bankenverband

Position paper

of the Association of German Banks on deepening the capital markets

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Summary

Deep and efficient EU financial markets are vital for the financing of the EU's upcoming challenges – in particular, the transformation or transition of our economy. This realisation, and as a result, the goal of completing EU capital markets union is gaining increasing support. However, current political measures – and the development of the market – remain insufficient. Given that the 2024 European Parliament election is taking place and a new EU Commission will be formed this year, it is vital that the EU continues to press ahead tenaciously with this project.

The Association of German Banks has supported capital markets union from the very beginning. This position paper first sets out the guidelines for further progress that are important from the private banks' perspective – in particular, the right mindset that all measures have a stronger focus on developing the competitiveness of the markets and a greater degree of pragmatism going forward. Our paper also highlights the link between the stability, integrity and competitiveness of the markets. The paper then presents details of the important measures that are appropriate for strengthening the EU capital markets.

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1. Introduction

- All stakeholders agree that financing the transformation of our economy to a sustainable and digital economy will require enormous sums of private capital. It is also clear that this capital cannot be made available solely through bank loans or public money and that the capital markets in the EU will also have to play a key role here.
- In March 2023, the heads of five EU institutions – the Commission, the Council, the ECB, the EIB and the Eurogroup – underlined the importance of EU capital markets union and called for rapid and substantial progress. More recently, in March 2024, the ministers of finance of the Eurogroup submitted a proposal with 13 measures to drive the project forward.
- The strengthening and competitiveness of the EU capital markets has long been an important goal for the Association of German Banks. The key element in achieving this will be a regulatory framework that makes the capital markets not only secure and efficient, but also attractive and liquid. This would take appropriate account of and harmonise the interests of issuers, investors and service providers. From the private banks' perspective, the following three aspects are key in achieving this:

A) Mindset

- An efficient and competitive capital market is needed for the transformation of the economy. If you want an EU capital market of this kind, then you must also be in favour of the globally valid logic and functionality of capital markets.
- This means accepting the generally applicable rules inherent to the market. There is a basic tension between returns, security and liquidity. For example, greater security does not automatically mean greater returns. And this could not be prescribed through legislation either. The "magic triangle" of capital market investment absolutely must be taken into account when drafting the regulatory requirements and frameworks.
- The capital market comprises a variety of participants and products. The products go through different phases (primary market, secondary market and custody/administration/asset servicing). The different market participants, including investors, issuers, their service providers and various market infrastructures, all have different tasks. It is important to tailor the regulation to take account of these differences.
- A "capital-market mindset" is needed to create rules that ensure an attractive, efficient, secure and internationally competitive capital market.

B) Liquidity

- It is important that the capital market is deep and liquid. Investors are generally looking for profitable investments. This means they are looking for products from stable issuers with strong earnings and development potential. The environment, i.e. the market, should be secure, efficient and, above all, liquid. This is the only way to ensure that investors are able to buy their investments at a fair price and sell them again at any time.

- To be efficient but also attractive as a capital market, the regulation must enable a high level of liquidity, in particular. This is the best way to promote the global competitiveness of the capital market and attract the required capital.

C) Pragmatism

- The transformation of the economy will not wait until an ideal EU capital market – or capital markets union – has been created. It is unrealistic to expect that full harmonisation of important legal areas, such as civil law or tax law for example, can be completed in the short term, this is also not necessary.
- In order to create or promote attractive, competitive EU capital markets, those regulations in the EU that are really relevant for the capital market should therefore be targeted for harmonisation. By taking a pragmatic approach, among other things through targeted partial harmonisation, there are many small steps that can take us in the right direction.
- In the following, we review the current state of play and propose guidelines and measures to achieve efficient and feasible progress in the short term to deepen EU capital markets and ensure their global competitiveness.

2. Current status and need for action: the transformation needs capital

2.1 Current status

- Europe needs a deeper capital market in order to tackle and finance its greatest challenges – the green and digital transformation and strengthening its resilience.
- In recent decades, many different measures have been implemented or initiated in order to create uniform and efficient capital markets in the European Union (EU). There is, for example, standardised EU-wide regulation for financial market infrastructures and securities trading (MiFID II/MiFIR, EMIR, CSDR).
- However, the potential of the capital market in Europe has not yet been fully realised and is at different stages of development across the individual member states. The situation has, in fact, worsened due to Brexit. Although cross-border activities between the EU member states are certainly possible – it still has a long way to go compared to the rest of the single market. Overall, capital market activity in the EU is considerably less deep than in other comparable economic regions.
- The global attractiveness and competitiveness of EU capital markets must also be improved in order to attract both investors and borrowers from inside and outside the EU.
- In the EU Commission's action plans on capital markets union from 2015 to 2020, a series of measures were identified, which were aimed at further developing the market. The Commission continued to implement these plans with corresponding draft legislation, but, in our view, not always with a capital market mindset: they include a high level of bureaucracy and insufficient attention to global competitiveness.
- There also seemed to be no clear vision about capital markets union and no appropriate recognition of the role of capital providers (investors) and borrowers (issuers) as well as the role of banks and other financial market service providers as key market players acting as intermediaries between the two sides.
- Instead of standardising products through legislation, there should be a greater focus on the principles of markets and competition. While protecting investors and stability stands front and centre, no consideration was given to the competitiveness of the EU capital market.
- Ultimately, the European harmonisation of legal standards in general terms was described as progress, but, at the same time, progress was only made in areas where the political interests allowed it to – instead of targeting and consistently harmonising what is really relevant to the capital market.
- It is, however, not the legislation that is key. The fate and/or deepening of the EU capital markets remains a fundamental question of social will and of culture. Products are traded on the capital market. Investing capital offers opportunities – and is usually associated with risk. In general, there is no risk culture in the EU – and the required financial knowledge is also lacking. Savings accounts and government pensions are well established – but as a rule, it is an individual's own investments or private retirement provision that give them an understanding of the capital market and can open up further opportunities. In fact, the current government is discouraging retail investors from investing in the capital market.

- Market participants are prepared to help develop flexible regulations to further harmonise processes in the EU by developing market standards. The Giovannini barriers were identified and measures were implemented to overcome them more than 20 years ago. These market standards still work well and efficiently today. Opportunities such as these should continue to be utilised and expanded in the EU.

2.2 Need for action: competitive EU capital markets

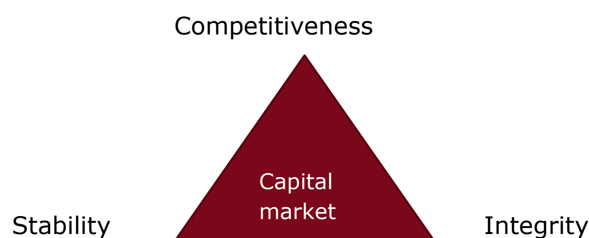
- Energy transition, decarbonisation, digitalisation, diversification of economic activities, innovation, start-ups, growth and succession not only require significant amounts of additional capital, but sometimes also different risk profiles and maturities than was previously the case. Without capital markets, it will not be possible to finance the green deal, the digital transformation and achieve greater resilience.
- In order to achieve these goals that the EU has set itself, in order to strengthen the European economic model and to allow citizens in the EU to participate more in this growth, the potential of the capital market must be unleashed. This applies to both the financing power from Europe as well as the global competitiveness of the market and its attractiveness to foreign investors. Good regulatory EU frameworks for capital investment should also be accompanied by developments at the national level. One example of this might be promoting capital market-based retirement provision.
- Not least, a deep EU capital market could strengthen Europe’s sovereignty by countering, at least in the future, one-sided global dependencies in interest rate and currency policy and increasing the EU’s influence on international rule-setting. The EU capital market is therefore strategically important for Europe.

3. Target vision: deep and competitive capital markets

- A deepening of the capital market in the EU cannot be designed from scratch on a blank piece of paper, it must be **developed from what already exists**: A strong single market with nearly 450 million inhabitants, but with different legal systems and financial markets and a less developed capital market overall – especially since the UK's withdrawal from the EU. In order to further develop what is currently in place, there must be a coherent target vision.

3.1 Triad of stability, integrity and competitiveness

- The strengthening of EU capital markets – EU capital markets union – will require a **triad of stability, integrity and competitiveness**. All three principles are essential:
  - **Stability** means economic sustainability – minor crises are possible but are generally recognised earlier in a system with a strong capital market and are resolved within the system.
  - **Integrity** also means sustainability – the interests of all participants are protected and investor protection, in particular, ensures that all stakeholders can and want to continue to take part.
  - **Competitiveness** is essential to ensure that market performance meets the expectations of participants, and the EU market can hold its own in global competition. And, in turn, market liquidity is a requirement for competitiveness. It is not only issuers that require liquidity in the market in order to raise capital; liquidity is also a key investment criterion for investors, in particular. A lack of liquidity - i.e. the ability to buy or sell assets at a fair price, at any time and at short notice – keeps investors away.
- The three principles complement one another. Sometimes there are conflicting objectives, for example between protection for investors and competitiveness, which then need to be resolved. At the same time, the principles are mutually dependent. Without stability, no capital market is competitive, but without (global) competitiveness, it cannot be stable in the long term either.
- Triad:



- It is imperative for the further development of the EU capital market that competitiveness is used as a guiding principle for revising existing EU rules and for drafting new regulations. As in other areas of EU regulation, the capital market requires as much regulation as is necessary – but as little as possible.

3.2 Europeanising legislation

- The member states of the EU have each formed different legal areas, which have developed over a long period of time. In some areas, this development stands in the way of establishing a deep, common and above all efficient market – and should be remedied. However, harmonisation is not an end in itself. We would not achieve a deepening of the market by **Europeanising every law**. The rest of the EU single market also works perfectly well without full harmonisation. The key thing here is that the advantages of legal harmonisation must not outweigh the disadvantages. The EU can and should contribute to overcoming fragmentation by harmonising important aspects in certain areas of law that are also relevant to the capital market (such as tax, insolvency or supervisory law).
- Market participants basically require efficient and reliable legal foundations throughout the EU. With these in place, they can then develop those solutions and products that meet the demands of the economy and prove to be competitive.

3.3 The role of banks

- Capital market regulation should equitably take account of the interests of the issuers, on the one hand, and those of the investors, on the other. This is the only way to ensure stability and efficiency of the capital markets. Investors and issuers are generally customers of banks. **Banks therefore play a key role in the capital market:** They bring together the issuers that are looking for capital and the investors that are looking to provide the capital. Capital markets union therefore needs strong issuers, strong investors and strong banks.
- Competitive capital markets are linked to and dependent on an efficient banking market. This is also why the capital market and the banking market must be aligned and capital market and banking regulation must be harmonised.
- One example of how the banking and capital markets need to be harmonised is in relation to the securitisation instrument. Even in a flourishing capital market, most types of financing, for example for small and medium-sized enterprises, is done best through bank loans. However, securitisation allows parts of the loan assets to be passed on to interested investors, thereby allowing the market to participate in the financing. This gives investors access to a segment that would otherwise be virtually inaccessible to them (directly) – and banks can free up capacity to meet additional demand for credit.

4. Key measures

4.1 Competitiveness as a benchmark

- The EU capital market is one of the most strictly regulated capital markets in the world. This has its advantages, but also leads to bureaucratic hurdles and disadvantages for liquidity, efficiency and competitiveness.
- In order to strengthen the capital markets in the EU, the focus should be placed on its competitiveness. This applies to new regulations as well as to revisions to existing legislation. A review and amendment of capital market regulation, including Level 2 and Level 3, would be an important measure for the Commission.
- Of course, competitiveness and the strength of the capital market are not ends in themselves – they must serve to finance the economy and make it easier for people to participate in the growth.
- Examples of appropriate revisions to existing capital market law with the aim of breaking down administrative hurdles and increasing the attractiveness of the market include the current EU Listing Act and the streamlining of the regime for systematic internalisers following the MiFIR review. These examples are a step in the right direction for the EU. But this can only be the start. Further steps that always take international standards into account are necessary: For example, the Commission's proposal for standardising the structure and format of prospectuses does not correspond to international standards, which means that a separate prospectus would be needed to address investors in the US market at considerable additional cost.

4.2 Legislation and regulation

- For some time now, there have been calls for a whole range of different measures to increase the competitiveness of EU markets as a whole. These specific and sometimes very technical legislative and regulatory measures or reforms should be carefully reviewed and systematically implemented.

4.2.1 Improving the securitisation process

- Banks provide businesses in the EU with reliable and proven financing in the form of loans. However, in the medium term, banks will not be able to provide the required volumes to finance the transformation without help from the capital markets. Securitisations are a suitable instrument for passing on granted corporate loans to the capital market and thereby enabling the relevant investors to participate in the financing of the economy. Using securitisations, some of the capital and liquidity tied up on banks' balance sheets can be freed up, allowing banks to provide more financing for businesses.
- The political will to strengthen the securitisation market is there. It is widely recognised that the securitisation instrument acts as a bridge between bank-based corporate financing and

the capital market. However, turning this political will into concrete proposals for action has not yet materialised.

- The aim of the measures should be to optimise the production line for securitisations. It should be possible to process securitisation transactions as smoothly as possible and without delays. The requirements should be amended so that it is possible to enter the market without having to overcome major hurdles. The attractiveness of this instrument compared to instruments with a similar risk profile must be restored. In general terms, this instrument must be made fit for the challenges of the future.
- The expected demand for financing from businesses will be huge. Securitisation is a key management tool for efficient capital allocation. It should be more flexible and more widely applicable. To achieve this, the framework conditions would need to be improved. And to do this requires taking a holistic view of the securitisation process because there is no single way of giving the securitisation market a strong new impetus. Suitable starting points might include tackling known regulatory hurdles (homogeneity requirement, conservative risk assessment), which will need to be adjusted, and greater standardisation to reduce transaction costs through the market itself or by the legislator. Also, amendments could be made to the legal framework (e.g. simplifying cross-border securitisations) and the EU could adopt the directive on the third-party effect of assignments of receivables, which has been in the pipeline for some time now. Furthermore, greater reliability in the supervisory review process would contribute to improving the securitisation process in general.
- Further details are listed in our current position paper on securitisations.

4.2.2 Clearing and derivate markets

- Hedging risks on the capital market is essential to protect businesses from fluctuations in interest or currency rates, for example. Functioning and efficient clearing and derivative markets are crucial for the stability of the financial system.
- Even though the importance of EU clearing houses has grown, the most important international clearing markets are still in London and the US. As things currently stand, only around one quarter of the liquidity in the euro clearing market is provided by EU market participants. The legislative measures to strengthen clearing in the EU (EMIR 3.0) are only going to be able to change this in the long term. In order to strengthen the clearing market in the EU, the attractiveness of and the liquidity in the EU market must be increased and the legal and regulatory frameworks need to be modernised and strengthened, particularly when it comes to the key infrastructures and the legal basis for risk management (see below for details on the Financial Collateral Directive (FCD) and the Settlement Finality Directive (SFD)). In order to achieve a sustainable strengthening, the EU clearing markets need to be made even more competitive internationally. At the same time, it is imperative that European institutions and capital market participants retain access to international capital and clearing markets.

4.2.3 Insolvency law – targeted partial harmonisation

- National insolvency laws are closely interwoven with other areas of law (from corporate law, social and labour law to contract and tax law) and have evolved over time at the respective member state level. The insolvency legislation can therefore not be harmonised independently of other areas of the laws of the members states.
- Full harmonisation of all these legal areas is not realistic in the short term and the European Union may not have the legislative competence in all these legal areas – however, such full harmonisation is not required to integrate and to strengthen the EU capital market.
- The approaches currently being pursued by the EU Commission to harmonise insolvency law have – up to now – primarily addressed insolvency law aspects that are of limited relevance for the capital markets. Thus, the focus should be shifted to a more targeted harmonisation of insolvency law aspects which directly strengthen the efficiency of the capital markets. The background to this consideration is that corporate insolvency represents a typical investment risk and it is therefore of secondary importance to investors which law applies if their investment is lost. Much more important, however, is the potential insolvency of their counterparty, i.e. default of another market participant.
- Given the key role that market infrastructures, such as central securities depositories (CSDs) and central counterparties (CCPs), financial collateral and netting agreements, play as risk mitigation instruments in the capital market, revising the two EU directives on financial collateral arrangements (Financial Collateral Directive, FCD) and finality (Settlement Finality Directive, SFD) is therefore the right way forward.
- If EU-wide harmonisation at the critical interfaces of contract and insolvency law for the legal relationships between regulated professional market participants and the capital market infrastructures they use can be further advanced, this will immediately and visibly strengthen the performance and international attractiveness of the European capital market.
- The FCD and SFD, which have been in place for over 20 years but have not been thoroughly modernised since, should be adjusted to the developments in the capital markets and systematically expanded. Currently, they do not take adequate account of the increased importance of CCP clearing or the development of the pan-European settlement platform. Both directives continue to be key building blocks of the current architecture of the European regulatory framework for capital markets business.

4.2.4 Tax law – targeted partial harmonisation

- Full harmonisation in the area of tax law is also neither realistic nor completely necessary – but targeted partial harmonisation would be all the more important.
- **Value added tax (VAT) on financial services:** As services provided by banks and similar financial institutions are, generally speaking, exempt from VAT, they cannot deduct the VAT on their incoming services and therefore VAT does not have a neutral effect on them, contrary to the neutrality principle. As a result, this non-deductible input tax on purchased services becomes a cost burden for the banks, which is subsequently passed on to customers. This

"hidden VAT" often undermines the development of efficient and economically sound business structures. This is because the additional VAT burden usually cancels out any desired synergy effects – even in the context of digitalisation. However, this development would be essential for ensuring the global competitiveness of European banks and also for the ability of banks to finance the transformation.

- On top of which, there is a lack of legal security due to the absence of a definition for the term financial services. The list of tax-exempt financial services in the directive on the harmonisation of the laws of the member states relating to VAT, which forms the legal basis for national VAT laws, is too restrictive and no longer reflects today's realities. Although the financial services sector has been subject to constant change since the introduction of the directive in May 1977 and is still subject to change, particularly from increasing digitalisation, the tax-exemption regulation for financial services in the VAT system directive has not undergone a fundamental overhaul. There are many issues that still need to be clarified by the European Court of Justice. The legal uncertainty as to whether a financial service is exempt of or subject to VAT has a direct impact on banks' business relationships with their corporate and retail clients, be it in relation to financing, capital investment or asset management.
- Revising the current rules for charging VAT on financial services and adapting them to today's realities would improve the legal certainty and neutrality of VAT for banks, remove obstacles for economically efficient business models and prevent all kinds of distortions of competition, thus benefitting customers and the economy. As well as strengthening the international competitiveness of European banks, this would also create a level playing field for competition within Europe.
- In this context, it should also be ensured that different providers of financial services (e.g. banks and fintechs) are treated equally in terms of VAT in order to prevent distortions of competition within the financial services sector.
- The proposals put forward by the EU Commission back in 2007 to modernise VAT on financial services should be looked at again as a matter of urgency and the EU should press ahead with implementing the findings of the study commissioned in 2019 and the consultation carried out in 2021.
- **Process for refunding withholding taxes:** Complex withholding tax processes for cross-border income from securities are a major obstacle to completing the single market for capital. A reform of the withholding tax procedures would be a key element in mobilising capital and investment income and would bolster support for integrating European capital markets.
- Investors must currently apply for the withheld tax to be refunded. This application is submitted to the tax authority of the source country by the entity subject to the withholding tax and must include a preliminary certificate confirming the residency for tax purposes of each investor. This procedure means that investors must often wait a very long time for their refund – a refund is even effectively impossible in some member states. The money is therefore tied up (in the short term) and is not available for further investment. Due to the complexity and costs of the refund procedure, investors often simply don't bother to apply

even though they are legally entitled to the refund. As a result, they end up paying the highest rate of withholding tax thus making cross-border investments unattractive.

- Proposals submitted by the EU Commission in 2023 in a draft directive entitled 'FASTER', on faster and more secure procedures for refunding excess withholding tax on dividends are basically the right approach. However, in order to strengthen the EU capital markets, there are eight simplifications and practical changes that need to be made and disproportionate obligations for intermediaries that need to be removed.
- For it to be successful, there should be a common and standardised system for withholding taxes, in particular for refunds, that allows financial intermediaries to set prices for their services and not introduce disproportionate liability regimes. Furthermore, the system must prevent different interpretations among member states.

4.2.5 Retail Investment Strategy (RIS)

- As mentioned above, the risk culture and required financial knowledge are generally weak in the EU. According to the EU Commission, in 2017, EU households held only 17 percent of their wealth in financial instruments (shares, bonds, investment funds and derivatives), while in the US this figure was around 43 percent. The aim of the EU Commission's Retail Investment Strategy is to ensure retail investors can take full advantage of the capital markets. The strategy not only looks to improve financial literacy but also to introduce numerous detailed requirements for securities service providers.
- However, this multitude of detailed specifications is not suitable for achieving the stated aims. The bureaucracy introduced with MiFID II will not only be retained, but considerably increased. The sale of securities will not be made easier, but more difficult. In addition, there is also the threat of a significantly reduced range of products, with the loss of bespoke investment solutions and options for risk diversification. This additional regulation will lead to a high level of implementation complexity and ultimately to high costs for citizens that want to invest their money on the capital market. This will make the capital market unattractive for them.
- However, the aim of the Retail Investment Strategy is to encourage more retail investors to invest on the capital markets. Investors should be able to build assets without unnecessary complications, whilst enjoying a high degree of investor protection. At the same time, more invested private capital from citizens will be used to achieve the goal of the green and digital transformation.
- Investors must have the freedom to decide for themselves how they want to pay for their services. Legislative interventions into pricing or fee structures will definitely not revitalise the capital market, which functions according to economic principles. Financial instruments must offer good value for money – but this goal cannot be achieved with excessive regulation. And free or inexpensive products are not automatically better or more suitable for investors. Depending on the risk appetite and risk acceptability of the investor, it makes sense to offer certain quality features that minimise risk, for example, and therefore require corresponding pricing. It is also important not to overburden investors with obligatory but unnecessary

processes with investment advice and with non-advised services as well as avoiding information overload.

- At the same time, measures that incentivise general capital market-funded asset building and funded retirement provision would be beneficial.
- In addition to EU regulation, measures at the member state level would also be essential. These may vary from member state to member state. In the case of Germany, for example, it would be particularly important to focus more on developing elements of private retirement provision.

4.3 Process of setting legislation and regulation

- As well as making very targeted changes to key areas of material EU law, it would also make sense to make changes to the underlying EU legislative process. It is currently too cumbersome, even where existing laws are only being revised.
- In order not to hinder markets developing rapidly and to ensure that legislation can be implemented more quickly, legislation at level 1 (political legislation) should generally only set targets and avoid detail, complexity and granularity as much as possible. Efficiency (cost-benefit ratio) as well as flexibility of market participants and supervision must be the guiding principles when choosing the right way or means to achieve the objective.
- The approach to measures at levels 2 and 3 should also be for principles-based requirements as much as possible and should avoid complex, detailed specifications.
- Competitiveness must also be the benchmark for legislation at the implementation level (levels 2 and 3) and therefore for the European supervisory authorities in their function as legislators (not as supervisors). As a result, among several possible measures that could be used to achieve a regulatory objective, the one that strengthens the competitiveness of EU capital markets the most – or weakens it the least – should always be chosen.

4.4 Europeanisation and coherence of supervision

- In addition to harmonising capital-market regulation and legislation across the EU in those areas where it makes sense, supervision of compliance with these rules also plays a significant role in the development and harmonisation of capital markets in the EU.
- As well as the national supervisory authorities, there are also the European authorities whose responsibilities are divided between them.
- The same applies to supervision (as to regulation): Europeanisation, harmonisation and coherence should be sought where this makes sense for the development of the capital markets and ultimately for the financing of the economy.
- It does not make sense if EU requirements are applied or interpreted differently or if an unequal level of control by national supervisory authorities leads to a different level of quality and protection and, as a result, to regulatory arbitrage. The fact is that the rules are not strictly supervised in some member states. However, the solution on this point cannot be to impose increasingly stricter requirements at EU level, only for them not to be complied with

uniformly everywhere. How EU requirements are applied and monitored must be standardised across the EU. In doing so, it will certainly be possible to take account of market-specific features and the different legal structures in the member states.

- As with the legislation, not all supervision needs to be transferred fully to EU authorities. Partial solutions are the right way to go here, too. Distinctions should be made according to the degree of development of the respective market segment or according to product and activity (e.g. market infrastructures such as CCPs, CSDs, trading venues, regulated markets, securitisations, funds, prospectuses, trade settlement, etc.).