Franco-German Council of Economic Experts

CAPITAL MARKETS UNION

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Franco-German Council of Ministers
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Capital Markets Union: why do we need to address it now?

1 **Growth**: DE and FR are maturing economies with low potential growth. Funding the green transition requires supply of risky investment

2 **Resilience:** Capital market-oriented system versus banking centered system can improve resilience and recovery following crises

3 **Strength**: Finance has become a strategically-important sector in the global economy. Policies needed to strengthen EU capital markets.

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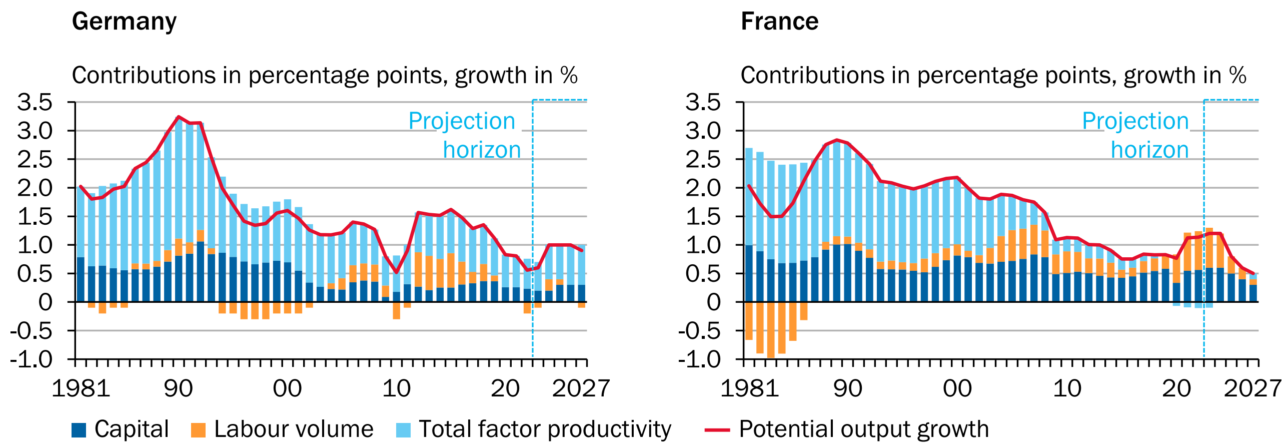
1 Building CMU can help promote growth

Low potential growth in DE and FR according to European Commission estimates



Source: European Commission

- Potential output **growth in decline** in most advanced economies.
- **Aging population** will soon depress growth particularly in DE (and with some delay in FR).
- In FR, total factor **productivity** will contribute ~0 pp to growth by 2027, but 0.5 - 0.7 pp annually in the US.
- **Innovation-driven growth** requires strengthening capital markets rather than expanding the banking sector.

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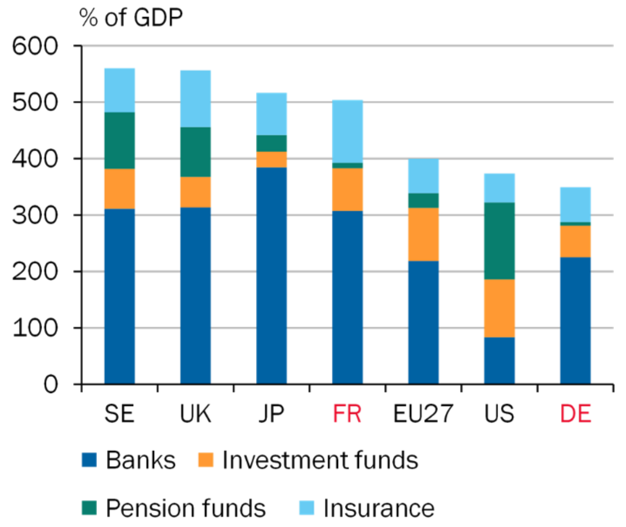
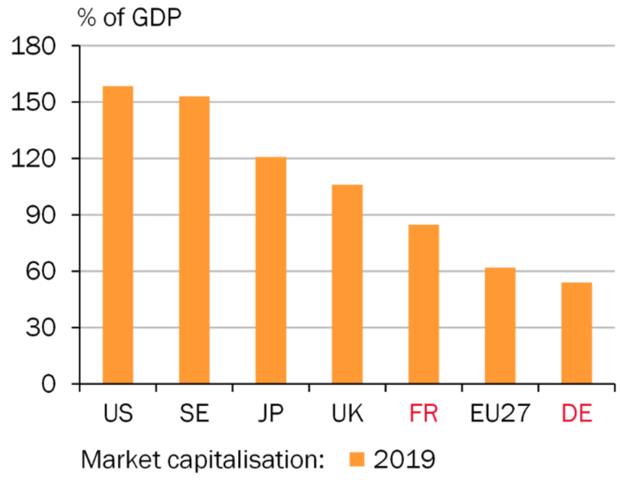
2 Improve resilience by broader funding base for firms

DE and FR have **small capital markets** and **large banking markets**



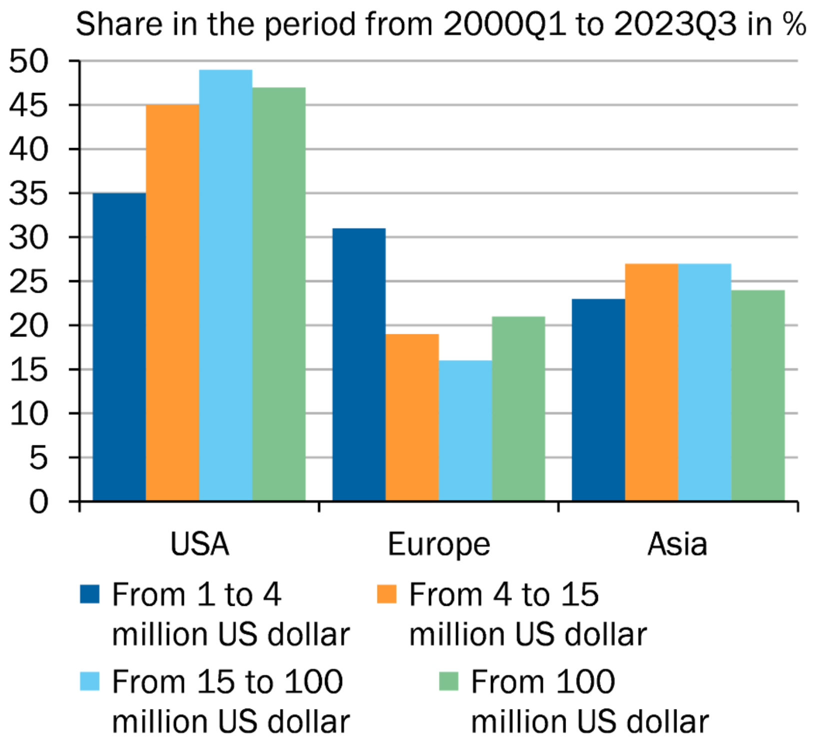


Sources: BoJ, CEIC, ECB, Fed, World Bank, own calculations

- EU financial architecture very **bank-biased**, and banking still essentially domestic
- **Equity markets** in Europe are **small** relative to US
- **Equity markets** can provide a "**spare tire**" in corporate funding during times of crisis

3 Strengthening European capital markets in a global setting

European companies realise large financing rounds comparatively rarely



Source: Dealroom.co (2023)

- Europe should become a larger player in international financial markets
- European capital markets are vital for funding of **strategically important and future-oriented growth industries/technologies**
- Part of the drop in European VC funding in 2023 was driven by **US investors pulling out** of Europe (fickleness)
- Europe risks losing promising firms – 40 out of 147 EU **unicorns relocated their HQ abroad** from 2008 to 2021

Most efficient policy actions for a growth-oriented CMU agenda

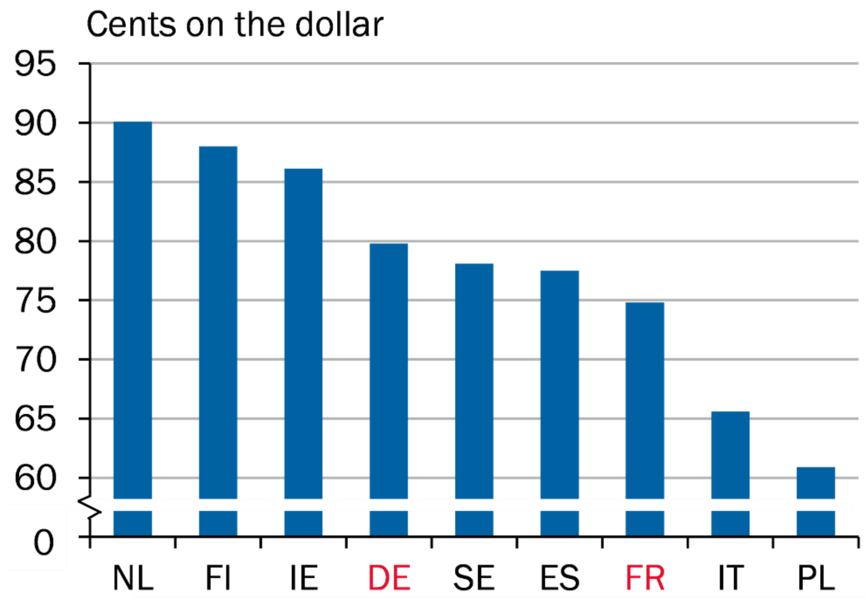
1. **Simplifying valuation** of foreign assets to improve cross-border investment opportunities: Harmonising insolvency laws and access to information

Building trust in capital markets

2. **Strengthening European supervision** of capital markets: reforming ESMA and EIOPA
3. **Increasing household participation** in capital markets
4. **Reorienting** institutional investors towards **European equity markets,** including VC and PE
5. **Increase VC funding** through a European Sovereign Fund for example by scaling up the European Investment Fund (EIF)

1. Simplifying the valuation of foreign assets by harmonising insolvency laws

Significant differences in recovery rates across European countries



Source: World Bank (2019)
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Bankruptcy codes vary widely across EU countries

- **Differences** in determinants of **recovery rates**
- Makes it **difficult to assess recovery rates** when investing across borders

Need for harmonisation of insolvency laws:

- Potential **reallocation gains**: domestic PE funds more likely to invest cross-borders
- Potential **deepening of PE markets**: EU-based funds more attractive with EU portfolio
- Harmonization may **facilitate Pan-European securitisation,** benefitting smaller countries with smaller asset pools

1. Simplifying the valuation of foreign assets by enhancing transparency

Lack of standardised financial reporting across EU countries

- Difficult for investors to **compare and value private assets** in foreign markets
- Esp. concerns **larger SME**, for which market finance would be an attractive borrowing source
- Databases for private firms exist (e.g. AIDA, DIANE, MARKUS, ASTREE), but regulatory **discretion in reporting requirements**
- Collecting data from **local business registries tedious**

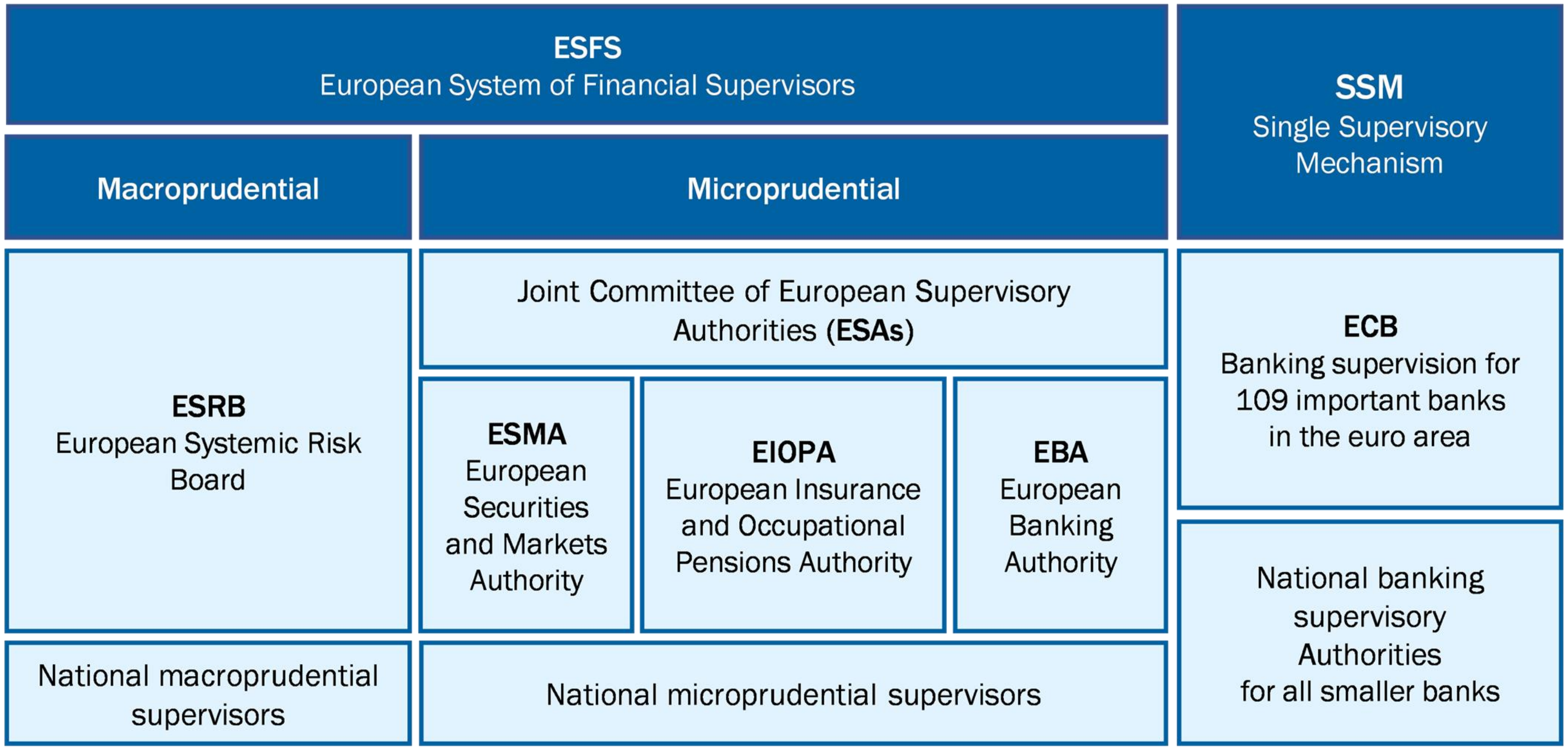
Extend existing initiative (ESAP) to private firms

- Extend based on fiscal reporting **to increase visibility of SMEs** to potential foreign investors
- **Harmonise disclosure requirements** across member states

2. Trust in Capital Markets: Supervision

Current set-up of EU financial market supervision

Institutions of European financial market supervision



Source: own representation

2. Trust in Capital Markets: Supervision

Supervisory fragmentation

- **Fragmentation** along national lines is a **great obstacle** to integrated capital markets

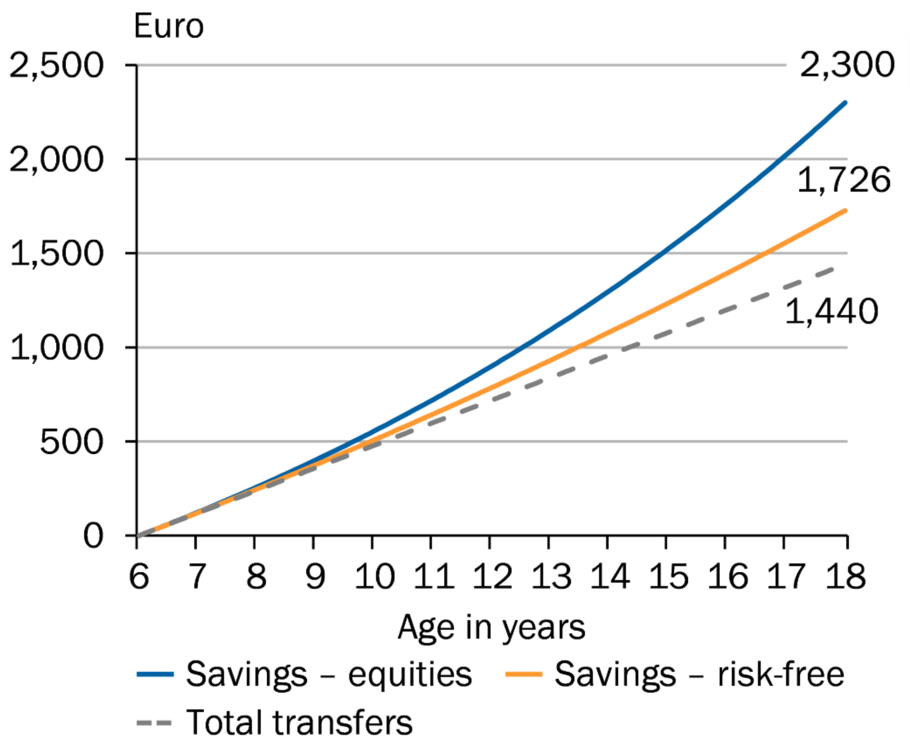
Reform of ESMA as a catalyst

- **Structure**: Compact board, funding by levies on supervised entities
- **Scope:** EU-critical financial market infrastructures, audit firms, enforcement of corporate financial and sustainability-related reporting
- **Multi-location** organization: ESMA offices in the main financial centers of the EU and distributed mandate bringing it closer to market participants

Parallel Reform of EIOPA

2. Building trust in capital markets: EU-funded investment accounts for children

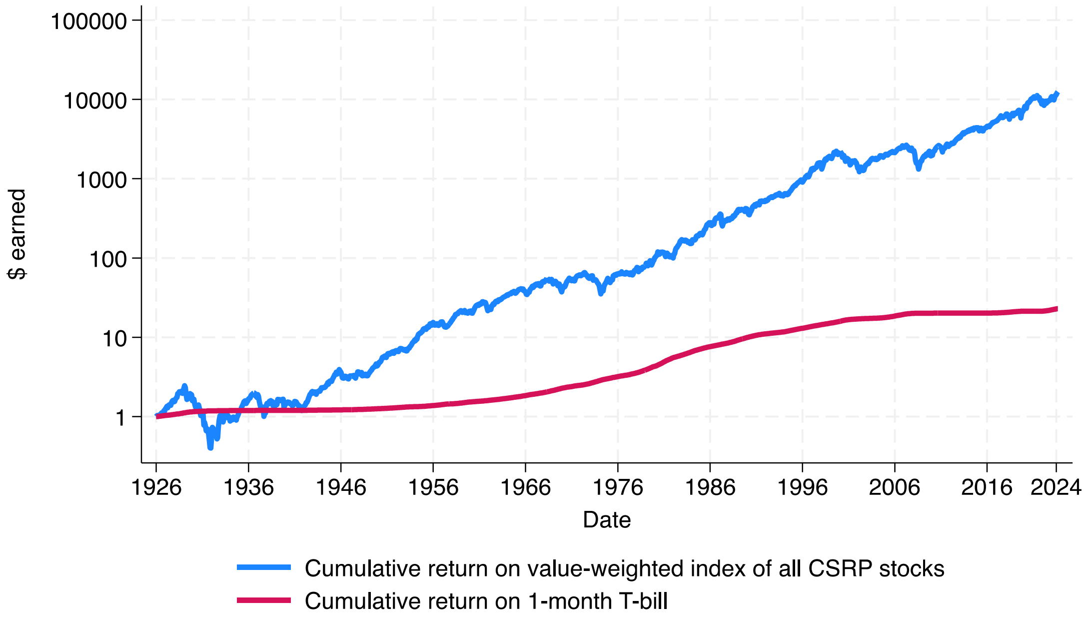
Total savings is average 25% higher when fund invests in equities rather than risk free



- **10 euros per month** in the form of a fund share for every child from 6 to 18.
- Annual costs of ~7 Bn € for EU27
  - **Broadly diversified** fund
  - Could be used for additional savings
  - Parents could match savings amount
- Children would **experience different financial cycles** and understand the **long-term low risk and high returns of equities**
  - Overcome failures of financial literacy training
- Israel initiative launched in 2017 for all children could serve as a role model.

2. Building trust in capital markets: EU-funded investment accounts for children

Over long-time periods, stocks dominate bonds even accounting for risk (equity premium puzzle)



Source: Ken French Data Library, own calculation

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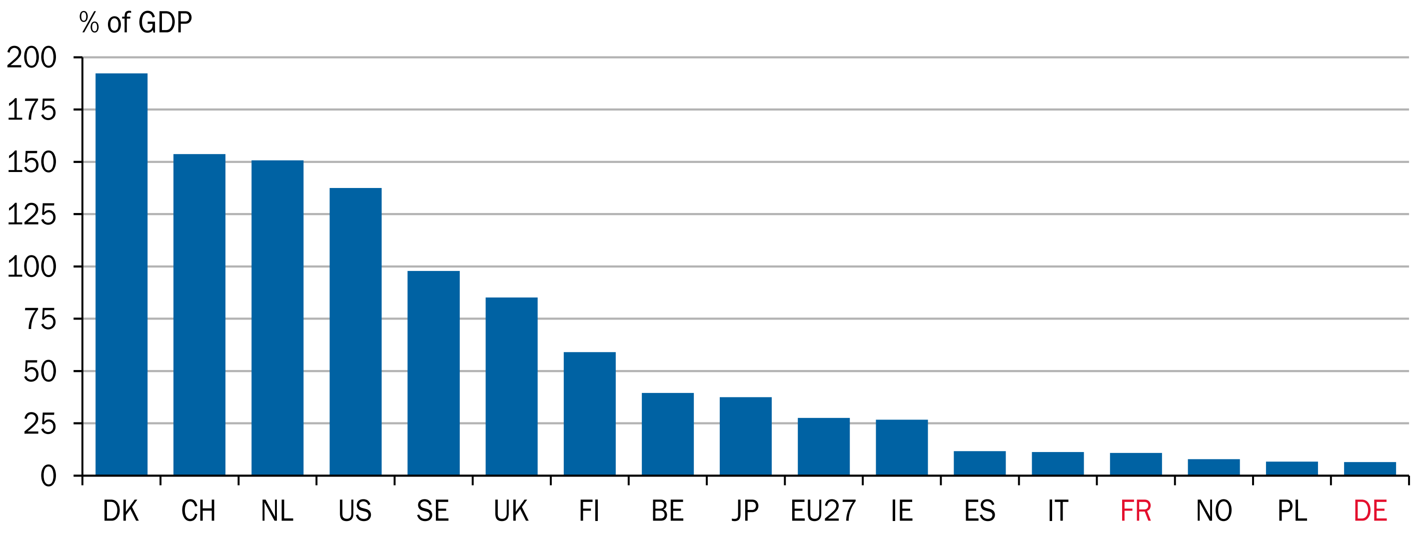
3. Lack of institutional investment: Private pension funds

Small share of private pension fund investments relative to GDP in both DE and FR



Investment assets of private pension providers in OECD member states in 2022

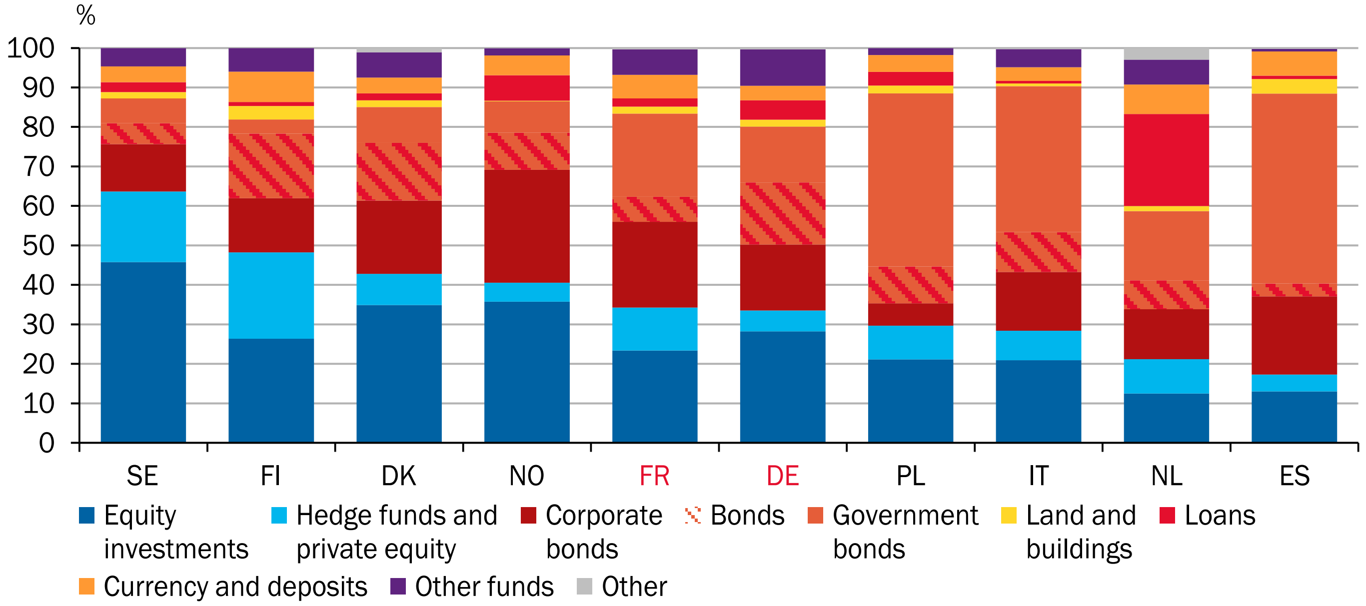
Sources: OECD, own calculations

- **Differences** in pension fund sizes **reflect retirement systems**
- **Strengthening supplementary funded pensions** could increase the amount of capital collected by pension funds
- Funds should **invest globally and broadly diversified** in order to protect pension assets. Large sums should also be invested in the EU, given their economic importance

4. Lack of Institutional Investment: Insurance companies

Asset allocation of insurance companies tilted towards low risk sovereign bonds

Asset allocation of insurance companies in selected countries in Q4 2022



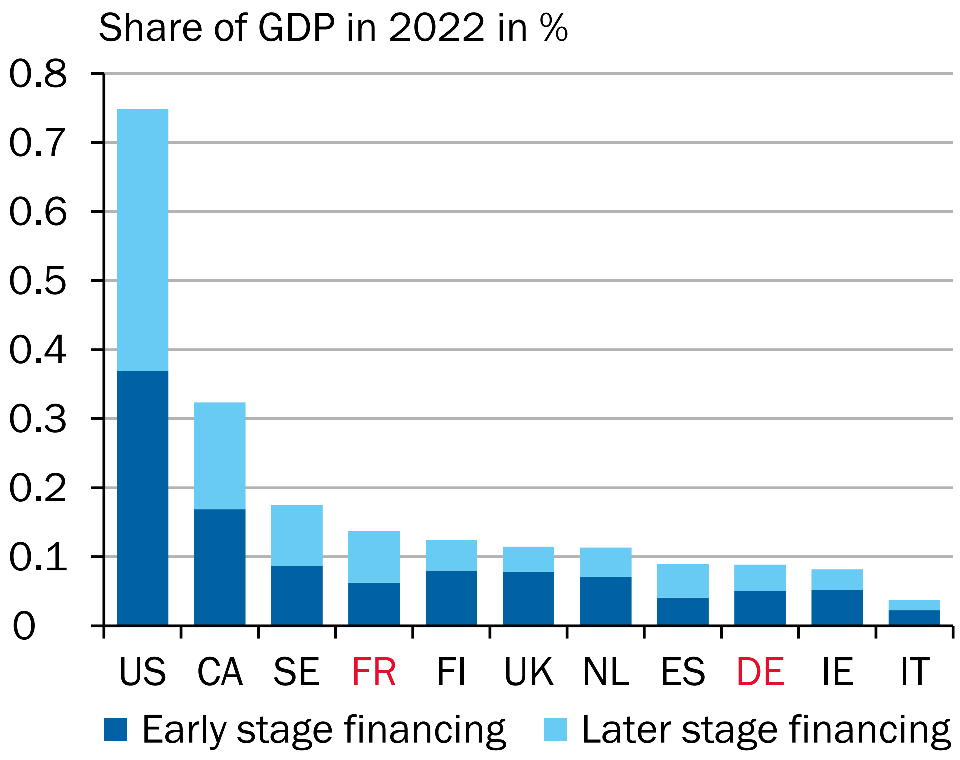
Sources: EIOPA, own calculations

What explains equity-averse investment choices?

- **Product offering**: guaranteed life insurance products
- **Supervision**: significant cross-country differences in supervisory culture and practices despite same Solvency II regulation
  - **Motivation for EIOPA reform**
- **Culture**, cf. attitudes towards capital markets

5. Increasing public investment in VC markets

Venture capital financing stronger in North America compared to Europe



Source: OECD

- Lack of institutional investors may justify role of public funds in funding VC markets
  - Positive association btw public and private funding of early-stage start-ups
  - Key: **investment via funds (LP) rather than direct investment**; leave selection of industries, technologies, and stages to the experts (cf. KfW)
  - Issue: **scale-up**
- Further **develop and reform the EIF**:
  - Increase overall funding
  - Invest in both early and late stage
  - No direct investment
  - Israeli Yozma program could serve as inspiration

Proposed Policy Actions for a Growth-oriented CMU Agenda

Attract funding - deepen capital markets

1. **Simplifying valuation** of foreign assets to improve cross-border investment opportunities

Building trust in capital markets

2. **Supervision:** strengthening/reforming ESMA, EIOPA
3. **Households:** increasing participation

Direct funding towards growth

4. **Reorienting institutional investors** towards European equity markets, including VC and PE
5. **Increase VC funding** through a European Sovereign Fund for example by scaling up the European Investment Fund (EIF)