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DRAGHI REPORT:
SUMMARY OF RECOMMENDATIONS ON CMU AND FINANCIAL SERVICES

Introduction

This note summarises, on four pages, the recommendations in the Draghi report,[1] published on 9 September 2024, on Capital Markets Union (CMU) and financial services. The report of about 400 pages explores strategic actions for growth in the EU. Financial services are addressed as part of the 10 sectoral policies and 5 horizontal policies, and are included in some specifically dedicated chapters, which build on previous official sector reports published this year (eg by the ECB, ESMA and Letta).

CMU and financial services

1 The objective of the report is to propose a growth strategy for Europe. To meet this objective, the report estimates that a minimum annual additional investment of €750 to €800 billion is needed.

2 The report argues that a key question that arises is how the EU should finance the substantial investment needs that transforming the economy will entail. Two key conclusions can be drawn for the EU. First, while Europe must advance with its CMU, the private sector will not be able to bear the lion's share of financing investment without public sector support. Second, the more willing the EU is to reform itself to generate an increase in productivity, the more fiscal space will increase, and the easier it will be for the public sector to provide this support.

3 The report states that a key reason for less efficient financial intermediation in Europe is that capital markets remain fragmented and flows of savings into capital markets are lower. Europe is faced with an unprecedented need to raise investment at both massive scale and rapid speed. The key objectives in the report for the EU and concrete policy proposals relating to CMU and financial services are as follows:

Reducing capital market fragmentation

4 The first key objective is to reduce fragmentation of the Single Market by removing barriers for innovation, company growth and large infrastructure projects in Europe, thereby increasing demand for risk capital and for higher volumes of finance through capital markets.

5 To help achieve this objective, the report proposes to introduce a European Security Exchange Commission. ESMA should transition from a body that coordinates national regulators into the single common regulator for all EU security markets, similar to the US SEC. For this purpose, ESMA should be entrusted with exclusive supervision over:

[1] EU competitiveness: Looking ahead - European Commission (europa.eu), 9 September 2024.

(i) large multinational issuers; (ii) major regulated markets with trading platforms in various jurisdictions; and (iii) CCPs. ESMA's governance and decision-making processes should be modified along similar lines as those of the ECB Governing Council so as to detach them as far as possible from the national interests of EU Member States. To overcome likely opposition, the EU regulator will have to share supervision with national regulators and elicit their cooperation along lines similar to the ESM with national central banks in euro area banking supervision.

6 The report also proposes to reduce regulatory fragmentation to deepen the CMU:

- Harmonising insolvency frameworks will be critical to remove fragmentation created by differing creditor hierarchies, while the EU should continue to eliminate taxation obstacles to cross-border investing.

- These measures would in turn make it easier to foster centralisation in clearing and settlement. Ultimately, the EU should aim to create a single CCP and a single CSD for all securities trades, starting by consolidating the largest CCPs and CSDs.

7 The report also argues that the EU must better channel households' savings to productive investments. The easiest and most efficient way to do so is via long-term saving products (pensions). To increase the flow of funds into capital markets, the EU should encourage retail investors through the offer of second pillar pension schemes, replicating the successful examples of some EU Member States.

8 Finally, the report recommends that the Commission should assess whether further changes to the capital requirements under Solvency II are warranted by further reducing the capital charges on equity investments held for the long term.

Increasing the financing capacity of the banking sector

9 A second key objective is to expand bank finance by overcoming excessively restrictive regulation on securitisation, and where necessary by revisiting prudential regulation, to have a strong and competitive banking system.

10 The report recommends that the Commission makes a proposal to adjust prudential requirements for securitised assets. In parallel, the EU should review transparency and attractiveness. Setting up a dedicated securitisation platform, as other economies have done, would help to deepen the securitisation market, especially if backed by targeted public support (for example, well-designed public guarantees for the first-loss tranche).

11 To complete the Banking Union, the report recommends that the EU should assess whether current prudential regulation, also in the light of the possible upcoming implementation of Basel III, is adequate to have a strong and internationally competitive banking system in the EU. The report recommends that a minimal step towards completing the Banking Union would be to create a separate jurisdiction for European banks with substantial cross-border operations that would be "country blind" from the regulatory, supervisory and crisis management viewpoints.

Increasing the financing of corporates through capital markets

12 The report states that, at least since the 1960s, Europe has relied much more on banks than on securities markets to fund its companies. Even though the role of non-bank finance has increased over time – with "a rising ratio of bonds to loans in external finance" – companies in the EU continue to rely much more on bank lending. Within Europe, reliance on capital markets is much greater in some Member States, such as Scandinavian countries and the Netherlands, than in others, including Germany, Italy and Spain.[2]

13 The report concludes that, generally, banks "are not best placed to finance innovation, which requires a greater presence of patient and risk-tolerant equity investors", as banks typically operate under a heavy burden of prudential regulation and lack the expertise to screen and monitor innovative companies. The report recommends that, at a minimum, a financial structure that favours innovation "should be at least partly equity-financed and/or have long-term debt financing".[3]

Deploying the EU budget more effectively

14 A third key objective is to make more effective use of the EU budget by focusing funding on strategic priorities, simplifying the administrative burden, improving the leverage of the EU budget and of the overall EU financial architecture to support investment.

15 Examples include: leveraging of the EU budget by substantially increasing the use of guarantees, in particular, loans, blending instruments and other types of financial instruments in support of strategic sectors of the economy across the policy priorities supported by the EU budget; and enabling the EIB Group to take on more and larger high-risk projects, focusing on innovative projects, start-ups and scale-ups, making greater use of EIB Group's own financial firepower.

Issuing a common safe asset to finance joint investment projects

16 A fourth key objective is the introduction of regular and sizeable issuance by the EU of a common safe and liquid asset to enable joint investment projects among Member States and help integrate capital markets.

17 Building on the model of the NGEU, the report recommends that, if the political and institutional conditions are in place, the EU should issue common debt instruments to finance joint investment projects that will increase the EU's competitiveness and security. As several of these projects are longer-term in nature, such as financing R&I and defence procurement, common issuance should over time produce a deeper and more liquid market in EU bonds, allowing this market to progressively support the integration of Europe's capital markets.

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[2] page 285, 286 of the Annex [link]
[3] page 286, 287 of the Annex [link]

Strengthening governance and simplifying rules

18 The report's proposals on governance and simplifying rules are also relevant to CMU and financial services.

19 On strengthening governance, the report recommends that Council votes subject to qualified majority voting (QMV) should be extended to more areas, and if action at the EU level is blocked, a differentiated approach to integration should be pursued.

20 On simplifying rules, the report argues that the regulatory burden on European companies is high and continues to grow, but the EU lacks a common methodology to assess it. To start lowering the "stock" of regulation, the report recommends appointing a new Commission Vice President for Simplification to streamline the acquis, while adopting a single, clear methodology to quantify the cost of the new regulatory "flow". The EU should fully implement a cut by 25% of reporting obligations and commit to achieving a further reduction for SMEs by up to 50%, upholding proportionality for SMEs in EU law and extending it to small mid-caps.