefore be scrapped and its current powers transferred to the new Executive Board.

In addition to these governance adjustments, it would also be useful to revise the organisation of supervisory work at ESMA under an integrated model, by creating joint supervisory teams (JSTs) under ESMA's lead. This model would also be based on AMLA or the SSM. Documentary and on-the-spot supervisory work would hence be conducted by teams of ESMA staff working with national competent authorities under the leadership of ESMA, and individual decisions would then be taken by ESMA's Executive Board.

This type of organisation would facilitate ESMA's upskilling in its new supervisory tasks leveraging national supervisors' expertise, and would also offer guarantees to entities transitioning to ESMA supervision by enabling them to maintain their pre-existing level of dialogue with their domestic national competent authorities.

ESMA should also be granted real no-action letter powers when certain level 1, 2 or 3 rules appear clearly inapplicable in the light of market developments or financial stability concerns. The introduction of a power of this kind in the ESA review has not yet made for the effective deployment of this tool, since ESMA was not granted a power of suspension of obligation, but rather a power of deprioritisation. Consequently, ESMA only uses this tool when a revision of the relevant legislation is underway and provided that it has received guarantees from co-legislators that this revision will definitely change the provision concerned to address the problem identified. Conversely, no-action letters from American authorities are more explicit as to the suspension of legal effect. This asymmetry of means between the EU and third-country jurisdictions has created competitive disadvantage situations due to the lack of agility granted the European authorities.

Finally, to enable ESMA to better consider the competitiveness of European financial market players and markets, the objectives assigned to it should be broadened to explicitly include the competitiveness of European markets, in addition to the goal of ensuring 'the integrity, transparency, efficiency, and proper functioning of financial markets' already assigned to it. This expansion of ESMA's objectives would be comparable to that recently implemented by the FCA (Financial Conduct Authority) and the PRA (Prudential Regulation Authority) in the United Kingdom.

4.3. ESMA's powers should be extended by different means depending on the actors and markets covered

4.3.1. Mandatory supervision by ESMA is essential for the most cross-border and systemic market infrastructures

Clearing houses and central securities depositaries (CSDs) are of the most significant systemic importance.

Since the 2008-2009 crisis, central clearing has been concentrated among a few systemic central counterparty clearing houses (CCPs)[106]. The monopolistic nature of clearing houses – associated with massive scale effects due to netting transactions and the advantages associated with available liquidity – foster the emergence of extremely large actors operating across national borders. The systemic importance and cross-border nature of clearing houses is well known and regularly observable[107].

CSDs deliver securities in exchange for settlement once two counterparties have concluded an agreement on the securities markets.[108] They are therefore also of systemic importance due to their role at a number of stages key to the smooth running of the financial markets, whether in terms of issues or settlement-delivery. They are governed by a certain number of rules harmonised at European level, in particular with respect to prudential and internal organisation requirements, by means of the Central Securities Depositaries Regulation (CSDR), which came into force on 1 February 2022.

However, supervision of the CCPs and CSDs remains entirely vested in national authorities.

Only third-country CCPs are paradoxically subject to European supervision. ESMA measures the systemic importance of third-country clearing houses for the financial stability of the European Union with the assistance of the central banks. The EU has also logically tasked ESMA with the direct supervision of the most systemically important third-country clearing houses.

For European CCPs, the option of centralised supervision has been systematically ruled out by somewhat fallacious arguments. An idea often put forward is that only the country in which the clearing house is established could bear the budgetary cost of a

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106 CCPs are private sector infrastructures that intervene in the "post-market" phase, i.e. after the trading of securities on the markets. Their role is to limit the counterparty risk by intermediating between buyers and sellers to ensure the delivery and payment of securities during the transaction conclusion phase, including in the event of default by one of the parties. Following the 2008 crisis, the use of clearing houses was gradually made mandatory for certain transactions to strengthen financial stability by reducing the risk of chain defaults on the markets. However, effectively reducing financial stability risks by means of the obligation to use clearing houses implies that the CCPs themselves apply strict risk management measures. In the European Union, the EMIR regulation in effect since August 2012 lays down the main prudential rules applicable to clearing houses.

107 In 2022, huge numbers of European energy players were subject to massive margin calls issued by EEX established in Germany and ICE Clear Europe established in the United Kingdom. Yet the sums called were in part due to risk management models submitted for the approval of national supervisors alone.

108 Central securities depositories ensure that securities are not delivered if payment has not been made and vice versa, record newly created securities (securities created by issues) in a book entry system and keep centralised accounts to ensure that the number of securities created equals the total number of securities in circulation at any given time.

resolution. However, in the highly improbable event of a resolution, losses would be shared among European actors: the framework for the recovery and liquidation of European clearing houses adopted in 2020 is based on the principle of an allocation of losses between the clearing house, clearing members and, where applicable, their clients. These last two categories imply that losses are shared on an intra-European basis with, most probably, a massive impact on the clearing member banks.

The EMIR colleges do not take issue with the principle of national supervision. These colleges (see Figure 43) are made up mainly of ESMA, the CCP's national competent authority, which also chairs the college[109], competent authorities responsible for the supervision of the clearing members making the largest contributions to the central counterparty's default fund, and competent authorities responsible for the supervision of the trading platforms and central securities depositories to which the central counterparty provides services.

Figure 43: Composition of the college of supervisors for the French CCP LCH SA (pre-EMIR3.0)

Source: Banque de France (link)

While their opinions remain non-binding, the EMIR colleges have not become supervisory tools, but rather chambers recording the decisions made by the national competent authority and, at best – but highly variable from one clearing house to the next – mechanisms for the exchange of information[110].

With respect to the CSDs, the latest revision of the CSDR called the "CSDR refit" made it a requirement for colleges to have an extremely reduced role of mere information

109 With the upcoming entry into force of EMIR3.0, ESMA will become co-chair of the colleges with the national competent authority concerned. ESMA will therefore be involved in setting the dates of college meetings and their agenda. Nevertheless, EMIR3.0 explicitly provides for the national competent authority to have the last word on these aspects in the event of disagreement. The development is therefore purely symbolic.

110 The European Commission made the following observation in its impact study drafted for the EMIR3.0 review: "Confidential information provided to DG FISMA services stated that there is a risk that, following authorization, CCP colleges have become a mechanism for the exchange of information, rather than an effective supervisory tool."

sharing when the CSD is of systemic importance to two Member States other than its State of establishment[111].

The post-market infrastructures are therefore natural targets for a mandatory transition to ESMA supervision[112].

This transfer of supervision to ESMA could be a gradual process, initially concentrating on the most systemically important CCPs and CSDs, which could be selected on the basis of a combination of quantitative criteria regarding (i) the volume of transactions/securities handled by these infrastructures, and (ii) the scale of the cross-border part of their business, for example by measuring the different Member States' exposure to the market infrastructure.

Secondly, a transition to ESMA supervision could be considered for all clearing houses and central securities depositories so as to prevent the perpetuation of a situation whereby smaller market infrastructures can benefit from a competitive advantage by retaining the benefits of what might be laxer supervision depending on their place of establishment.

In addition to its beneficial effect for financial stability, assigning the supervision of the CCPs and CSDs to the European level would also reduce post-market fragmentation and be conducive to integration among large pan-European groups. In general, this development would guarantee a uniform interpretation of the different applicable European regulations and would prevent regulatory arbitrage and competitive distortions[113]. In breaking with the multitude of colleges, it would also allow for a more efficient allocation of public supervision resources.

In the specific case of CCPs, transition to single European supervision would drastically reduce time-to-market and costs for private actors[114].

In the case of CSDs, supervision with European legitimacy could enable issuers, especially public issuers, to opt where relevant for CSDs that are not established in their country. This could strengthen competition between CSDs and reduce settlement-delivery costs.

Trading venues of European scale would also benefit from an integrated supervision through ESMA. Although they do not directly have a systemic dimension comparable to that of CSDs and CCPs, their operational resilience is a central point for the proper functioning of markets.

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111 These colleges are then made up mainly of the relevant CSD's national competent authority, ESMA and the national competent authorities of the Member States in which the CSD's activity is deemed significant. The minimal frequency of college meetings is also very low (one per year).

112 The ECB will need to be involved in certain decisions, especially concerning clearing houses with a credit establishment licence.

113 For example, the interpretation of the substantive scope of clearing house decisions, which must be subject to an EMIR college opinion in a necessarily longer timeframe than a scenario where solely the national authority decides on a matter.

114 Although EMIR college decisions are not binding, they – justifiably – take time. A supervisor's approval for the launch of a service or line of business takes 8.5 months on average, with lead-times ranging from 3 to 15 months once the application has been declared complete by the national supervisor. Applications for validation of significant changes to risk models can take up to 2.5 years. Although these lead-times are due in part to the completeness checking stage, there is no doubt that the multitude of authorities involved in supervision decisions, when the only decision-making authority remains the national authority, not only fails to meet the financial stability objectives, but also increases the costs for private actors.

Over the past decade, several have pursued an ambitious consolidation strategy, like Euronext (exchanges in Paris, Brussels, Dublin, Lisbon, Oslo, Amsterdam and Milan) and Nasdaq Nordics (exchanges in Sweden, Denmark, Finland, and Iceland).

These consolidations should be significant levers for integrating European financial markets, providing investors with a theoretical single order book in the case of Euronext. From the issuers' perspective, this integration should allow access to a considerably expanded liquidity pool, even though post-trade fragmentation still limits effective investor access to this integrated liquidity pool.

However, the absence of integrated European-level supervision limits the benefits trading venues and their users derive from this bottom-up consolidation. For example, Euronext benefits from the coordination of its supervisors through a college, voluntarily established within the framework of a memorandum of understanding without EU level prescription. However, in the absence of a supranational legal basis, this relies on a consensus system, effectively aligning with the most demanding process of the concerned regulators. Therefore, Euronext submits requests for pre-validation of trading rule changes as they are required by the law of 3 of its 7 national supervisors. Audits are conducted on a national basis, even though the company operates a unified technological platform and internal subcontracting must be subject to complex formalization.

In this context, it is recommended to transfer the supervision of the most significant trading venues to ESMA. This transfer of supervision to ESMA would be mandatory based on quantitative criteria, similar to those used for DCTs and CCPs, this time considering the size and cross-border dimension of these operators' activities, to initially limit this supervision transfer to the operators with the largest and most international volumes. This integrated supervision would be intended to replace, rather than supplement, the supervision of the relevant national authorities.

This transition to integrated supervision would go hand in hand with the recognition of intra-group services, an alignment of the supervision mechanisms of operators and market rules, replacing the applicable national frameworks, and a centralization of reporting and monitoring systems.

4.3.2. For asset managers of European scale and their funds, a more integrated supervision is also recommended

As with trading platform operators, European supervision should be considered as a lever for competitiveness for European asset managers. Unlike the CCPs and CSDs, the other market players have less of a systemically important profile. This calls for the relevance of their integrated supervision to be considered, not in terms of financial stability stakes, but from the point of view of integration and competitiveness objectives.

Integrated supervision should enable European asset management champions to benefit from the economies of scale generated by the single market by benefiting from recognition of the group notion for those operating and singularly being recognised as integrated European groups.

This recognition of the concept of a group would, at a minimum for European-scale asset managers, involve the creation of mandatory colleges of supervisors led by ESMA. These colleges could help bring the entire market towards the path of integrated supervision and control the risk of a new form of fragmentation. They would be chaired by ESMA and able to issue binding opinions on certain key supervisory decisions.

For asset managers wishing to benefit from more integrated supervision, an opt-in arrangement for direct supervision by ESMA would be offered. Such voluntary mechanism would allow for the gradual building of ESMA's credibility as a direct supervisor, which could lead to an increasing number of actors opting for this integrated supervision as the associated benefits become established. The condition of explicit agreement from the concerned parties would ensure that the transfer of authority occurs under conditions favourable to their competitiveness.

The opt-in is therefore a response to the current political deadlock over the scale-up of European supervision. With some Member States and actors still opposed to any extension of ESMA's supervisory powers, the proposed approach would offer a simple option to voluntary players without any impact on those who wish to remain supervised by their national competent authorities.

Basically, certain market players could opt for a 28th European supervision regime enabling them to be supervised as integrated European groups**.** This 28th regime would provide a response particularly well suited to asset managers, many of whom operate in the EU on the basis of integrated models via entities established and accredited in several European Union jurisdictions. To mitigate the significant shift that moving from national to integrated European supervision might represent, it would be appropriate to allow them to make this transition either entity by entity or directly at the group level at their discretion

Distributed products could also be placed under this integrated supervision regime, in particular investment funds defined under European law (such as UCITS[115] and ELTIFs). In this case, the funds would be authorised and supervised by ESMA where their managers so request. From the point of view of corporate law and tax law, the vehicle could be registered in a Member State, but the financial product would be supervised by ESMA. A European support could even be developed in the long run based on the "European company" model.

For investment funds, the opt-in would offer a more effective marketing passport. A single validation of marketing documentation by ESMA would be planned, with no recourse possible by the competent national authorities: this would significantly accelerate the 'time to market' for funds, provided that ESMA's approval times are in line with those currently observed at the national supervisors. The single validation of marketing documentation would allow circumvention of the heterogeneity of national rules, particularly in terms of ESG communication. Furthermore, fund passporting would be facilitated by eliminating the notification requirement. It is also important to note that asset managers could choose to register and supervise some funds intended for cross-border purposes while keeping other funds under a national regime.

This opt-in option would also be offered to trading platform operators and post-trade infrastructures that wish to benefit from integrated supervision, but do not meet the quantitative criteria that make it mandatory.

115 Most likely on the condition of the directive becoming a regulation.

5. Ambitious efforts will be required to reduce post-trade fragmentation at the European level

5.1. European financial markets are characterized by a high degree of settlement-delivery fragmentation

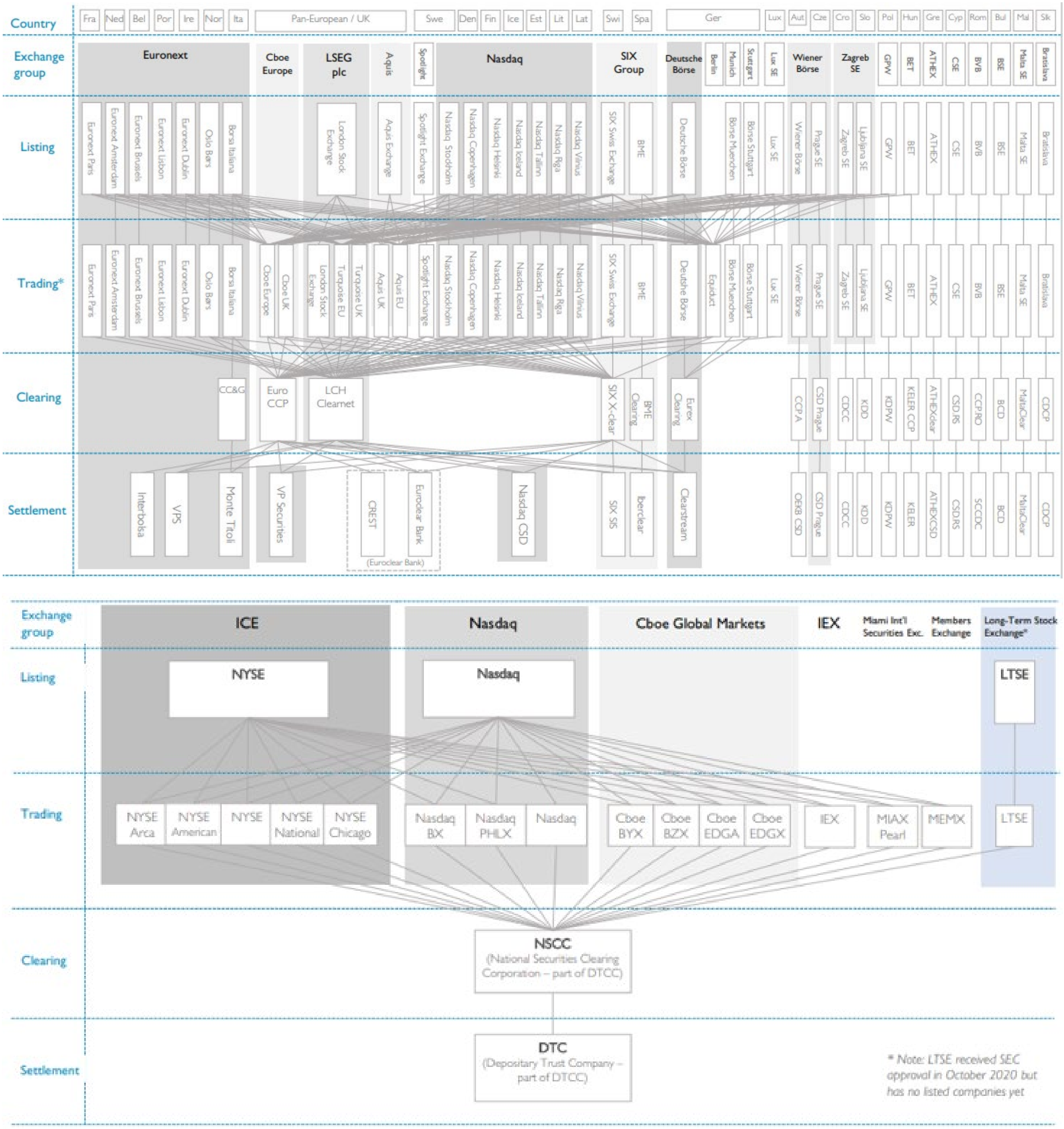
The market infrastructure debate is often focused on the benefits of a consolidation of exchanges, which is generally understood as the merger of listing platforms and the emergence of European primary markets. However, as previously seen, the consolidation of primary markets on a single technological platform does not allow for the generation of all the expected synergies due to the domestic supervision system.

But even if this obstacle were removed, the consolidation of the "upstream" stages of the trading chain would not be able to fully take effect as long as the "downstream" steps, the post-trade, remain domestically segmented.

Indeed, while the trading of financial instruments takes place on a multitude of trading platforms both in the US and the EU, the landscape of post-trade infrastructures in the European Union is, unlike the United States, particularly fragmented. This is mainly due to the multitude of central securities depositories (CSDs), and to a lesser extent, the architecture of central clearing infrastructures[116] within the European Union. There are indeed 28 active central securities depositories (CSDs) for equities within the European Union, whereas settlement and delivery are operated by a single entity in the United States. Therefore, the integration efforts of trading platforms by some European players do not fully suffice to reduce liquidity fragmentation, as issuers remain registered with domestic CSDs that are not harmonized and have limited interoperability.

116 Several clearinghouses coexist in both the United States and the European Union, although a single American clearinghouse operates in the equity market, while multiple clearinghouses do so within the Union.

Equity market structure in Europe (top) and in the US (bottom)



Source: New Financial, 2021 (link)

Europe seems to have far too many CSDs for the size of its markets. 28 CSDs operate in the EU – all active in the equity markets.[117] In the US – with a stock market more than four times the size of the European market in terms of capitalisation – all settlement goes through one agency, the Depositary Trust Company (DCT). The plethora of central securities depositories in the EU is nothing new and there has been no substantial change in this complexity, despite some consolidation efforts in recent years[118] by market operators such as Euronext or the Euroclear Group (see Table 3). Although individually, these groups have expanded their European footprint and made a

117 ECSDA, European CSD Industry Factbook, 2018-2019 update (link).

118 Euronext acquired the Portuguese CSD (2002) and the Italian Monte Titoli (2021). Euroclear was formed from the merger of the French, Dutch and British central securities depositories in the early 2000s, followed by the acquisition of the Finnish and Swedish CSDs in 2008.

substantial contribution to consolidating settlement operations within their scope,[119] the number of central securities depositories operating in the EU is still very high.[120]

Table 3: Groups of CSDs in the European Union

Deutsche Börse Group	Euroclear	Euronext
Clearstream Banking SA (ICSD)	Euroclear Bank (ICSD)	Euronext Securities Copenhagen
Clearstream Banking AG	Euroclear Belgium	Euronext Securities Milan
LuxCSD	Euroclear Finland	Euronext Securities Oslo
	Euroclear France	Euronext Securities Porto
	Euroclear Nederland	
	Euroclear Sweden	

Source: ESMA, Report: Provision of cross-border services by CSDs, 2024 link

CSDs are essentially anchored at national level, in terms of both clients served and securities managed. In the EU, only Estonia, Lithuania, Cyprus and Ireland do not operate "their own" national CSD.[121] In 2019, only 21% of direct CSD clients operating in Europe were established in a third country or in another member state of the Union[122] (see Figure 44). This national bias is also evident in the securities maintained centrally with CSDs established in the EU (see Figure 45), across all types of security (see Figure 46).

Figure 44: Domestic versus non-domestic participants connected with CSDs in Europe (excluding international CSDs), 2019

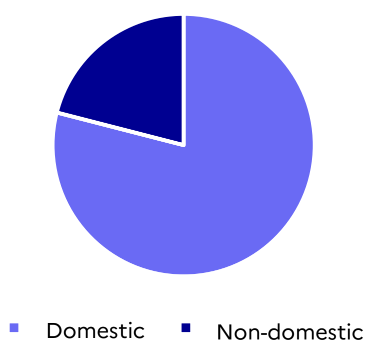
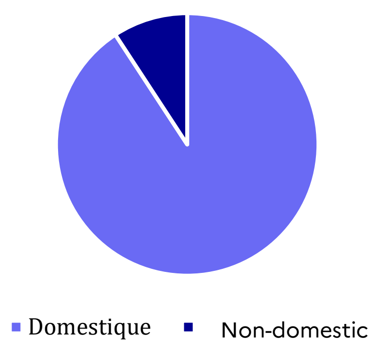


Figure 45: Domestic versus non-domestic securities maintained centrally at European CSDs



119 Euroclear Belgium, Euroclear France, and Euroclear Netherlands form the group of CSDs called ESES. Without actually merging the CDSs, the ESES platform offers operational consolidation with a single technical platform for the three. Legally speaking, each of the three CSDs operates all three ESES systems. Each is governed by the laws of the country in which it is established and supervised by the national supervisor(s).

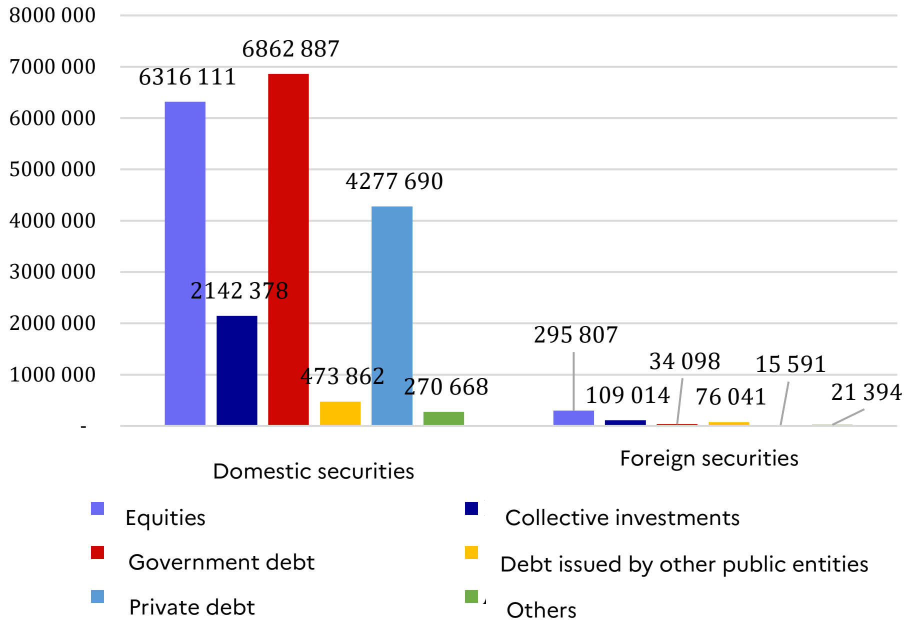
120 Except the Nasdaq CSD SE, which has a single CSD for Estonia, Lithuania and Latvia (where its head office is located), consolidation efforts have not reduced the number of CSDs.

121 List of authorised EU CSDs (link).

122 ECSDA, European CSD Industry Factbook, 2018-2019 update. This figure does not include international CSDs, which are non-domestic by definition.

Domestic

Figure 46: Aggregate values of domestic and foreign securities held centrally by all EU CSDs, by type of instrument (in € million)



Source: Figure 44: ECSDA, European CSD Industry Factbook, 2019, link. The scope of CSDs covered exceeds those established in the EU.
Figure 45 and 46: ECSDA, Database, 2022, link.

CSD's are anchored nationally for several reasons: (i) national sovereignty and financial stability; (ii) lack of harmonisation of securities law and tax law; and (iii) their shareholder base.

- Due to their large issue volume, sovereign debt issuers use their national CSD, overseen by the national supervisor, since the most systemically important CSDs are not subject to European supervision. 99.5% of public debt issued by EU governments is centrally maintained by the national CSD;
- As long as securities and tax laws are not harmonised,[123] all economic and financial participants, particularly custodian account keepers that perform functions related to the "life" of the security, will use the national CSD. Services provided by CSDs must comply with the securities law in the member state in which the issuer is established and in which the security is issued.[124] Absent harmonised securities laws across the European Union, clients tend to be biased towards their national CSD;
- Finally, the lack of fragmentation reduction prospects for the settlement of securities transactions in the EU is sometimes reinforced by the ownership structures of these entities: the existence of national silos can create a barrier to entry but, conversely, independence from primary markets limits the incentives to invest in facilitating listings from new jurisdictions. Overall, it is rare for central securities depository (CSD) operators to be motivated to move away from the

123 The Commission's legislative proposal aims to harmonise withholding tax procedures and ensure they do not discourage cross-border investment.

124 Article 49, Central Securities Depositories Regulation (CSDR)

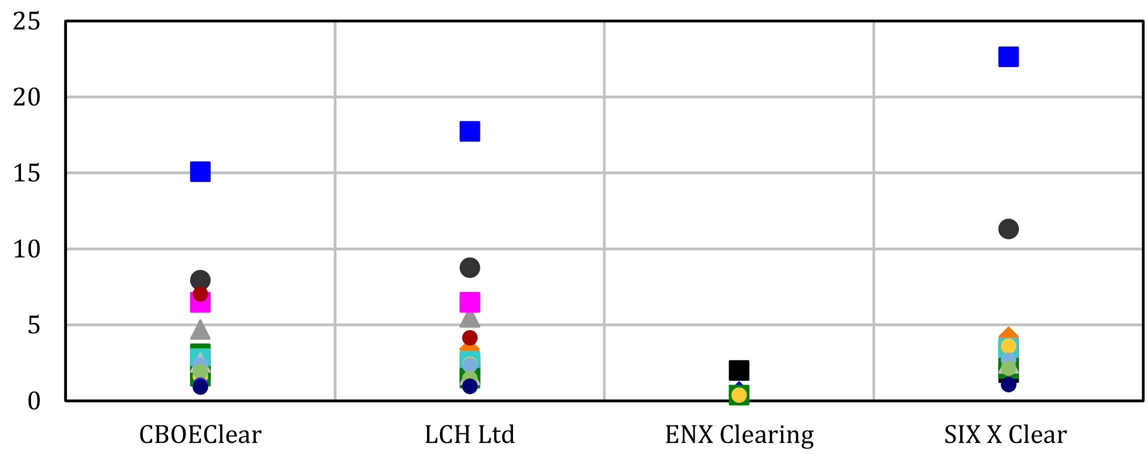
domestic status quo, as evidenced by the scarcity of consolidation operations in this sector and the commitment to substantial projects for operational convergence: Euroclear has not pursued this movement beyond the scope of ESES, and Euronext is beginning this work within the scope of the CSDs it owns. Additionally, national Central Banks remain committed to controlling their national CSD.

The upshot is that European users pay cross-border settlement costs that are probably far higher than in the United States. Unlike in the US, where there is a single CSD, there is no one concentrated pool of European securities in a single CSD open to all investors. In many cases, intra-European transactions involve a slew of interconnected actors, whether banks and/or several CSDs. The number of operators involved and the complex links between them (there are 122 unidirectional or bidirectional links125 between European CSDS) generate establishment and maintenance costs, ultimately passed on to users in the transaction costs.

Settlement costs charged by European CSDs also vary widely, as is evident from the difference in settlement fees applied to transactions in the same clearing house, depending on CSD used (see Figure 47). Rather than true competition, these price differentials seem to reflect the influence of CSD volumes on price. The range of prices illustrates not only poor interoperability between European CSDs, but also a disincentive phenomenon: an investor located in a large CSD's country will be discouraged from purchasing a security issued in another member state from a smaller CSD.

Fragmentation in the EU settlement infrastructure shrinks the pool of securities that can be easily accessed by investors, and notably retail investors, to those issued by the national CSD. Ultimately, complexity and pricing practices combined are bound to blunt the appeal of European financial markets for foreign investors.

Figure 47: Dispersion of the settlements cost reported by clearing houses according to European CSD chosen



Source: publicly available information on clearing houses, May 2024.

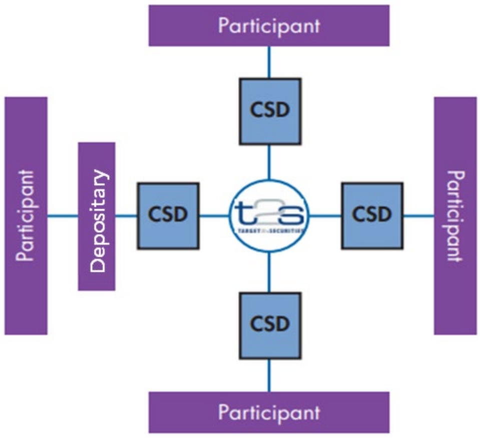
125 2022 Data, ESMA report on cross-border services link. ESMA found 161 links between European CSDs and 263 links when third-country CSDs are included. Account-opening by one CSD with another to submit settlement instructions.

Beyond differences in settlement-delivery fees, additional costs are also attributable to the custody fees of non-domestic securities: they represent a multiple of domestic costs for retail brokers, due to the lack of integration of banking platforms of custodian-account keepers, which necessitates multiple links to CSDs or the use of intermediaries.

5.2. Unfortunately, T2S has not succeeded in reducing this fragmentation

In a bid to achieve greater integration in the EU securities settlement system, Eurosystem launched Target2-Securities[126] **(T2S) in 2015.** T2S is a technical platform on which participating CSDs externalise their settlement activities. Designed to promote the settlement of securities in Central Bank currency, this platform was also aimed offering a solution to the fragmentation of securities settlement in the EU, by simplifying the purchase of non domestic securities and reducing the cost of cross-border settlement.

Diagram 3: simplified overview of T2S operation



Source: Banque de France, link

Therefore, TS2 should in theory have made cross-border settlement identical to the domestic settlement process, from both an operational and cost point of view. By hosting the securities accounts of all participating CSDs and the cash accounts of the related national central banks, T2S should have made it easy for European issuers (or investors) to access, via a single CSD connected to T2S, all investors (or securities) available at all other connected CSDs (see Diagram 3).

126 What is TARGET2-Securities (T2S)? (europa.eu).

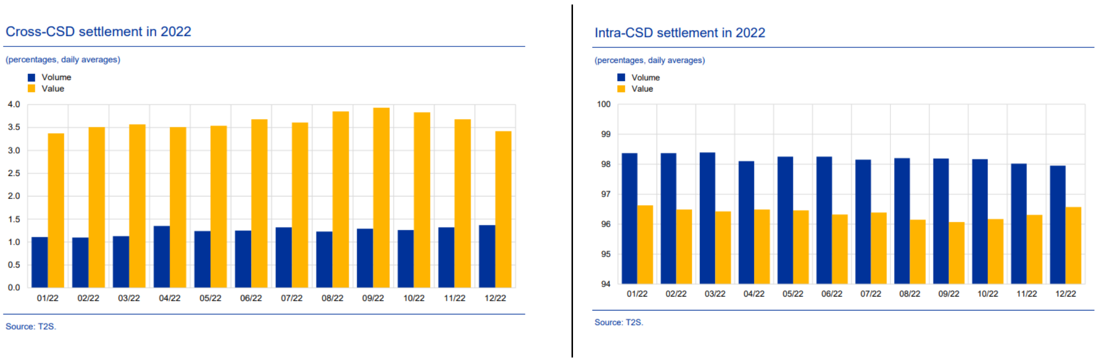
Despite its contributions in terms of settlement and delivery of financial transactions in central bank money, T2S has not developed into an integrated interoperable core for cross-border transactions as stated in its objective[127], but rather a technical platform essentially used for national purposes, contrary to its objective.

Instead of replacing the networks of links connecting CSDs, T2S has added to them, which logically prevents it from becoming the central core envisaged in Diagram 3. Since T2S is not legally a CSD, but a technical platform used by CSDs, the cross-border flow of securities on T2S is based on establishing links between CSDs, as well as on the technical settlement process on the platform.

Data on the volumes settled on T2S are not publicly available, but the platform is bypassed for a very large share of settlement activity, whether cross-border or not. This is true for settlement transactions by international CSDs and for settlement directly by custodian account-keeper networks.[128]

T2S is also used by CSDs for mainly domestic purposes. In terms of both volume and value, transactions with a cross-border dimension (flows directly on T2S by two CSDs are referred to as cross-CSD settlement) on T2S represent only a tiny minority of the flows transiting on the platform. In 2022 they amounted to less than 1.5% of volume and 4% of amounts (see Figure 48). The vast majority settled via T2S, in terms of volume and value, are "intra-CSD" (98% and 96%, respectively): a single CSD handles the transaction flows on T2S for other CSDs, on behalf of all their participants, including cross-border transactions where relevant. Hence, in this configuration, the cross-border part of settlement is done through links and, later, outside T2S.

Figure 48: Percentage (in volume and value) of securities settled on T2S using cross-CSD (left) and intra-CSD services (right)



Source: T2S 2022 Annual Report

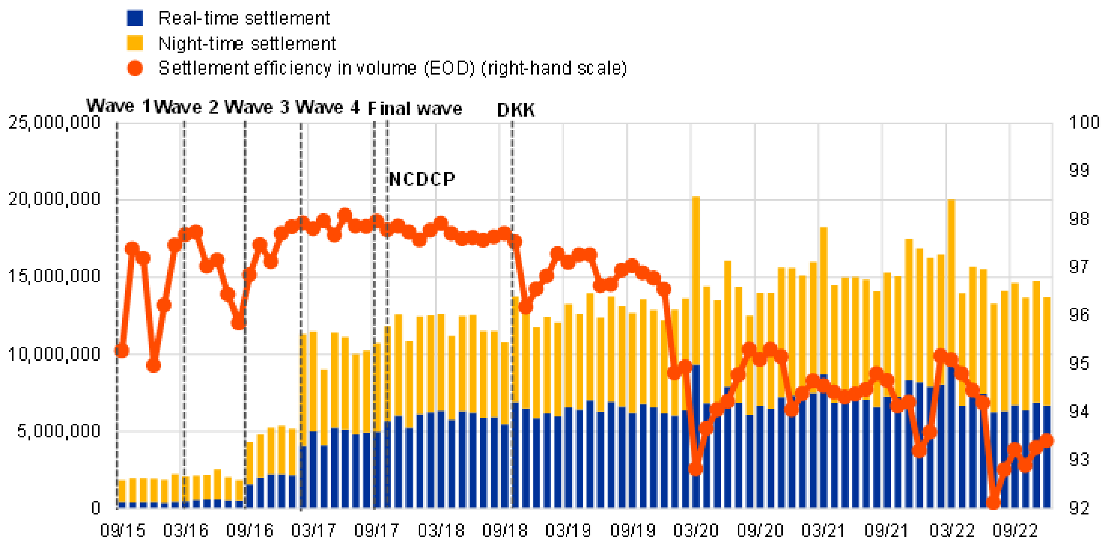
127 "The overall objective of T2S is to facilitate post-trading integration by supporting core, borderless and neutral pan-European cash and securities settlement in central bank money so that CSDs can provide their customers with harmonised and commoditised settlement services in an integrated technical environment with cross-border capabilities.", Introduction to the General Principles of T2S (link)

128 All settlement operations are in commercial bank money, which is logical for transactions denominated in a currency not available on T2S (such as the US dollar); however it does raise questions about transactions in euro.

Some current developments could have a positive impact (although to what extent is uncertain) on T2S cross-border settlement volumes in the EU. These initiatives include measures to harmonise withholding tax procedures[129] and, more generally, the initiatives of the AMI-SeCo working group, which advises the Eurosystem on securities and collateral. Turning to T2S's geographical coverage, Euroclear Bank announced its migration to the platform in September 2023, and Euronext has been using the cross-CSDs settlement-delivery function since 2023, utilizing the interoperability link at its CSD level. While it has practically reached its geographical coverage potential in the EU with 24 CSDs connected, it is more difficult to assess the volume effect of this most recent wave of connections, since international CSDs settle the majority of trades in commercial bank money, while T2S only settles in central bank money.

Nor has T2S delivered on all its promises for greater efficiency, which could tarnish its appeal for market participants. The rate of unsettled transaction is volatile and has actually gradually worsened (it is usually under 95%), which mars its appeal for market participants. This performance can only partially be attributed to the introduction of the new T2S statistical framework in 2020.[130]

Figure 49: Variation in volumes settled in T2S and settlement efficiency at end of day



Source: ECB, Target2 Securities Annual Report 2022 Left-hand scale: number of transactions, monthly totals; right-hand scale: settlement efficiency, percentages)

Notes: Migration wave 1: 22 June-31 August 2015; migration wave 2: 29 March 2016; migration wave 3: 12 September 2016; migration wave 4: 6 February 2017; final migration wave: 18 September 2017; NCDCP (Slovakian CSD): 27 October 2017; Danish kroner: 29 October 2018.

129 The "Faster and Safer Relief of Excess Withholding Taxes (FASTER)" initiative seeks to harmonise systems for withholding tax on dividends. The wide array of different procedures has been identified as one of the fiscal barriers to cross-border investments.

130 The ECB notes that settlement efficiency fell to 94.81% in January 2020 as a consequence of the new statistical framework.

5.3. To reduce this fragmentation, an increased contribution from T2S will need to complement efforts on securities law convergence

5.3.1. It is first necessary to enhance the attractiveness of T2S and enable it to perform other functions traditionally offered by CSDs

To make the most of this European settlement platform, its by-laws could be revised to delete the principle whereby T2S cannot legally become a CSD.

This principle seems incompatible with the purpose of facilitating cross-border transactions for two reasons:

- T2S cannot hold a pool of securities that can be directly accessed by the 24 CSDs connected to the service. Ruling out CSD status means T2S is not authorised to directly provide issuers with a notary service (initial recording of securities in a book-entry system), or to provide and maintain securities accounts at the highest level (central maintenance service).[131]
- T2S cannot be the nodal point for settlement/delivery of cross-border transactions, since CSDs require a connection to T2S and links between them to use the service.

Given the demand, a European infrastructure would offer at least three advantages:

- Truly neutral settlement, which would not encourage national issuance and bias: by providing a genuine pool of securities, T2S would level the playing field. In this scenario, European investors from two different Member States (especially countries with different-sized capital markets) would no longer incur abnormally high settlement costs.
- Lower costs and greater transparency: total settlement costs would likely reduce: (i) fewer intermediaries and links would be required (there would be an option to connect directly to T2S via a bank, or the national CSD); (ii) a volume effect created by – potentially substantial –issuance on T2S, and by greater interoperability between T2S and CSDs as a result of the change in status; and (iii) T2S's policy of charging at cost. Fewer intermediaries should bring greater transparency regarding total settlement costs.
- Financial stability gains on two counts: transactions in central bank currency would increase in tandem with greater volumes on T2S. Settlement in central bank money is safer than in commercial bank money. The T2S CSD would have to be operated and supervised at European level since, like the platform in its current form, it is by its nature of systemic importance for the financial stability of the European Union.

However, in order to deliver the expected benefits in terms of post-trade integration, such an expansion of the functions offered by T2S would require that a convergence of securities law be undertaken within the European Union. This issue, traditionally

131 Article 2 of Regulation 909/2014 of the European Parliament and of the Council of 23 July 2014 provides that a CSD means a legal person that operates a securities settlement system [...] and provides at least one other core service. These core services are listed in Section A of the Annex to the regulation and include a notary service and central account maintenance.

sensitive due to the desire of many Member States to retain their national specificities, should be approached with caution due to the potential implications for the protection of the ultimate holders of the financial securities involved. The convergence of securities law could also have the effect of enhancing the appeal of a consolidation movement among central securities depositories (CSDs), as well as their ability to attract non-domestic issuers, with potential benefits from the perspective of issuers and investors providing a "private" response.

Furthermore, efforts must be made to make T2S more attractive and efficient. Specifically, it is important to extend the operating hours of the T2S system, allowing it to conduct settlement operations 24/7. To make the platform more attractive, reducing operating costs should be a priority: offering T2S services 'at cost' to market players is already a useful measure, but it should not replace efforts that can be made to reduce the platform's operating costs by leveraging operational efficiency gains. Finally, operational improvements could also be implemented to reduce the rates of settlement failure observed on the platform

5.3.2. In the longer term, it is necessary to work towards the development of a blockchain-operated settlement and delivery service by T2S

Markets around the world are looking at how blockchain technology could be applied to market infrastructure to improve the securities chain, with an ever-growing list of public and private initiatives. Numerous experiments have confirmed the technology's potential. In this regard, it is estimated that the volume of tokenized assets should reach $5 trillion USD by 2030[132]

The EIB has successfully pioneered digital bond issues in partnership with different private actors and varying the technical parameters of the issues. Of particular interest is the January 2023 issue[133] which tested the use of “smart contracts”[134] for settlement.

In another private initiative, JP Morgan developed an asset tokenisation platform (Onyx Digital Assets) that offers instant and simultaneous settlement (known as atomic settlement) of repo transactions.

But, the sheer number of these initiatives creates a risk of increasing market fragmentation – which is precisely what blockchain technology claims to be the answer for – which poses an interoperability challenge, since participants may seek to promote their own technical and operating solution.

However, a bold and ambitious technological project capable of replacing traditional securities chain has yet to emerge in Europe. Building reliable and robust market infrastructure based on blockchain technology with buy-in from all market participants requires substantial investment. The scale of investment needed is challenging for private developers, even given the expected potential profits. Within the EU, implementation of the pilot regime[135] for market infrastructures based on blockchain technology under certain conditions has been relatively limited to date. Candidates are

132 McKinsey (link)

133EIB (link)

134 A computer programme or code on a blockchain that automatically executes transactions according to the criteria written into the code and then sends the information to be permanently recorded on the blockchain ledger.

135 Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 (link)

few and far between, mainly due to difficulties in ensuring interoperability and creating a common standard for distributed ledger technology (DLT). Witness for example the failure of Liquidshare[136] in France.

Public authorities, notably the Bank for International Settlements (BIS) and the ECB, are clear about the need to avoid increasing market fragmentation, which would diminish blockchain technology's contribution to improving market infrastructures. The BIS has propose combining all tokenised financial assets and tokenised settlement assets together in a "unified ledger" (a single blockchain infrastructure) developed by central banks. The proposal has also found favour with the ECB Governing Council (see its press release of 7 March 2024).[137]

In the Committee's view, T2s is the right system to take on the task of developing blockchain-based settlement within the EU. Through the Eurosystem, the EU can build on the existing settlement infrastructure that already links in and works with the Target settlement system and is due to be strengthened. To fully leverage blockchain's potential for post-trade settlement and build user confidence in a "unified ledger", it is vital to have a wholesale digital central bank currency as a reliable settlement asset. The ECB's call for interest[138] in trials to explore the potential of new technologies is a major first step in the development of a "European unified ledger", and should be primarily directed towards wholesale central bank digital currencies..

Such project could yield several key benefits:

- Cheaper, more reliable settlement.
- "Atomic" settlement (instantaneous and simultaneous) at any time, would help reduce counterparty risk and therefore also lower margin calls. On the other hand, transactions would need to be pre-funded (no recourse to the loan market, the counterparties to the transaction would need to have the security and liquidity at their disposal at the time of the transaction). T2S's ability to deliver T+0 service is crucial, especially as some markets are considering moving to T+1 settlement.
- The emergence of a European blockchain standard, overseen by European central banks, to address the challenges of strategic autonomy that come with this technology, which is underdeveloped in the EU, primarily due to the sector's difficulties in reaching agreement on such a costly technology.

136 Liquidshare was founded in 2016 as a partnership between a number of market participants. The fintech aimed to develop blockchain-based post-trade settlement infrastructure to improve market access for SMEs. It ceased trading in September 2022.

137 Statement by the ECB Governing Council on advancing the Capital Markets Union (europa.eu)

138ECB (link)