Dialogue &co – episode 1: The Savings and Investments Union

Voice-over: Welcome to Dialogue &co, a podcast in which Banque de France's experts discuss current economic issues. Today, the first episode is on the Savings and Investments Union. Since spring 2024, this Union has attracted a lot of attention. And for good reason: it was the focus of three reports, one French and two European. They all stress the need, indeed the urgency, of making faster progress towards completing it. To find out more, Vincent Bignon, economist, interviews Agnès Bénassy-Quéré, Deputy Governor of the Banque de France.

Vincent Bignon: Ready? Well then, let's get started. Hello Agnès.

Agnès Bénassy-Quéré: Hello Vincent.

Vincent Bignon: Before diving into the details, could you remind us of the origins of the Capital Markets Union project, whose new phase is now called the Savings and Investments Union?

Agnès Bénassy-Quéré: Of course, the project dates back to 2015. At the time, the idea was to facilitate savings and investment flows within the European Union. In theory, these capital flows are free within the single market, but in practice they meet with numerous regulatory and tax barriers. So let's take a step back in time. 2015 was just after the global financial crisis, the euro area sovereign debt crisis, a major crisis... The European Financial Stability Facility was set up in 2010 to help Greece. This fund was transformed in 2012 into the European Stability Mechanism, which is still in place today, but more fundamentally, Europeans at the time realised that there was a design flaw in European monetary union, namely that we had a single market but no federal budget. So let's compare with the United States where there are federal states. Take Texas for example. Texas' economy is heavily dependent on oil. If oil prices fall, the revenues of companies in Texas will fall, which means they will pay less tax, their employees will also pay less tax and, possibly, they will receive federal unemployment benefits there. So the federal budget has a stabilising role. In Europe, we have nothing like this. We have a European budget of around 1% of GDP, which does not have a macroeconomic stabilisation role dimension. But more importantly, at the time, a great deal of research showed that even in the United States, the federal budget did play a stabilising role, but less so than the federal capital market, i.e. capital flows between the federal states. So, if I go back to my Texas example, Texan companies that are affected by a crisis will pay smaller dividends to their shareholders and these shareholders are in other federal states. They will also pay less tax, as we said earlier, but also lower dividends. But the employees of these Texan companies and Texas residents will continue to receive dividends from other federal states, from companies located in other states. So the fact that Texans' savings are diversified throughout the United States and that company shareholdings are also diversified is extremely stabilising, and this is really primordial, more important than the federal budget. There is nothing to stop this system being replicated in the European Union. Yet, in the European Union, there is a national bias, meaning that household savings, which are generally intermediated by investment funds, are insufficiently diversified: they are too concentrated in each country and, moreover, company shareholdings, particularly in SMEs, are not very diversified, which means that these stabilising elements are weak in the European Union.

Vincent Bignon: That's very interesting, Agnès, because it suggests that there is in fact a learning effect. We're in the process of figuring out how to solve some of our problems in Europe. What was the action plan for the capital markets union and what went wrong as of 2015? And what worked out?

Agnès Bénassy-Quéré: The European Union has been very active, even though it is not very visible. A number of directives were adopted, more than 30 pieces of legislation, to harmonise the rules of the game, including corporate insolvency law, the framework for investment funds and central securities depositories, which are sometimes referred to as the registrars of financial markets, since it is they who keep the information on the securities held by everyone. These actions have therefore led to significant progress. In fact, a Banque de France *bulletin* shows that there is a degree of convergence in the corporate insolvency laws, but we're not there yet, and this convergence is still insufficient.

Vincent Bignon: So why is the subject resurfacing now, in 2024?

Agnès Bénassy-Quéré: The subject has arisen again, not against the backdrop of a financial crisis or euro area crisis, but rather in the context of financing the green transition, or digital transition for that matter, and the need for innovation. Investment needs for the European Union as a whole are estimated at between EUR 400 billion and EUR 600 billion a year, in addition to the investment made each year in the European Union, and also taking into account the fact that less will be invested in the brown economy. These figures are huge. The Capital Markets Union project has been redefined somewhat with this in mind: it has changed its name, as you said in your introduction, to the Savings and Investments Union, and it has also changed its purpose. You may be familiar with Musgrave's theory whereby there are three reasons for public intervention: allocation, stabilisation, and redistribution. In 2015, the main reason was clearly the need for macroeconomic stabilisation. In 2024, the need, allocation-related, is first and foremost to increase investment, the path to sustainable long-term growth. From this point of view, the European Union is fortunate to have abundant savings - one might even say excess savings - in relation to its investment needs, which are currently lower than these savings. As a result, these excess savings are invested abroad, resulting in a current account surplus. This money could be invested in Europe if there were more investment opportunities, but it would have to be profitable for businesses. So, in the absence of such opportunities, savers are investing their excess savings outside the European Union. But there is scope for financing additional investment in the European Union. These savers could therefore enjoy a better return with unchanged risk if they had access to savings products that were better diversified across the European Union and more diverse in terms of size, for example, of companies. They could also enjoy higher returns with unchanged risk if they had longer-term investment products. The problem is that long-term investing means locking in your savings for a lengthy period. And so, understandably, households prefer liquid savings. But if the European capital market were more active, more liquid, with more people buying and selling every day, then households purchasing long-term securities would take fewer liquidity risks, because they would know that tomorrow, if they needed to, they could sell without incurring a loss because they could easily find a buyer. So here we see that the European capital market is a true ally of European savers. It is also an ally of businesses, since it would lower the cost of financing for European companies.

Vincent Bignon: So Agnès, if I understand correctly, this can benefit both companies and savers. Wasn't this also the point made by Enrico Letta, a former Italian Prime Minister, in his recent report?

Agnès Bénassy-Quéré: Yes, indeed. In his report, Enrico Letta stresses that what we used to call the Capital Markets Union, which seems somewhat technocratic and far removed from the people, is in fact a project to benefit savers on the one hand and businesses on the other, with a view to fostering investment and the green transition. This is a very important point which brings us back to the allocation motive for this public intervention and, at the same time, takes us further away from the stabilisation objective, even though this is not in fact contradictory.

Vincent Bignon: It's for businesses and it's for savers, but in Europe, companies traditionally rely on banks for their financing. So why do you want to develop market financing?

Agnès Bénassy-Quéré: As Mario Draghi explains so well in his report, banks are struggling to finance innovation, particularly innovation by start-ups that have little physical capital that they can use as collateral to secure bank loans. In addition, banks offer loans but do not necessarily offer to invest in companies. And that's what innovative companies need. This project is not at all about sidelining the banks. On the contrary, it is a question of helping the banks to have more firepower by developing the capital market in a way that complements bank financing. At the same time, the European Banking Union, which dates from around the same time, a little earlier, is well advanced today, and has already made significant progress. It is not yet fully completed. The last stage is the most difficult: crisis management and deposit insurance. It is important to complete it so that, alongside a pan-European capital market, we have a genuine banking union with cross-border banks.

Vincent Bignon: In practice, how can we achieve this Savings and Investments Union? What concrete proposals can be made?

Agnès Bénassy-Quéré: Many concrete proposals have been made, for example in the eponymous report by Christian Noyer, former Governor of the Banque de France. At the Banque de France, we are focusing in particular on four areas where progress can be made. Market supervision, the revival of securitisation, venture capital, and innovation in the post-trade arena.

Vincent Bignon: We'll come back to the meaning of post-trade in a moment. The Banque de France's first proposal concerns the supervision of capital markets. But there is already a European supervisory authority. This is the European Securities and Markets Authority. So why should we change the way supervision is organised?

Agnès Bénassy-Quéré: Today, the European Securities and Markets Authority (ESMA) already supervises the rating agencies. In general, however, it does not supervise directly, but coordinates national supervisors, which in France means the *Autorité des marchés financiers* (AMF – French financial markets authority). For example, it is the AMF that checks compliance with European investor information requirements. It also supervises investment funds and market infrastructures such as clearing houses and central securities depositories (the so-called 'registrars') when they are located in France. This two-tier structure, where power is essentially exercised at national level, results in a piecemeal implementation of European rules. And this fragmentation pushes up costs. For example, when a savings product is marketed across the European Union, each time it must comply with local requirements imposed by European regulations, which are implemented in different ways. Similarly, an asset manager wishing to offer its services to savers in another country must deal with specific supervision conditions in each country. Centralising supervision would enable new financial players to operate at a pan-European level, while at the same time supervising them closely and consistently throughout the European Union. This would make it possible to monitor risks to financial stability and boost savers' confidence. In the United States, the financial markets are overseen by a powerful federal authority, the Securities Exchange Commission (SEC). This means that common rules can be applied uniformly, and the well-known economies of scale can be exploited to the benefit of businesses and savers. The idea would be to transform the ESMA into a European SEC. This won't happen overnight, but we could start with the most important market infrastructures or the big investment funds. The idea would be to replicate for market supervision what we are already doing for banks, with European single supervisory mechanism that has been gradually put in place, and in which the European supervisor has considerable power, and does more than coordinate national supervisors, but directly supervises systemically important entities and banks. Recently this architecture proved entirely successful, with the banking crisis in the United States and Switzerland in 2023 not causing a domino effect in EU countries. So supervision has indeed made the banking system more resilient.

Vincent Bignon: So in a way, it's a question of ensuring equal treatment across the different European countries when it comes to savings and investment financing. Is that right?

Agnès Bénassy-Quéré: Exactly. Whether you're based in Paris, Berlin or Ljubljana, you'll have access to the same savings products, and if you're a business, you'll have access to the same loan pools.

Vincent Bignon: The second area targeted by the Banque de France is securitisation. Can you remind us what this is?

Agnès Bénassy-Quéré: Securitisation refers to the transformation by a bank of a loan portfolio, such as property loans or loans to SMEs, into securities that can be traded on the financial market. Vincent, have you ever borrowed money from the bank?

Vincent Bignon: Yes.

Agnès Bénassy-Quéré: Me too. So that's two loans. The bank will take these two loans, bundle them with other loans it has made to other people, and this loan portfolio will then be assigned a credit rating. I have no doubt that your credit quality is excellent. It will transform this portfolio into securities with different risk levels, possibly several securities, and will either sell them on the market or keep them on its balance sheet and use them when it needs liquidity, for example, as collateral to obtain liquidity on the interbank market or from the central bank. For you and for me, it's transparent. We continue to repay our bank each month. But the repayments are in fact transferred to the holder of the security, and the holder of the security may change over time, during loan period. So, at your level, nothing has changed, but for the bank, it changes everything, because it now has securities whose risk can be shared with investors on the market. And these investors will themselves be able to diversify their risk by buying securities from different banks. This allows the bank to take loans off its balance sheet, thereby reducing its exposure to certain risks and transferring them to investors. The bank will therefore be able to grant new loans and take on new risks, since it has reduced its risk exposure. And that's why it is useful: it's going to increase the banks' capacity to make loans, and therefore to finance new investments. Before, we took the example of housing loans - but the same is obviously true with SMEs for investments in the green transition, for example.

Vincent Bignon: For the bank, securitisation is an instrument for managing its balance sheet and its liquidity. Does it facilitate lending? And enhance the financing of the economy?

Agnès Bénassy-Quéré: Exactly. It increases the banks' firepower. We know that banks occupy a unique position in financial markets because they know their customers and know how to assess risk. It's a very valuable attribute. They know how to assess the risk of individuals and SMEs. So they will continue to be main players in the lending market. But then, by securitising their loan portfolios, they will, in a way, make room on their balance sheets for new loans, because banks obviously need to manage their risk exposure. It's in their interest, but it's also in the interest of the community. We spoke earlier about the European supervisor who ensures that they don't take on too much risk, because we know what happened when systemically important banks in the euro area took on too much risk. So as to avoid any repetition of such excesses, banks are now very closely supervised.

Vincent Bignon: So why is it beneficial for savers? For example, if I want to save, will securitisation do anything for me?

Agnès Bénassy-Quéré: Yes, indeed. Savers or asset managers to whom they have entrusted their savings will be able to invest in a wider range of investment products, particularly long-term investments. By increasing the maturity of their loans, savers will be able to achieve a higher return, but the fact that these products are traded on a liquid market limits the risk, since they can sell the securities they have purchased on the market at any time if they need liquidity. For example, today the safest securitisation tranches (we said earlier that you can transform a portfolio into several securities rather than a single security, so we're going to classify them in order of risk) benefit from an additional yield of around 50 basis points, or 0.5 percentage points, over sovereign bonds. This extra return is by no means negligible, given the tiny amount of risk involved.

Vincent Bignon: Doesn't this bring back bad memories of the global financial crisis?

Agnès Bénassy-Quéré: Yes, naturally. This revival of securitisation is frightening. It brings to mind the role of securitisation in the 2008 financial crisis. But at the time, European banks had bought US-backed securities from households whose ability to repay their loans had not been checked. Since the financial crisis, securitisation standards have been completely overhauled and tightened, and opacity has been considerably reduced. The banks, as we said earlier, are better supervised, their loan portfolios present much lower risks, which are much healthier and much more closely monitored. And banks can no longer transfer all the risk to the markets, so it is in their interest to keep a close eye on borrowers' ability to repay their debts. So we shouldn't throw this tool out with the bathwater, as it were. It would be like banning the use of scissors, claiming that scissors can be used to commit a crime. Clearly, banks will remain the main providers of investment finance in Europe, with or without securitisation. Simply put, securitisation increases their firepower. This is where the complementary nature of bank financing and market financing really becomes apparent.

Vincent Bignon: Today, nothing stops banks from securitising their loans. And yet, according to the Draghi report of last September, which you mentioned, annual securitisation issuance stood at just 0.3% of Europe's GDP, compared with over 4% in the United States in 2022. Why is there such a difference in securitisation practices between the United States and the European Union?

Agnès Bénassy-Quéré: The difference between the two areas is truly striking. In 2022, the European Commission looked into this question, and ESMA is also studying it and has launched a consultation. The Banque de France responded to this consultation. And why did it respond? Because the Banque de France has a reasonably comprehensive view of securitisation transactions since the data provided by the banks is used by the Banque de France to assess the quality of the securities backing the loans, in particular as these securities can then be used in monetary policy operations to obtain liquidity from the central bank by pledging them as collateral. It's important to know what they're worth.

Vincent Bignon: So, do you have a fairly accurate idea of how to assess the quality of a securitisation?

Agnès Bénassy-Quéré: Yes, indeed. We realised that only a small share of the data provided by the banks behind this securitisation was actually used to value these asset-backed securities. This leads us to believe that the reporting requirements for banks could be significantly relaxed without in any way diminishing the quality of this securitisation.

Vincent Bignon: What other initiatives could be taken to encourage more securitisation in the interests of savers and businesses?

Agnès Bénassy-Quéré: Two other types of initiative come to mind. The first one concerns the prudential treatment of securitised loans, which could be slightly adjusted, i.e. for the institutions holding these securitised loans, how much capital they should put up against these positions. And we realise that these prudential requirements are sometimes out of step with the more general treatment of the associated risks, and therefore inconsistent with the other prudential considerations. For example, the capital requirement for holding the senior tranche, i.e. the least risky part of the securitised portfolios, is the same as that for the whole underlying portfolio. And yet, by definition, the risk is lower. That's somewhat odd. That's the kind of thing we're currently looking at. The other idea is to set up a dedicated securitisation platform at the European level in a harmonised manner, so as to lower the costs of securitisation, particularly for countries with less developed financial centres, which currently face particularly high costs for securitisation and for bringing securitised loans to the market.

Vincent Bignon: So the idea is that harmonising securitisation would increase liquidity because there would be less need to understand how it works because all the products would be similar?

Agnès Bénassy-Quéré: Exactly, and it's all consistent, we can see that it goes hand in hand with a single supervision of banks, a single supervision of markets, harmonisation of products, uniform implementation of regulations, so as to create both confidence and liquidity.

Vincent Bignon: The Banque de France's third proposal concerns venture capital funds, which are in fact institutions that invest in the capital of innovative companies, known as start-ups, and therefore take on a high level of risk. What is the problem between Europe and the United States?

Agnès Bénassy-Quéré: We can see that for two economies of comparable size, the volume of venture capital is totally different. Between 2013 and 2022, an average of EUR 23 billion was invested each year in the European Union, compared with EUR 149 billion annually in the United States. This gap is particularly glaring at the later stages of a start-up's development, when large amounts of funding are required.

Vincent Bignon: Do we know more about European venture capital funds? Do we have any details about this?

Agnès Bénassy-Quéré: What we observe is that European venture capital funds are, in reality, not very European. They mainly invest in their home countries, in the innovative companies that are in their immediate vicinity, and this limits their size and their ability to diversify. This reflects the fact that the European Union lacks the scale to take start-ups to the mature development stage, making them dependent on US or Asian funding and giving them a strong incentive to relocate, to the United States for example.

Vincent Bignon: So there's a problem. How can we develop such funds to boost innovation? What does the Banque de France propose?

Agnès Bénassy-Quéré: We could wait for the regulatory differences between European countries to be levelled, in particular with the harmonisation of insolvency law, with the single supervisory authority and the harmonisation of taxation. These developments are very welcome, but they will take time. So it's not worth making them a prerequisite. In any case, we believe that public intervention could prove useful to temporarily correct this shortcoming in the single market regarding the financing of start-ups. There have been some interesting initiatives in Europe in the past, but what we need to do now is specifically encourage venture capital funds to become pan-European, both in terms of the origin of investors and the allocation of capital. Public intervention, for example via the European Investment Bank, could be conditional on a diversification of funds across Europe.

Vincent Bignon: The Banque de France's fourth and by no means least important proposal for reviving the Capital Markets Union is based on technological innovation. That's what you were saying at the beginning about the post-trade aspect. Can you explain what you are trying to achieve with this fourth proposal?

Agnès Bénassy-Quéré: Of course, our starting point is a simple but often overlooked fact: fund-raising for a company doesn't happen at the snap of the fingers. On the contrary, when a company raises funds on the markets, either by issuing shares or bonds, then when these securities are traded on the markets, and finally when they are redeemed in the case of bonds, various financial intermediaries are involved. Trading platforms, CCPs, central securities depositories (i.e. the registrars) and payment and settlement systems. These institutions often differ from one country to another, the regulatory frameworks also vary and so do the types of financial securities. So we have a circuit of financial securities that varies across countries and also according to the size of the company.

Vincent Bignon: In practice, what does this mean for businesses?

Agnès Bénassy-Quéré: For SMEs, the transactions are much more complex, since the securities are settled in commercial bank money by means of transfers between banks. The life cycle of the security is much more complex: these securities are not deposited with the central depositories, they are not deposited on the T2S platform, but sequentially with the different intermediaries, which generates high issuance costs and acts as a real barrier to issuance, as stated in the Noyer report of April 2024. The operational costs of issuance are too high and SMEs are unable to issue for this reason.

Vincent Bignon: It is therefore important to lower the cost of issuing securities for the smallest companies and for intermediate-sized enterprises. The Banque de France is proposing a unified ledger, which immediately brings to mind the blockchain or tokens. Why would this help lower costs?

Agnès Bénassy-Quéré: Perhaps we should recall what a token is. A token is the digital and actual representation of a given asset, which can be a bond or a share traded on a market. How can tokenisation reduce costs while ensuring the security of transactions? Because this technology enables instant and irreversible transactions. This reduces delays and risks in markets. For example, a delay on a financial market is a problem because it introduces valuation risks for securities between the two dates, since their values fluctuate. The value of securities may be affected by exchange rate fluctuations or interest rate movements. By shortening delays, we reduce risks in markets. And this also reduces operational risks, the risk of errors in the chain of participants. Mechanically, this lowers the cost of checking and monitoring transactions. There is no need to carry out checks at each stage of the transaction chain. Transactions are recorded permanently and transparently for all market participants. This is a distributed register that allows all market players to access information at all times.

Vincent Bignon: In economics, we know that transparency is an important prerequisite for the smooth functioning of transactions, not only day-to-day transactions but also financial transactions. What would blockchain have to offer in this specific case?

Agnès Bénassy-Quéré: For investors, this is very useful because, for example, if they purchase securities that are linked to performance indicators, as in the case of social or environmental criteria, transparency is essential, and blockchain will make it possible to monitor these indicators in real time. It would also enable a financial asset manager, for example, to know the composition of his fund's liabilities, who has invested, when and how much, and in particular to better anticipate liquidity shocks when people want to exit their investments.

Vincent Bignon: And for companies?

Agnès Bénassy-Quéré: As regards companies, for example intermediate-sized enterprises, this unified ledger would enable them to find out the identity of their shareholders in real time at a very low cost. Today it's possible, but it's very complicated. Furthermore, blockchain also makes it possible to create tokenised securities associated with smart contracts, which are self-executing computer programs that enforce the terms of a contract automatically and without intermediaries. This enables, for example, the automation of payments, bond payments, dividend payments or securities transfers. But smart contracts are also a way of incorporating different EU laws. So, even before these laws are harmonised, we could incorporate specific national features into smart contracts, to provide a framework for the execution of contracts.

Vincent Bignon: And that makes for smoother transactions?

Agnès Bénassy-Quéré: And that makes them safer and more transparent.

Vincent Bignon: So it contributes to the European Capital Markets Union. But what does the proposal for a unified ledger involve?

Agnès Bénassy-Quéré: The idea behind the unified ledger is to address the persistent fragmentation of European financial markets by using blockchain technology. Each specialised financial entity - the CCPs, the central bank, the central depository - would remain responsible for its own activities, but the transaction chain would be implemented rapidly and securely. The unified ledger would accommodate all types of tokenised assets under a single governance framework, supported by the Eurosystem and therefore by the central bank currency, which would itself be tokenised. The idea behind the unified ledger is to address the persistent fragmentation of European financial markets. This fragmentation may also increase with innovation: We are seeing the development of private trading platforms that are not interoperable, and which could therefore actually increase fragmentation. The idea is to harness this technological innovation by placing it within a unified European framework that would in some way replicate, in the blockchain universe, what we know today with a financial system that is hierarchical, with the central bank making wholesale payments between banks, and then the commercial banks, which have their non-bank customers. So we are transposing this resilient pyramid system that prevents monetary fragmentation into the blockchain universe, because at the top of the pyramid is the central bank currency that unifies the entire payment system.

Vincent Bignon: Thanks, that's fascinating. If you had to sum up very briefly, could you tell us why a better integration of capital markets would be good for Europeans and good for the world?

Agnès Bénassy-Quéré: To recap, Europe is facing very significant investment needs. It has substantial savings. These savings are not currently being put to good use. They are too domestic, not long-term enough and not profitable enough for investors. So the idea is to boost investment in the green transition in Europe, with lower costs for businesses and greater investment opportunities for savers, who will be able to diversify their savings and get a higher return for the same risk. And doing so will require a number of adjustments to the European capital market. We've talked about four initiatives that we at the Banque de France feel are key. However, we must not lose sight of the fact that if we are to increase investment in the green transition, what is important is that the investments are profitable. It's one thing to lower the cost of financing, but it's even more important to increase the return on the investment itself in terms of net present value for investors and entrepreneurs. And this requires green transition policies. So the financial market will support the transition, but it can never replace it. What is absolutely essential is what we already know: carbon pricing and the regulations that enable companies to submit to their banks, and by extension to financial markets, profitable investment projects.

Vincent Bignon: The Savings and Investments Union is therefore not a substitute for another public policy, but it can complement it and boost it.

Agnès Bénassy-Quéré: Exactly, it can facilitate it, but not replace it.

Vincent Bignon: Thank you Agnès.

Agnès Bénassy-Quéré: Thank you Vincent!

Voice-over: Thank you to everyone who helped us prepare this episode. If you liked it, don't hesitate to subscribe to Dialogue &co and leave comments and stars. See you soon for another economic discussion with experts from the Banque de France.