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Joint statement

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Enhancing EU Capital Markets

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The European Union needs to build stronger and deeper capital markets to finance opportunities such as the green transition or the rise of artificial intelligence, and to promote the resilience of EU economies in the face of financial shocks. Deep and liquid capital markets are essential to ensure long-term growth and to overcome the decline in the growth potential of European economies. Market-based financing encourages investment in new, riskier technologies and in research and development. However, Europe's financial architecture is still predominantly bank-based with largely national flows.

We propose five policy measures to support a growth-oriented CMU agenda.

To simplify the valuation of financial assets, the EU should extend the European Single Access Point (ESAP) initiative to private companies. In addition, improving and harmonizing national insolvency regimes can reduce costs, better allocate resources and encourage cross-border investment.

To enhance the effectiveness of its supervision and to make it more conducive to market integration, the EU should strengthen and reform the European Securities and Markets Authority (ESMA). The redesign of ESMA's governance should include a compact executive board with sole authority over all administrative and supervisory decisions, and its activities should be funded primarily by a levy on the entities and market segments it supervises.

Strengthening supplementary funded pensions could increase the amount of capital raised by institutional investors and invested in equity markets and as a result improve the depth of capital markets. Differences in national supervisory culture and practices may be the main reason for the equity-averse investment choices of insurers in some European countries. Deepening European supervisory integration through a reform of the EIOPA could harmonize supervisory culture.

To foster the development of the EU venture capital (VC) market, the EU and Member States should increase public co-financing. This can be achieved by increasing funding to the European Investment Fund (EIF) and the European Tech Champions Initiative (ETCI).

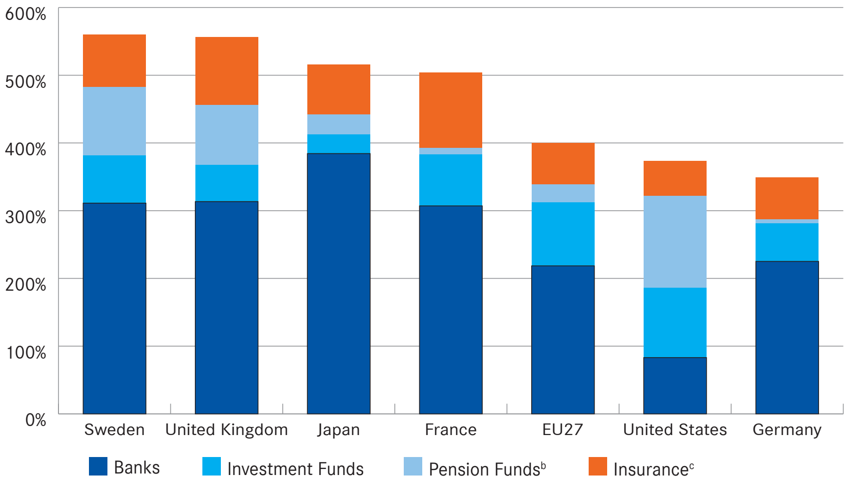
To build household confidence and participation in capital markets, the EU could introduce EU-funded investments accounts for children. This would allow children to experience different financial cycles and understand the long-term low risk and high reward of investing in equities.

Like most advanced economies, the EU is suffering from a long-term decline in growth potential. New opportunities like the green transition or the rise of artificial intelligence have emerged, but our capacity to fund the investments and benefit from these opportunities remains uncertain. Recent crises, like the Great Financial Crisis or the Euro sovereign debt crisis of the mid-2010s, have also highlighted the lack of resilience of our economies in the face of financial shocks. We need to build a stronger, deeper capital market to face these challenges.

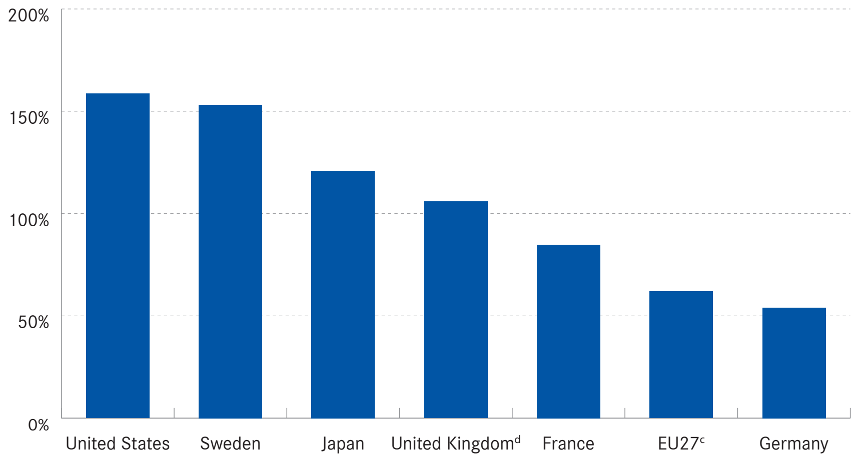
Capital markets allow firms to obtain medium and long term funding directly from investors, including both public and private equity as well as debt funding, without banks and other types of intermediation. Deep and liquid capital markets are essential for providing long-term growth (Beck et al., 2023). They help allocate capital to the most productive and innovative companies. Market-based financing fosters investment in new, riskier technologies and in research and development. The European financial architecture, however, is still predominantly bank-based (Figure 1, a) with small public equity markets (Figure 1, b). Moreover, financial flows remain largely national. Ten years ago, there was a strong push for a Capital Markets Union (CMU), yet with limited progress. We believe now is the time to act on the current momentum and deliver on the Capital Markets Union's potential.

Figure 1. France and Germany have small capital and large banking markets

a. Banking sector in Germany and France of high importance in relation to the capital market (% of GDP)[a]



b. Low market capitalisation on the companies listed in Germany (2019, % of GDP)



[a] In each case, assets in relation to GDP. Average values from 2010 to 2020. [b] EU27 excluding values from Cyprus. [c] EU27 excluding values from Luxembourg. [d] Data for 2018 instead of 2019.
Sources: BoJ, CEIC, ECB, Fed, World Bank, own calculations. © Sachverständigenrat | 23-271-02.

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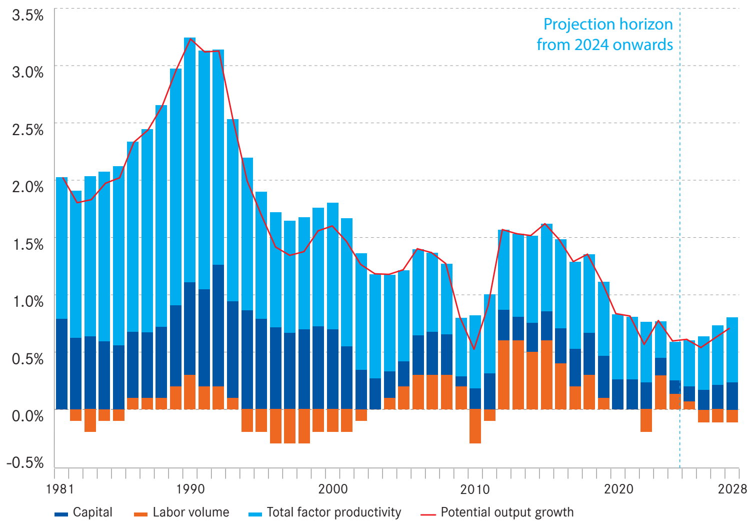
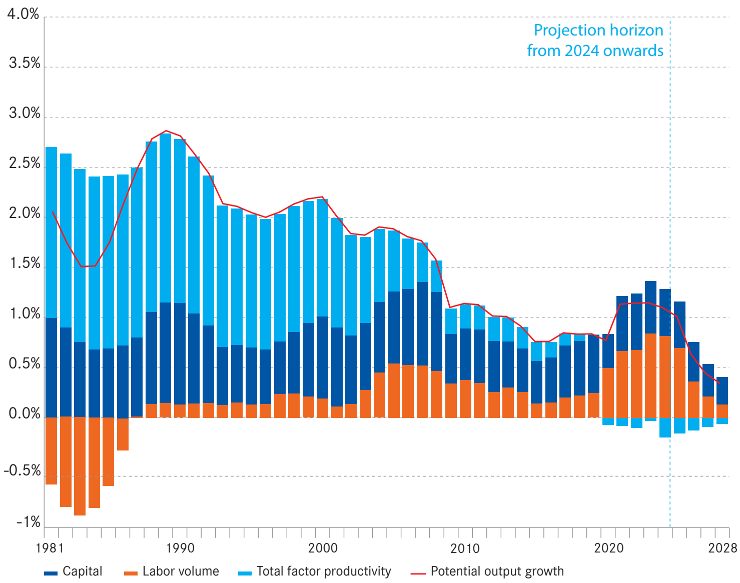
This decade's potential output growth in almost all advanced economies across the EU will lag behind its historical trends according to projections by the European Commission. Specifically, demographic ageing will tighten labour supply and thus depress growth in Germany (Figure 2a) in the coming years, and with some delay in France (Figure 2b). Furthermore, declining growth contributions from total factor productivity (TFP) are particularly alarming, as they point towards a slowdown of technological progress and input factor reallocation to productive enterprises. For instance, in France, TFP contributions to growth are projected to remain negative until 2028, compared to 0.7 - 0.9 percentage points per year in the United States (European Commission, 2024).

Figure 2. Low potential growth in Germany and France

a. Germany



b. France



Source: European Commission. © Sachverständigenrat | 23-458-01.

Existing policy proposals in the CMU space revolve around either fostering the European banking sector or expanding European equity markets. For example, one policy option often evoked to strengthen European banks is to further develop securitization (e.g. DG Trésor, 2024). While it is true that the European market for securitization is anaemic relative to its US counterpart and that securitization can free up banks' balance sheets and lower funding costs for corporates (Nadauld and Weisbach, 2012), it is unlikely to foster growth and investment in innovative, future-oriented firms that are able to pursue strategically important innovation.

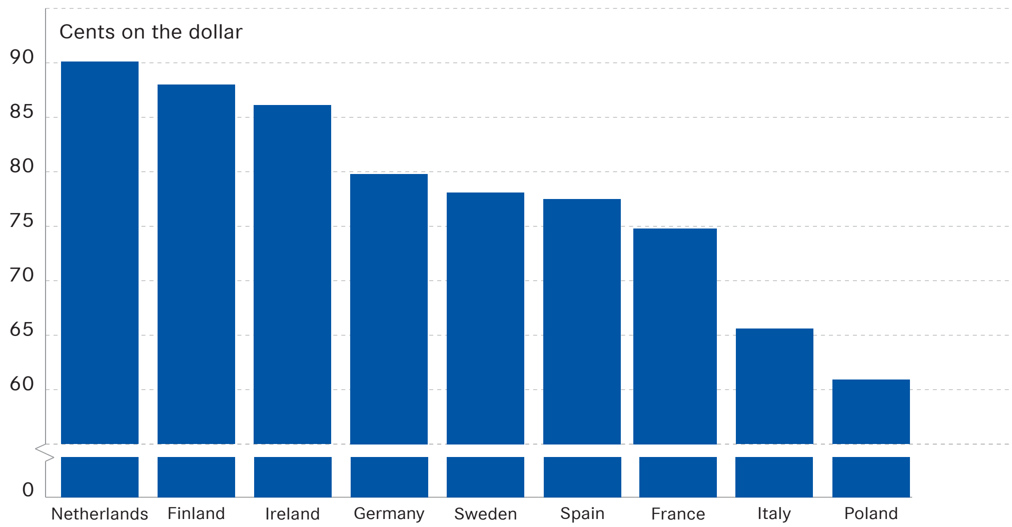
Instead, we propose in this statement a growth-oriented CMU agenda. Innovation-driven growth requires strengthening capital markets rather than expanding the banking sector. Capital markets can finance innovative and risky sectors that rely on intangible assets like patents. Venture Capital is particularly well suited to provide start-ups not only with funds, but also with advice, access to networks and monitoring. The financial architecture in the EU however remains very bank-biased, and banking is still essentially domestic with limited cross-border lending. Strengthening capital markets, especially equity markets, would broaden the funding base of firms. Finally, stronger equity markets will provide a "spare tire" in corporate funding in times of crises improving resilience (Levine et al., 2016). Below are five policy actions to support this growth-oriented CMU agenda.

Simplifying the valuation of foreign assets

A critical area for greater EU-level convergence is the frictionless access to corporate information, including financial and sustainability-related disclosures. A lack of standardised financial reporting across EU countries makes it difficult for investors to build comparable indicators and value private assets in foreign markets. This especially concerns larger SMEs, for which market finance would be an attractive borrowing source. One ongoing initiative that deserves continued attention is the ESAP (European Single Access Point), part of the CMU action plan of 2020, which consists of creating a single access point for financial and non-financial information on European companies and providing direct, centralised access to regulated information. The expected outcomes are to increase transparency, reduce asymmetry of information and open up more sources of financing. It also provides a strategic advantage for SMEs, which will gain visibility from investors. Extending the existing European Single Access Point (ESAP) initiative to private firms would increase transparency and simplify access. EU member states would need to harmonise reporting requirements for private firms.

A second area where harmonisation has the potential to improve transparency is insolvency laws. Bankruptcy codes vary widely across EU countries, making it difficult to assess liquidation values of assets when investing across borders and resulting in large variation in recovery rates. (Figure 3) Improving and harmonising national insolvency regimes in Europe serves several purposes: cost reduction, better allocation of resources to more efficient or innovative companies, encouraging cross-border investment and reinforcing financial stability. The harmonisation of insolvency laws has the potential to deepen private equity markets by establishing larger EU-based funds that invest across borders. Moreover, it may facilitate pan-European securitization, benefitting smaller countries with smaller asset pools.

Figure 3. Significant differences in recovery rates following insolvency across European countries



Note: Recorded as cents on the dollar by secured creditors through reorganization, liquidation or debt enforcement (foreclosure or receivership) proceedings.

Source: World Bank 2019. © Sachverständigenrat | 24-144-01.

As noted above, the European securitization market pales in comparison to the US market, and European banks would benefit from its expansion. However, we question its potential to foster investment in risky growth-oriented companies. These differences are driven by the large US market for residential mortgage backed securities (RMBS). Issuances backed by other forms of collateral in the EU make up around one third the size of the US market without RMBS.

The importance of RMBS in securitization is mainly driven by Government-Sponsored Enterprises (GSE) such as Freddie Mac and Fannie Mae who provide a guarantee for mortgage backed securities by taking on credit risk rather than substantial differences in regulation. Mortgages in the United States are highly standardised and thus suitable for securitization nationwide (Levitin, 2023). European mortgage markets vary significantly with respect to factors such as average maturity, share of variable rate contracts, or public support measures, including interest rate deductions or government guarantees (van Hoenselaar et al., 2021). This, together with differences in tax and insolvency law, make cross-border securitization difficult. Without the establishment of a large government entity providing support and a joint EU-wide housing policy, it seems unlikely that the European securitization market will come close in size to the US market.

In order to grow the European securitization market, new buyers will need to be established. Around 50% of total European securitizations were retained by banks and not sold to investors. While the development of a market for securitizations has the potential to further deepen capital markets in Europe, the impact will be limited without a joint housing policy.

Strengthening European supervision of capital markets

The EU should reinforce its supervisory effectiveness and make it conducive to greater market integration by strengthening and reforming both the European Securities and

Markets Authority (ESMA) and the European Insurance and Occupational Pensions Supervisory Authority (EIOPA). Supervisory fragmentation along national lines has emerged as a bigger obstacle to EU capital markets integration than the remaining regulatory differences. Transformative progress can realistically be achieved in this area to catalyse the next steps of the CMU.

ESMA is the EU's financial markets regulator and supervisor. It does this by promoting supervisory convergence between National Competent Authorities (NCAs) as a "supervisor of supervisor", directly supervising specific market players, such as credit rating agencies, and monitoring financial markets. The transformation of ESMA should include its governance and funding framework. ESMA's Board of Supervisors is currently made up of representatives of the national supervisory authorities in the EU Member States as well as the three other states of the European Economic Area. A reformed set-up could consist of a compact executive board of five or six members that has sole authority over all administrative and supervisory decisions. ESMA's existing Board of Supervisors would remain the decision-making body for rule making. Funding should primarily be provided by a levy on the supervised entities and market segments, with a possible residual role for the EU budget to cover expenses associated with rule making and other non-supervisory activities.

In order to avoid supervisory fragmentation and a related scope for capture, it is important to shy away from creating sub-entities under ESMA that deal with specific tasks. In the past, this has occurred in the case of the supervision of central counterparties established outside of the EU (third-country CCPs) with the so-called CCP Supervisory Committee. Instead, a unitary framework of decision-making should be preserved.

The supervisory model of an empowered ESMA can be a combination of direct and joint supervision. It may be useful to distinguish between purely wholesale supervised entities activities on the one hand, and those with a retail component on the other hand. For wholesale activities, exclusive direct supervision by ESMA, with no role for national authorities, may be preferable. It should include at least all financial market infrastructures that are critical on an EU scale, such as most stock exchanges, central counterparties, and securities depositories, with possibly a complementary role for the ECB on a subset of these. Moreover, it should entail the enforcement of regulatory requirements for which cross-border comparability is paramount, such as the implementation of public financial and sustainability reporting standards. For activities with a retail component, a variation of the joint supervisory team should be considered. Depending on specific mandates, ESMA should be sole supervisor or act as decision-making hub for tasks shared with national authorities.

A multi-location organisational concept would bring ESMA closer to market participants while reaping the benefits of supervisory integration. It would also help mitigate worries that a stronger ESMA would mechanically result in the one-sided favouring of Paris as a wholesale financial centre.

With the expansion of its supervisory scope, ESMA may need to open offices in major centres of market-related activity, including Amsterdam, Brussels, Dublin, Frankfurt, Luxembourg, Milan, Madrid, Stockholm, Vienna, and Warsaw, and perhaps more.

Reorienting institutional investors towards European equity markets

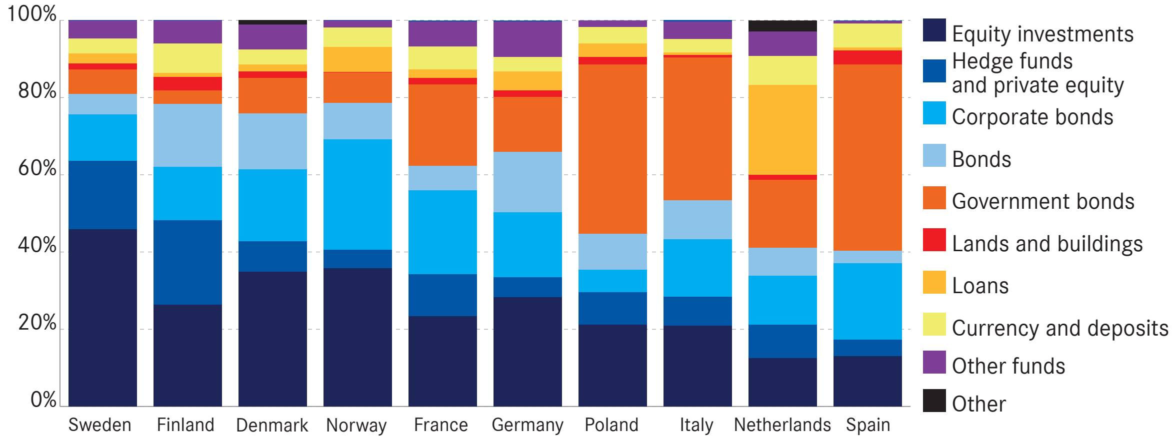
Institutional investors, such as investment funds, insurance companies and pension funds, typically provide depth and liquidity in capital markets. Private pension funds in both France and Germany are small compared to those in Denmark, the Netherlands or Sweden, reflecting large differences in retirement systems. Strengthening supplementary funded pensions could increase the amount of capital collected by pension funds (GCEE, 2023; Nöh et al., 2024). This would create large pools of capital and provide high investment volumes over extended periods. Pension funds could be opened up to all EU citizens. As a result, pension provision would not be directly linked to the workplace and could be maintained when changing jobs within the EU. This would have a positive impact on labour mobility in the EU. Of course, these funds should invest globally and in a broadly diversified manner in order to protect pension assets. As a result, however, large sums could also be invested in the EU, given its economic importance.

In the case of individually attributable shares in pension funds, the broad population would also be brought into contact with capital markets. This would potentially promote the equity culture as a whole. If this were accompanied in the future by auto-enrolment in the pension scheme with an opt-out option, capital market participation would rise sharply. The literature on behavioural finance (e.g. Mitchell and Utkus, 2004) shows that auto-enrolment with an opt-out option can increase participation by 25 to 35 percentage points (Beshears et al., 2006). In the United Kingdom, the introduction of auto-enrolment increased the participation rate in the occupational pension schemes to 86% of all private sector employees (Department for Work & Pensions UK, 2020).

Although regulatory requirements are not likely a major obstacle for investment decisions, they may prevent pension funds from investing directly in stocks and bonds (OECD, 2022). In most countries, assets that are not traded on regulated markets, such as unlisted shares, are subject to stricter limits than listed securities. Furthermore, most countries have bans or caps on investment in private investment funds. Some of these are below 5% of an investor's capital (OECD, 2022). Raising and standardising investment limits for pension funds would be welcome and give them more room to make their own investment decisions. Similar measures have already been successful in the United States. There, the growth of venture capital funds is largely attributed to a change in the regulation of pension funds (ERISA) in 1979, which allowed them to invest in riskier assets for portfolio diversification purposes (Gompers and Lerner, 1999). This played an important role in increasing the total volume of investment in venture capital funds from 424 million US dollars in 1978 to more than 4 billion US dollars in 1986. The share of this money sourced from pension funds grew from 15% to more than 50% over the same period (Gompers and Lerner, 2001).

Insurance companies currently play a more important role in both France and Germany given their larger size. However, the asset allocation of French and German insurance companies is rather conservative. In 2022, around one third of the assets of insurance companies in both countries were invested in equities including private equity, while government and corporate bonds accounted for more than 45% of their assets. (Figure 4)

Figure 4. Asset allocation of insurance companies differs across European countries sharing the same Solvency II regulation, with many tilted towards low risk bonds (Q4 2022)

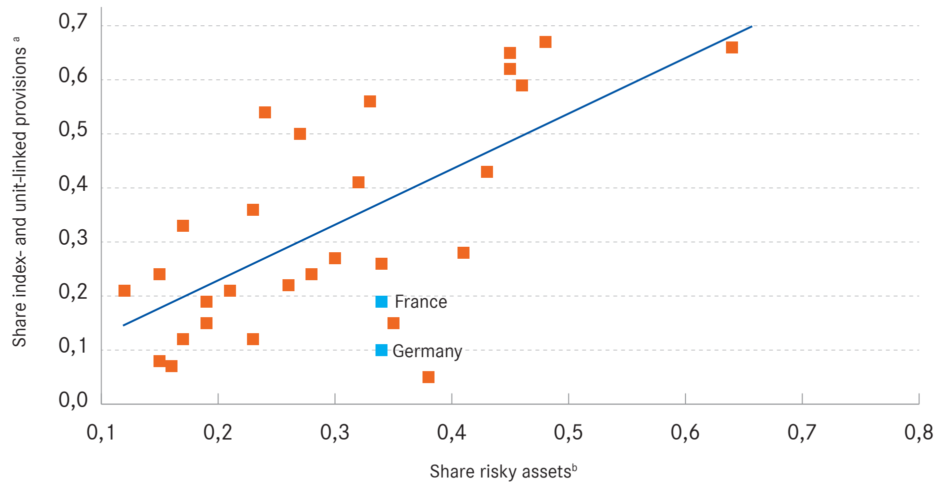


Source: EIOPA, own calculations. © Sachverständigenrat | 24-082-01.

One reason for the equity-averse investment choice is the type of products sold by German, French or Italian life insurance companies. Under traditional life insurance policies, the insured receives a guaranteed return plus a profit participation. The insurance company chooses how to manage assets and bears the financial risk. These portfolios predominantly invest in low-risk fixed-income assets such as government bonds to ensure they meet minimum returns. Index- and unit-linked insurance policies, in contrast, do not offer guaranteed returns but a variety of investment risks and returns to choose from. The policyholder bears the risk of poor investment performance. While provisions for index- and unit-linked life insurance make up 10% to 25% of insurers liabilities in Germany, Italy and France, they make up over 60% of total insurance liabilities in Sweden and Finland. Focusing on the 30 countries in the European Economic Area (EEA), (Figure 5) reveals a clear correlation between the share of riskier assets held by insurance companies and the share of provisions for life insurance without guaranteed returns relative to total liabilities.

A change of product offering might alter insurance companies' choice of investment classes going forward. In the meantime, strengthening supplementary funded pensions without guarantees could increase the amount of capital collected by institutional investors and, in turn, invested in equity markets. At the same time, the equity-averse investment choices of insurers in some European countries are also due to differences in domestic supervisory culture and practices, despite all countries sharing the same Solvency II regulation. This in turn could motivate deepening European supervisory integration via a reform of the European Insurance and Occupational Pension Authority.

Figure 5. Correlation between risky assets and provisions for non-guaranteed life insurance (Q4 2022)



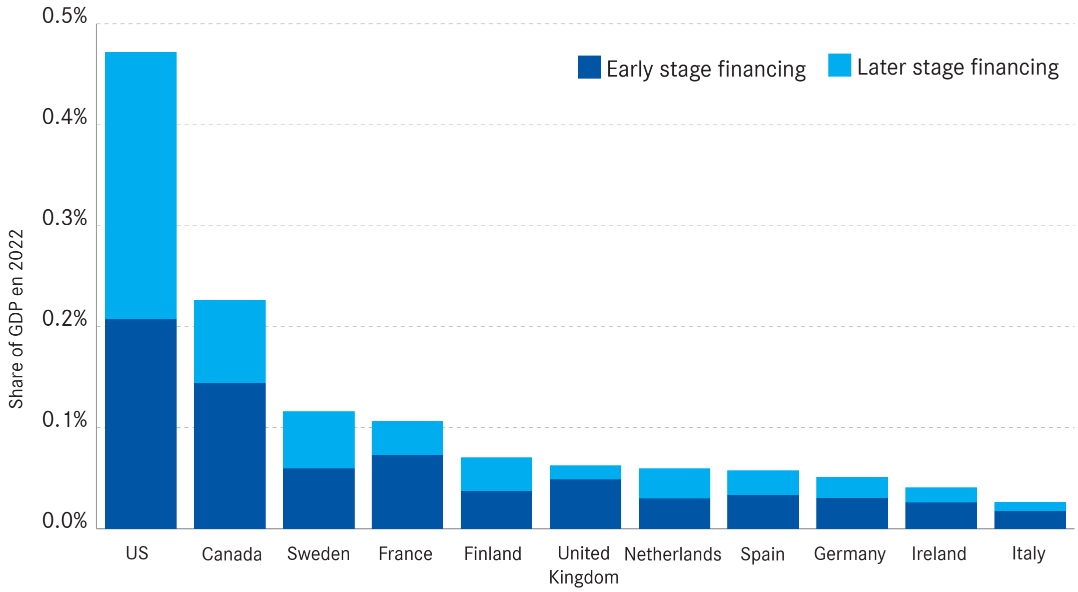
Notes: [a] Share of technical provisions for index-linked and unit-linked life insurance relative to liabilities. [b] Risky assets defined as stocks, hedge funds and private equity funds.
Source: EIOPA, own calculations. © Sachverständigenrat | 24-086-02.

Increase, coordinate and improve the governance of public VC funding at the European level

Despite an increase in VC funding for start-ups across Europe, the overall volume of venture capital investment remains significantly lower compared to the US, with volumes in France and Germany being five and eight times smaller relative to GDP, respectively. (Figure 6, a). Furthermore, the EU continues to face a shortage of large institutional investors that can participate in larger-volume late-stage financing rounds. (Figure 6, b) VC in Europe lacks the beneficial networking effects and positive externalities that come with the geographic concentration of investor expertise, which are vital grounds for a thriving VC ecosystem.

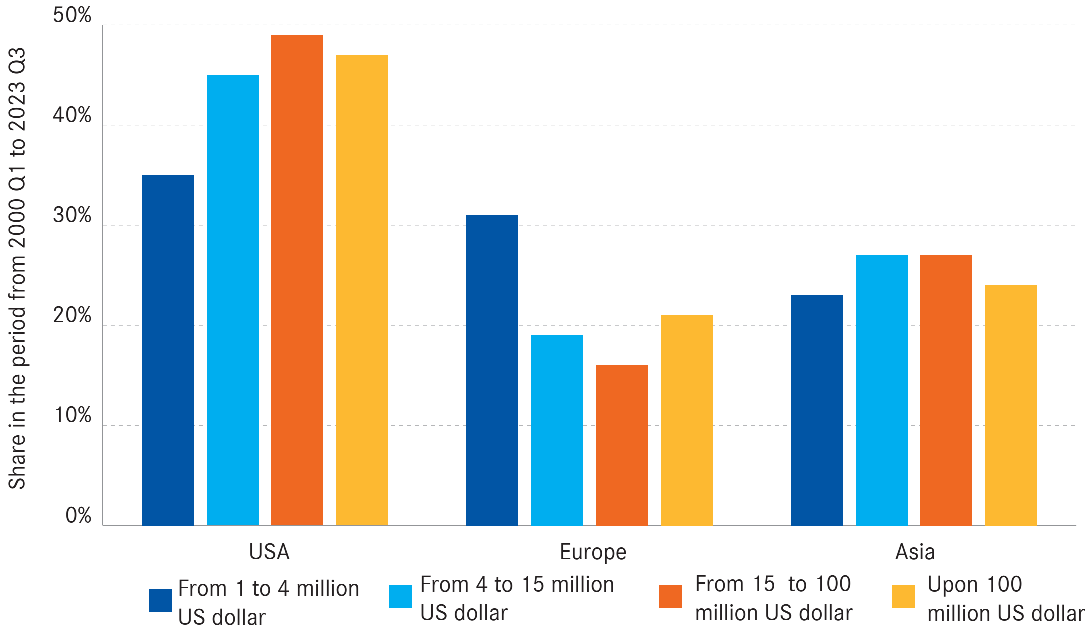
Figure 6. Venture Capital funding still severely lags behind in Europe, especially for late-stage funding

a. Venture Capital financing stronger in North America compared to Europe



Notes: [a] Including seeds, start-up and early stage.
Source: Dealroom.co (2023), OECD, own calculations. © Sachverständigenrat | 24-172-01.

b. European companies realise large financing rounds comparatively rarely



Notes: Share of global deal volume in the period from 2000 Q1 to 2023 Q3 in %. The difference to 100% is distributed across the rest of the world.

Source: Dealroom.co (2023), OECD, own calculations. © Sachverständigenrat | 24-172-01.

The VC segment plays a critical role in driving innovation, particularly in highly developed countries where maintaining control of the innovation frontier in key technologies is crucial. The current landscape of the VC industry is concentrated both financially into large funds and geographically in the US. This imbalance results in a substantial amount of EU-US flips for innovative firms. Out of every 10 acquisitions of European start-ups, 9 are made by American buyers (CAE, 2016), posing significant challenges to Europe's growth and sovereignty.

The relative atrophy of European VC can be attributed to several factors. Capital markets lack depth, and institutional investor participation in these segments is low, thereby limiting financing sources for innovative companies. Europe lacks robust pension funds with a long-term horizon, which play a crucial role in financing start-ups in the US. European institutional investors prefer liquid and secure investments over start-ups to meet households' demand for guaranteed returns. Moreover, the lack of serial entrepreneurs is often cited as a sizable hurdle for EU VC to catch up to the US in terms of performance (Axelson and Martinovic, 2016; EIF, 2023). In the US, successful entrepreneurs reinvest their gains into other businesses, providing seed funding and entrepreneurial expertise, creating a multiplier effect. This is less effective in Europe due to successful entrepreneurs moving abroad.

While the early-stage VC segment has experienced positive growth in recent years, the weakness in the late-stage segment still hinders the ability of companies to scale up effectively. As VC is both crucial and underdeveloped, public co-investment in funds (Limited Partners) can provide significant support and help address market failures such as positive externalities linked to innovation, the pro-cyclical nature of private funding, and the difficulty for the private sector to finance particularly risky segments, especially as Europe still aims to initiate an ecosystem dynamic.

Such state-backed initiatives pose, however, significant risks if going beyond the realm of investment as Limited Partners. If pursuing direct investment choices, the government-backed investment entity doesn't necessarily carry the specific expertise to identify future sectors and companies. It is not inherently better, and likely worse at "picking winners" than the private sector. Moreover, direct public investment can crowd out private actors who compete under different profitability and capital-raising objectives. Another risk is that lobbying groups might influence political decisions and politicians may be tempted to use policies for electoral purposes. Once launched, it is challenging to terminate public initiatives. Finally, the significant involvement of the public sector may be perceived negatively by foreign investors if they see the state-backed fund as the "strong arm" of the government. These factors contribute to the inconsistent long-term success of industrial policies and the accumulation of institutions over time (CAE, 2016).

Instead, it is important to build on initiatives that have proven successful in jump-starting a VC ecosystem. The Israeli Yozma program is among them (Avnimelech et al., 2004; Wonglimpiyarat, 2016). This program successfully leveraged public funds to attract private investments by providing government matching funds. For a typical venture fund of $20 million, the government would contribute

$8 million. Additionally, the program included a buyback option, allowing investors to buy back the government's stake within five years at the initial value plus a preset interest rate of 5-7%. Key features of the Yozma program included a focus on attracting foreign investors rather than relying solely on local financiers. This strategy aimed to bring international investment expertise and a global network of contacts to Israeli entrepreneurs. Moreover, the program maintained a simple administration process to avoid cumbersome procedures and reporting requirements.

To enhance the development of the EU venture capital market, concerted efforts are needed at both the national and European levels. A strategic approach involves increasing government co-financing, particularly targeting the late-stage segment of the market. This initiative should focus on leveraging resources through institutions such as the European Investment Fund (EIF) and the European Tech Champions Initiative (ETCI). These entities play pivotal roles in supporting scale-ups within the technology sector, aligning with broader EU objectives of fostering innovation and economic growth.

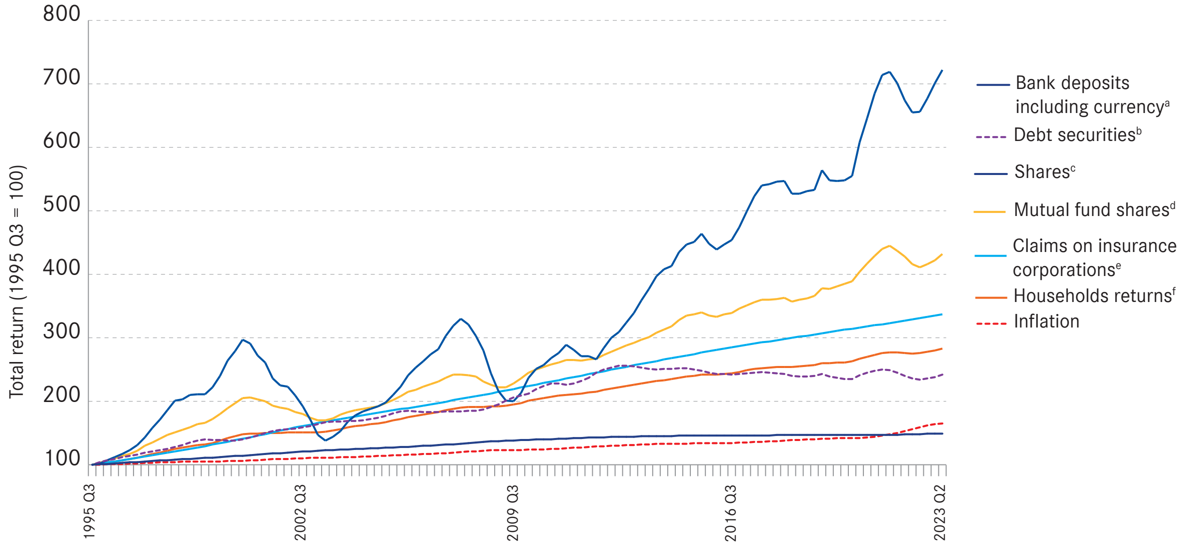
Furthermore, improving the governance and efficiency of public intervention is essential. Emphasising indirect investment via funds (Limited Partner) rather than direct investment allows for greater flexibility and risk management. This approach not only diversifies the portfolio of supported projects but also ensures that investments are guided by the expertise and market knowledge of experienced fund managers.

By adopting these measures, the EU can stimulate private sector participation in VC funding and create an environment for nurturing high-potential tech enterprises. This coordinated approach is essential for positioning Europe as a leader in innovation and entrepreneurship.

Building trust and increasing household participation in capital markets

EU households have relied on bank deposits to hold their savings, despite the low returns over time. German households held almost 42.8% of financial assets as cash and bank deposits in 2022, compared to 31.3% in France and 33.9% in the European Union (Eurostat, OECD). Investments in equities in the form of stocks and other equity account for a much smaller share of total holding in both countries. Returns, in the past 30 years, have been much lower for investments in fixed-income assets, including insurance products or debt securities, compared to portfolios that invest in stocks. For example, the Bundesbank estimates that a German household investment of 100 € in stocks at the end of 1995 would be worth 710 € at the end of 2023 compared to 148 € if held in bank deposits (including currency). (Figure 7) Looking at asset returns from the past 150 years, average annual nominal returns on equity have been over 10%, on par with residential real estate (Jordà et al., 2019). While investing

Figure 7. Returns by asset class in Germany: stocks have the highest returns in the medium and long term



Note: Estimates by Deutsche Bundesbank (2015) on returns of the main asset classes held by German households. [a] Based on harmonised MFI interest rate statistics. [b] Estimated average ex-post returns of debt securities held by private households. [c] Estimated ex-post total return based on established domestic and foreign indices. [d] Estimated based on the price changes of all publicly offered funds subject to reporting requirements in Germany. [e] Estimates using the current return on life insurance policies determined by Assekurata. [f] Return are weighted using asset class shares of German households.

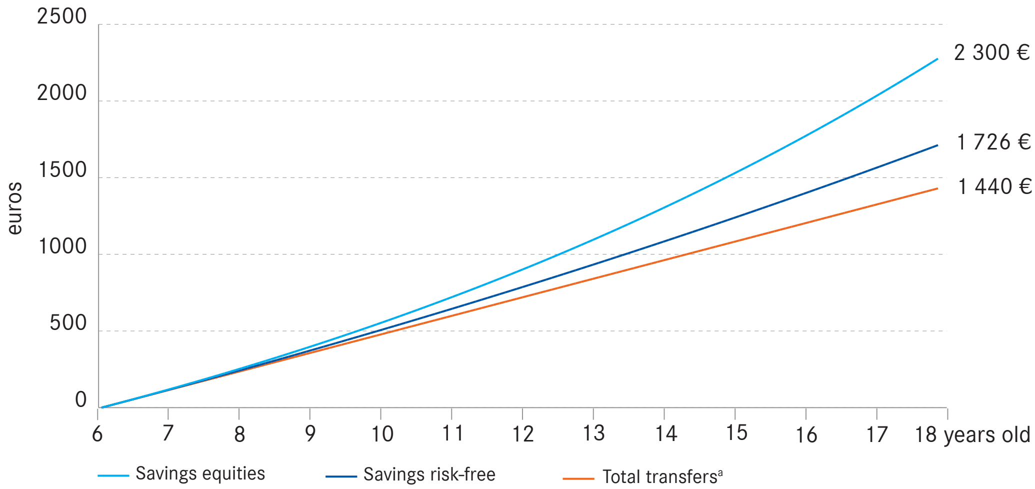
Source: Deutsche Bundesbank. © Sachverständigenrat | 24-165-01.

in residential housing would achieve similar returns to equities with a lower volatility, it is much more difficult to invest in and diversify. Yet, stock-market participation by all households in both France and Germany remains low, at an estimated 17% (AMF, 2022) and 18% (Deutsches Aktieninstitut, 2023).

In order to increase capital-market participation and build trust in capital markets, we propose implementing EU-funded investment accounts for children. (Figure 8) Automatically depositing, for example, 10 € per month and child from age 6 to 18 in the form of a fund share would enable children to learn from long-term investing. They would experience different financial cycles and understand the long-term low risk and high returns of investment in equities. Parents can be given the opportunity to match the savings amount, for example, from their monthly child allowance (e.g., Kindergeld in Germany). A similar scheme was successfully introduced in Israel in 2017. This measure will not significantly change saving behaviour in the short term, but can be effective in changing habits in the long run.

It will be crucial to select a low-fee and broadly diversified equity fund as the mandatory or at least default investment product. Parents might be given the opportunity to select an investment fund based on different risk categories, for example with different equity shares (e.g. 50%, 80% or 100%), though the experience from other countries shows that these choices tend to favour financially more literate household (who choose the higher share given their understanding of the diversification mechanism). Investment options should not include bank savings or insurance products. A template for selecting appropriate funds could be modelled on the Swedish Fund Selection Agency, which procures investment funds for the Swedish Premium Pension System with very low management fees. Children could then access funds once they turn 18 or continue to use the investment account for long-term savings.

Figure 8. Returns by asset class in Germany: stocks have the highest returns in the medium and long term



Note: Assumed annualized rate of return for 100% investment in global equities is 7.6% and for the risk-free investment it is 3%, based on analysis in Bucher-Koenen et al. (2019). Transfers are €10 per month from the age of 6 to 18.

Source: own calculations.

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