



*European Commission contribution  
to the European Council*

**Capital Markets Union:  
progress on building a Single  
Market for capital for a strong  
Economic and Monetary Union**

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PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN  
CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE  
AND THE COMMITTEE OF THE REGIONS**

**Capital Markets Union: progress on building a single market for capital for a strong  
Economic and Monetary Union**

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## 1. INTRODUCTION

This staff working document accompanies the Commission communication entitled ‘Capital Markets Union: progress on building a single market for capital for a strong Economic and Monetary Union’, which takes stock of the progress made in delivering the Capital Markets Union<sup>1</sup>.

The Capital Markets Union is necessary to strengthen and support the Economic and Monetary Union and the international role of the euro. Deep and well-integrated capital markets contribute to private risk-sharing, improve financial stability, increase economic convergence and help cushion potential future shocks in the economy. Moreover, the Capital Markets Union can improve companies’ access to financing by providing alternative sources of finance to complement bank financing, benefiting small and medium-sized companies in particular. It also increases options for savers and fosters investment by retail and institutional investors. The Capital Markets Union also plays an essential role in reorienting private capital flows towards long-term and sustainable investments.

The Capital Markets Union action plan and mid-term review contains 71 legislative and non-legislative measures<sup>2</sup>, all of which provide key contributions to the Capital Markets Union. Broadly, the measures aim at:

- financing innovation, start-ups and non-listed companies;
- making it easier for companies to enter and raise capital on public markets;
- investing for the long term, investing in infrastructure and sustainable investment;
- fostering retail and institutional investment;
- leveraging banking capacity to support the wider economy; and
- facilitating cross-border investing.

The Commission has tabled all the legislative proposals envisioned in the Capital Markets Union action plan and mid-term review. It has also delivered several other proposals relevant to the Capital Markets Union, notably three proposals related to sustainable finance and two aimed at reducing the high ratios of non-performing loans. The Commission reports on these legislative measures in the communication adopted today.

In addition to this legislative programme, the Capital Markets Union action plan and the mid-term review set out numerous non-legislative measures to boost investor confidence, strengthen key market infrastructure and open new funding channels. The Commission has carried out almost all of the non-legislative measures set out in the action plan and mid-term review such as workshops, studies and other publications. In addition to the activities detailed in this document, several studies set out in the Capital Markets Union action plan and mid-term review are still under way. The results of these studies will only be available at a later stage, and may feed into the work of the future Commission.

The Commission also committed to assessing the case for establishing an adequate framework for the amicable resolution of investment disputes. From the preliminary results of this assessment, no definitive conclusion can be made at this stage. More analysis is needed to complete the assessment.

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<sup>1</sup> [reference to accompanying communication].

<sup>2</sup> Communication ‘Action Plan on Building a Capital Markets Union’, COM(2015) 468, 30.9.2015; Communication ‘On the Mid-Term Review of the Capital Markets Union Action Plan’, COM(2017) 292, 8.6.2017.

### 1.1. IMPROVING ACCESS TO FINANCING FOR EU BUSINESS

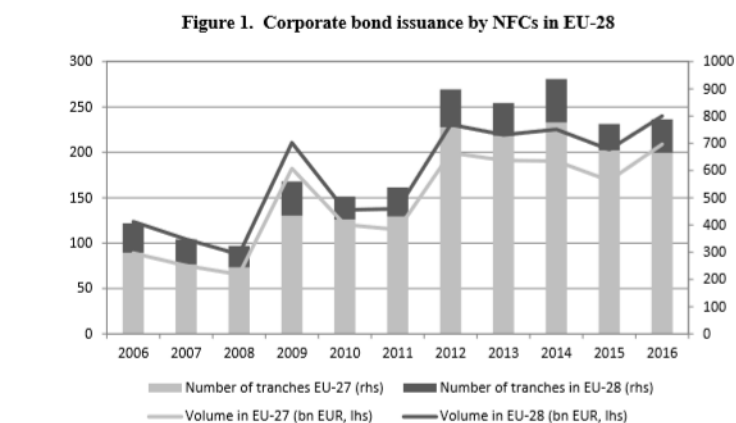
Under the Capital Markets Union action plan and mid-term review, the Commission committed to several measures to improve access to financing for EU companies. It has already carried out most of these measures. In the following sections, the Commission explains how the Commission carried out three further measures set out in the action plan and mid-term review:

- Review of the EU corporate bond markets (Section 1.2)
- Recommendations on private placement (Section 1.3)
- Assessment of the case for European secured notes (Section 1.4)

### 1.2. REVIEW OF EU CORPORATE BOND MARKETS

For larger companies, the issuance of corporate bonds is a key funding mechanism and as such, well-functioning corporate bond markets are essential to a successful Capital Markets Union.

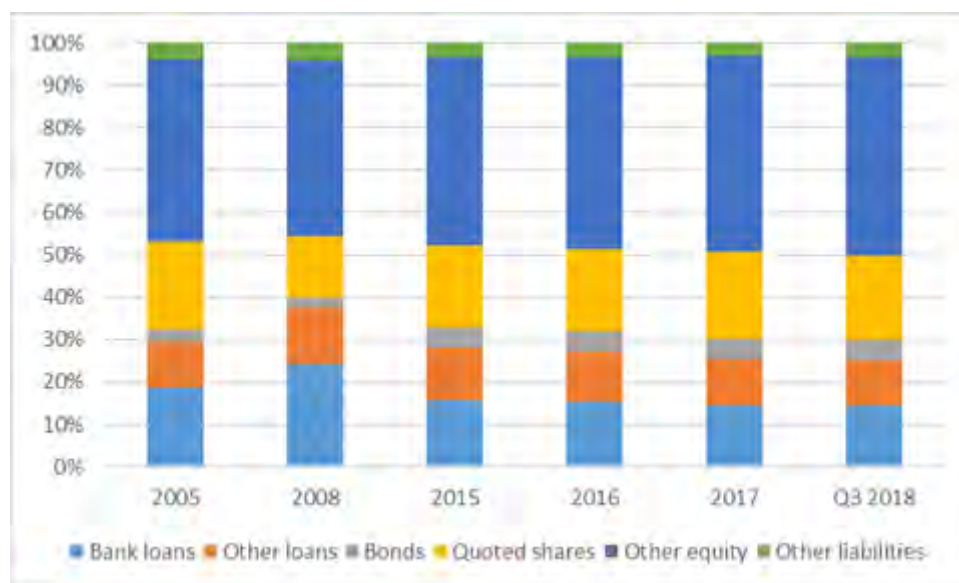
Over the last 10 years, issuance by non-financial companies of euro denominated corporate bonds has significantly increased.



This development has been driven by factors such as low interest rates and bond purchases by the European Central Bank. However, questions remain on how sustainable this trend will be when this economic environment changes.

Moreover, corporate bond markets still have the potential to become a larger funding source for non-financial companies. In 2016, they represented on average only 4.9 % of the total liabilities of non-financial companies in the Euro-area, which is significantly lower than the average of 11 % registered in the United States.

**Figure 2. Sources of funding of NFCs in the Euro-area (% of total liabilities)**



Source: ECB

In addition, despite the surge in primary issuance in recent years, some market participants have raised concerns about limited liquidity in secondary markets, notably in the context of the Capital Markets Union and the call for evidence<sup>3</sup>. Limited liquidity makes it difficult to trade in and out of corporate bonds. It can also result in higher costs and a higher risk for both issuers and investors. Ultimately, limited liquidity makes it less attractive for corporate borrowers to tap into this market.

The Commission launched two parallel activities. It commissioned a study on drivers of corporate bond market liquidity in the EU and it set up an expert group comprising 17 corporate bond market practitioners with a mandate to provide a cross-market analysis of corporate bond markets and recommendations on how to improve their functioning. Both the study and the expert group's report were published in November 2017<sup>4</sup>. They provide a detailed analysis of the market situation, which underpins the recommendations.

The expert group on European corporate bonds analysed the functioning of corporate bond markets from the perspectives of issuers, investors and intermediaries. They formulated 22 recommendations with six objectives:

- i. making issuance easier for companies;
- ii. increasing access and options for investors;
- iii. ensuring the efficiency of intermediation and trading activities;

<sup>3</sup> Commission's 2015 consultation on the EU regulatory framework for financial services.

<sup>4</sup> [https://ec.europa.eu/info/sites/info/files/171120-corporate-bonds-study\\_en.pdf](https://ec.europa.eu/info/sites/info/files/171120-corporate-bonds-study_en.pdf);

<http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=35759&no=1>

- iv. fostering the development of new forms of trading and improving the post-trade environment;
- v. ensuring an appropriate level of information and transparency; and
- vi. improving the supervisory and policy framework.

The following sections provide an overview of the measures taken by the Commission on EU corporate bond markets. The measures partly build on the expert group's recommendations, but several of these recommendations require further assessment before determining whether follow-up measures are relevant.

#### 1.2.1. Expert group's recommendations

##### 1.2.1.1 *Alleviating requirements on market sounding in the Market Abuse Regulation*

On 24 May 2018, the Commission tabled a legislative proposal to promote the use of SME growth markets and build a proportionate regulatory environment to support SME listing<sup>5</sup>. Specifically, the Commission proposed to exempt negotiated private placements of bonds with institutional investors from market sounding rules under the Market Abuse Regulation<sup>6</sup>. This exemption would be available when (i) the issuer seeking a private placement of bonds already has its equity or non-equity financial instruments admitted to trading on an SME growth market; and (ii) if an alternative wall-crossing<sup>7</sup> procedure is in place, in which case any potential qualified investor acknowledges the regulatory duties stemming from the access to inside information. This alternative wall-crossing procedure could take the form of a non-disclosure agreement. The proposal aims to alleviate the administrative burden on issuers of corporate bonds (and those acting on their behalf) as well as on investors. It should increase the attractiveness of private placements of bonds and help develop SME growth markets.

The proposal on the promotion of the use of SME growth markets is currently being negotiated by the co-legislators.

##### 1.2.1.2 *Adoption of the PEPP proposal*

The corporate bond markets in the EU are mostly dominated by institutional investors and monetary financial institutions with retail investors only playing a minor role. Broadening the investor base to include more retail investors could deepen and diversify the demand for corporate bonds, which should ultimately improve the liquidity of corporate bond markets.

In this regard, the Commission's proposal for a Regulation on a pan-European Personal Pension Product (PEPP), tabled on 29 June 2018, could increase retail participation in corporate bonds by making available financial instruments that provide easy access for retail investors. The European Parliament and the Council reached a political agreement on the proposal in December 2018.

##### 1.2.1.3 *Cross-border marketing of funds*

On 12 March 2018, the Commission tabled two proposals, in the form of a regulation and a directive, on the cross-border distribution of funds. With a total of EUR 14 310 billion in assets under management, the EU investment funds market is sizeable. However, in terms of cross-border distribution, it has yet to achieve its full potential. Currently, the distribution is predominantly divided

<sup>5</sup> Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 596/2014 and (EU) 2017/1129 as regards the promotion of the use of small and medium-sized companies growth markets — COM(2018) 331.

<sup>6</sup> Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation).

<sup>7</sup> Wall crossing is the act of making a person an 'insider' by providing them with inside information.



by national market, with 70 % of the total assets under investment funds' management registered for sale only on the domestic market<sup>8</sup>. Only 37 % of undertakings for the collective investment in transferable securities and about 3 % of alternative investment funds are registered for sale to more than three Member States.

Regulatory barriers between Member States are a disincentive to cross-border fund distribution. Notable examples of such barriers include Member States' marketing requirements, regulatory fees and administrative and notification requirements. The proposed package of measures therefore aims to reduce these regulatory barriers by removing unnecessary complexity and burdensome requirements and improving the transparency of national requirements. In parallel, the package ensures that the rules adequately protect investors.

Removing inefficiencies in the functioning of the Single Market for investment funds should reduce the costs for cross-border distribution. This should unlock the currently lost potential of the Single Market and accelerate the growth of cross-border distribution in the EU, reducing market fragmentation, increasing competition, and ultimately providing more investment opportunities for European investors.

In January 2019, the Council and the Parliament reached a political agreement on these proposals.

#### *1.2.1.4 Impact of MiFID II research rules*

Some available evidence and studies suggest that the shares of small and medium-sized companies may suffer from a low level of equity research coverage<sup>9</sup>. This lack of research may negatively affect the liquidity of securities issued by small and medium-sized companies and the cost of capital for such companies. In addition, various stakeholders have expressed concern that the new rules contained in the Markets in Financial Instruments Directive II on unbundling of research from trading fees could hinder research for small and medium-sized companies. To assess whether such claims are valid, the Commission has launched an external study to analyse the impact of the new rules on providing research for small and medium-sized companies and fixed income issuers. The study is under way and the final report should be delivered in the fourth quarter of 2019.

#### *1.2.1.5 Simplify the prospectus for small and medium-sized companies*

First, The EU Growth Prospectus, introduced by the Prospectus Regulation<sup>10</sup>, includes lighter disclosure requirements and aims to facilitate access to financial companies' markets particularly for small and medium-sized companies.

Second, the Commission proposal to promote the use of SME growth markets tabled on 24 May 2018<sup>11</sup> aims for an alleviated 'transfer prospectus' for companies listed for at least 3 years on an SME

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<sup>8</sup> [See for instance the Commission Staff Working Document — Impact Assessment accompanying the Proposal for a Regulation of the European Parliament and of the Council on facilitating cross-border distribution of collective investment funds and amending Regulations \(EU\) No 345/2013 and \(EU\) No 346/2013 {SWD\(2018\) 55 final}.](#)

<sup>9</sup> See for instance ECSIP Consortium, *Improving the market performance of business information services regarding listed SMEs*, September 2013; HM Treasury — Consultation on Financing Growth in innovative firms, August 2017.

<sup>10</sup> Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC.

<sup>11</sup> Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 596/2014 and (EU) 2017/1129 as regards the promotion of the use of SME growth markets — COM(2018) 331.

growth market and wishing to move to a regulated market. The current obligation to produce a full prospectus when moving to a regulated market is a disproportionate burden and incurs high costs for these companies. SME growth market issuers are already subject to ongoing disclosure requirements under the Market Abuse Regulation and the rules of the SME growth market operator, as required under Directive 2014/65/EU. Therefore, the Commission's proposal would allow companies to produce a lighter prospectus when transferring to a regulated market.

#### 1.2.1.6 Consolidated tape on corporate bonds

The consolidated tape is an electronic service that provides trade data for issues admitted on various stock exchanges in one single place, with the aim of overcoming market fragmentation. A consolidated tape provider should cover all transactions on equity and non-equity instruments, irrespective of the trading venues where the trades took place. The Markets in Financial Instruments Directive has introduced a regime for consolidated tape providers (as of 3 January 2018 for equity instruments and 3 September 2019 for non-equity instruments). This directive also provides for a possibility of a public procurement procedure for a public consolidated tape provider, should private initiatives fail to materialise.

No private entity has so far applied or been authorised as a consolidated tape provider. The Markets in Financial Instruments Directive II sets out that the Commission must, after consulting the European Securities and Markets Authority, present reports to the European Parliament and the Council on the functioning of the consolidated tape by September 2019. Among other aspects, the report should assess the availability and timeliness of post-trade information in a consolidated format, and assess whether that information is easily accessible, usable, and available on a reasonable commercial basis for market participants. The Commission has tasked the European Securities and Markets Authority with submitting a written contribution on this matter.

### 1.3. RECOMMENDATION ON PRIVATE PLACEMENTS

The expert group on European corporate bonds that analysed the functioning of corporate bond markets supported the development of private placements. Specifically, it noted that *'The expert group encourages the development of private placements, building on existing experience and markets. In particular, the development of private placements for small and medium-sized companies should be stimulated. The expert group calls on the Commission to expedite its long-promised recommendation on private placements in order to extend good practices from lead Member States to other Member States'*.

The Commission launched an external study to identify market and regulatory obstacles to developing private placement of debt in the EU.

The study also included several recommendations to encourage Member States to take national measures to support private placements as an alternative source of financing. The measures recommended by the study include:

- Establishing a national network made up of representatives of issuers, arranger banks and institutional investors, i.e. mainly insurance companies. This network should create awareness on private placements, e.g. by publishing guides on private placements and on the role of arrangers banks. It should also standardise contractual documents such as non-disclosure agreements, transaction term sheets, loan agreements and bond notes.
- Creating a withholding tax exemption for private placements, as was done, for example, in the United Kingdom. This should aim to avoid the taxation of interests when a foreign investor

invests in a private placement. This measure would favour cross-border investments and avoid fragmentation of the private placement market.

- Creating mechanisms in national corporate laws to facilitate private placement issuances. Some Member States have already taken steps in this direction, for instance by removing limits on the amount of debt that private companies can issue to favour the take-up of private placements/mini-bonds, or by introducing mechanisms to facilitate the representation of bondholders. This latter point is crucial when the private placement issuers face difficulties in repaying the private placements and when a restructuration of the issuance is necessary. A majority — rather than unanimity — of investors should modify the terms of the issuances when necessary.
- Further promoting standardisation, as the use of standardised documents and processes was identified as a good way to develop the private placement market.

#### 1.4. EUROPEAN SECURED NOTES FOR LOANS TO SMALL AND MEDIUM-SIZED COMPANIES AND INFRASTRUCTURE LOANS

In the Capital Markets Union action plan, the Commission committed itself to assessing whether, and how, to build a pan-European covered bond framework and to exploring the feasibility of similar funding tools for loans to small and medium-sized companies. Building on this assessment, the Commission followed up in the mid-term review with two further measures, namely: (i) to put forward a legislative proposal for an EU framework on covered bonds; and (ii) to assess the case for European secured notes for loans to small and medium-sized companies and infrastructure loans.

In March 2018, the Commission adopted a legislative proposal for a covered bonds framework<sup>12</sup>. Covered bonds are debt obligations issued by credit institutions and secured against a ring-fenced pool of assets to which bondholders have direct recourse as preferred creditors. Covered bonds are traditionally collateralised by high-quality assets, such as mortgage loans and public sector loans. At the same time, bondholders are still as entitled to claim against the issuing entity as ordinary creditors. This double claim against the cover pool and the issuer is referred to as the ‘dual-recourse’ mechanism.

European secured notes is a covered-bond-like instrument, which aims to cover a funding segment located between traditional covered bonds and simple, transparent and standardised (STS) securitisations. Loans to small and medium-sized companies and infrastructure bank loans are typically not eligible to serve as collateral for covered bonds as they do not meet the proposed criteria governing the quality of the covered assets. European secured notes could provide a useful additional source of funding, in particular for small institutions that do not have access to the securitisation market and/or have difficulty issuing unsecured long-term debt. European secured notes could increase the variety of funding tools available to banks, which in turn could unlock more financing for small and medium-sized companies and infrastructure projects, thus contributing to economic growth.

In view of this potential, the Commission has taken three initiatives to assess the case for European secured notes and to identify potential measures necessary at EU level to create such an instrument. Namely, the Commission: (i) issued a call for advice to the European Banking Authority; (ii) commissioned a feasibility study by an external contractor; and (iii) carried out a survey in the covered bond industry in the form of a questionnaire on European secured notes.

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<sup>12</sup> Proposal for a Directive of the European Parliament and of the Council on the issue of covered bonds and covered bond public supervision and amending Directive 2009/65/EC and Directive 2014/59/EU, SWD(2018) 50, SWD(2018) 51.

#### 1.4.1. Call for advice to the European Banking Authority

In October 2017, the Commission sent the European Banking Authority (EBA) a call for advice on the case for European secured notes. This advice should build on the extensive work already undertaken on covered bonds to identify best practices and give recommendations on how to harmonise covered bond frameworks in the EU.

Specifically, the EBA was asked to assess the following three aspects:

- i. the extent to which these best practices for covered bonds could apply with the necessary modifications to European secured notes;
- ii. the appropriate risk treatment of European secured notes in light of their features and expected risk-return profile; and
- iii. the effects European secured notes could have on individual banks in terms of asset encumbrance impact on unsecured bank creditors.

The EBA issued its final report on 24 July 2018, putting forward five recommendations for the Commission to consider should it wish to design the legislative framework for European secured notes<sup>13</sup>.

According to the EBA, European secured notes collateralised by loans to small and medium-sized companies could be structured as a dual-recourse instrument. Due to the high-risk profile of such loans, the EBA suggests a more restrictive framework (especially as regards coverage, liquidity and disclosure requirements), strict eligibility criteria at both loan and pool level, and a minimum level of overcollateralisation of at least 30 %.

In terms of capital requirement, the EBA advised that no preferential treatment be granted. However, the Commission could think about having a differentiated risk-weight treatment compared to unsecured notes subject to certain considerations.

The EBA does not recommend the creation of European secured notes collateralised by infrastructure loans. A dual-recourse structure for infrastructure loans is not appropriate given the lack of granularity in a cover pool, the complexity of the loan structures and the specific and different nature of infrastructure projects making it very difficult to create a high-quality dynamic cover pool of infrastructure loans.

The EBA recommends that the Commission investigate the case for a new distinct asset class for high-quality project finance loans in the form of a standardised EU infrastructure bond. Furthermore, the EBA would need to specify the features and the applicable framework for this potential new instrument.

Finally, concerning asset encumbrance, the EBA considers that the introduction of European secured notes collateralised by loans to small and medium-sized companies will not encumber the EU banking system's assets to an extent that would cause concern in the current financial environment.

#### 1.4.2. Feasibility study

The Commission procured a feasibility study on European secured notes. The study covers: (i) European secured notes collateralised by loans to small and medium-sized companies and by infrastructure loans; (ii) potential regulatory treatment of European secured notes; (iii) supervision;

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<sup>13</sup> European Banking Authority (EBA) report on European secured notes, 24 July 2018, available at: <https://www.eba.europa.eu/-/eba-publishes-its-assessment-of-european-secured-notes>

(iv) existing structures; (v) investor considerations; (vi) a specific analysis of 11 Member States; (vii) potential market size; and (viii) costs and benefits of European secured notes and potential legislation. The final report was published on 18 October 2018<sup>14</sup>.

On the potential regulatory treatment of European secured notes, the study concluded that it would be appropriate to extend some of the specific prudential treatments granted to covered bonds under EU legislation. These include: (i) exemption from clearing obligations under the European Market Infrastructure Regulation<sup>15</sup>; (ii) exemption from bail-in under the Bank Recovery and Resolution Directive<sup>16</sup>; (iii) lower risk weighting than equivalent unsecured bonds under the Capital Requirements Regulation<sup>17</sup>; (iv) tier 2 treatment under the Liquidity Coverage Requirements Delegated Act<sup>18</sup>; and (v) favourable treatment under the Solvency II Directive<sup>19</sup> only for European secured notes collateralised by loans to small and medium-sized companies.

Many of the ‘best practices’ for covered bond legislation, structuring and supervision recommended by the EBA can be applied to European secured notes without amendment. These include best practices for dual recourse, segregation of cover assets, bankruptcy remoteness, administration post insolvency, derivatives, appointing a cover pool monitor, supervisory oversight and the duties of the competent authority in insolvency scenarios. The other practices, except the loan-to-value limits, will require some modification before being applied to European secured notes. These practices include cover pools, geographical location of the underlying assets, coverage rules, liquidity coverage, stress tests and disclosure requirements.

The study concluded that there is a considerable investor appetite for European secured notes collateralised by loans to small and medium-sized companies, although there is scepticism as to whether this asset class will actually develop. The study also finds that investors are less interested in European secured notes collateralised by infrastructure loans mainly because of their different credit risk and complexity. Nevertheless, it appears to be appropriate that infrastructure bank loans are eligible for dual-recourse structures as long as these structures are completely distinct from European secured notes collateralised by loans to small and medium-sized companies

In particular, European secured notes for infrastructure loans should not benefit from the preferential prudential treatment that is proposed for European secured notes for loans to small and medium-sized companies, nor should it follow the EBA’s best practices on covered bonds. They should be branded in a way that ensures no contagion to either covered bonds or European secured notes for loans to small and medium-sized companies. In addition, Member States would be empowered to pass the

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<sup>14</sup> <https://publications.europa.eu/en/publication-detail/-/publication/6883690a-d025-11e8-9424-01aa75ed71a1/language-en/format-PDF>

<sup>15</sup> Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (2012), OJ L 201, 27.7.2012.

<sup>16</sup> Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (2014), OJ L 173, 12.6.2014.

<sup>17</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance (2013), OJ L 176, 27.6.2013.

<sup>18</sup> Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions Text with EEA relevance (2014) OJ L 11, 17.1.2015=.

<sup>19</sup> Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (2009), OJ L 335, 17.12.2009.

necessary laws to develop the asset class, putting in place supervisory processes to protect the interests of covered bondholders. The securities would be exempt from bail-in under the Bank Recovery and Resolution Directive and associated derivatives would be exempt from clearing obligations under the European Market Infrastructure Regulation.

All investors view the appropriate fair value of European secured notes to be between that of traditional covered bonds and unsecured bank debt of the same issuer, with small and European secured notes for small and medium-sized companies having the potential to be closer in pricing to the former than to the latter.

The two most important factors in determining the pricing of European secured notes relative to covered bonds are the prudential treatment for bank liquidity purposes and the collateral eligibility under the European Central Bank framework. The supervisory framework for European secured notes was also considered to be important. As it would be more difficult to define the asset class or harmonise structures across Europe as compared to traditional covered bonds, investors believe that greater transparency, more reliance on local supervisory processes and a clear harmonised definition are all equally important determinants of European secured notes pricing.

There will be substantial differences in the upfront and ongoing costs of European secured notes in different countries and for different issuers, particular due to the varying level of IT changes needed to support a small and medium-sized companies' loan-based transaction. This would not necessarily be the case for European secured notes for infrastructure loans given the nature of the underlying assets. Other upfront costs are expected to be similar to, but generally slightly higher than, the costs of a traditional covered bond transaction.

The yield demanded by investors depends highly on overall market yields. The study estimates that European secured notes' yield would represent an additional cost relative to traditional covered bonds of 8 to 13 basis points, but a saving relative to unsecured funding of 43 to 48 basis points. The credit enhancement required by rating agencies is expected to be around 23 % although this will vary substantially depending on the case.

If it is assumed that the European secured notes market would eventually finance the same proportion of the eligible underlying assets that the traditional covered bond market does in each country, the potential market size would be EUR 1 139 billion for European secured notes for small and medium-sized companies and EUR 195 billion for European secured notes for infrastructure. However, given the lower collateral efficiency and higher cost of funds for European secured notes as compared to covered bonds, it is highly unlikely that this would be the case. Under two of the three scenarios outlined in the study report, the market size is estimated at between EUR 86 and 121 billion (the third scenario provides no estimate).

The feasibility study also identified a number of possible benefits and costs of EU legislation. The potential benefits of European secured notes legislation include an increase in the availability of funds and a reduction in the cost of funding for the underlying assets in current market conditions for specialised lenders and in future growth scenarios where traditional funding sources are inadequate.

The costs of European secured notes legislation may include an adverse effect on the existing market for traditional covered bonds. This can be broken down into two categories: (i) damage that would occur by 'contagion' if a European secured note were to default; and (ii) damage that would result in the absence of a default such as competition for investors (the range of potential costs of a default is estimated at EUR 100–400 million).

### 1.4.3. European secured notes task force

In January 2018, the European secured notes task force of the European Covered Bond Council provided a response to the Commission's formal request for information and data on European secured notes. The request had set out 12 questions to be answered separately for each of the two underlying assets: (i) loans to small and medium-sized companies; and (ii) infrastructure loans.

The task force estimated the market size for European secured notes for small and medium-sized companies at up to EUR 260 billion for the eurozone, based on current total lending to small and medium-sized companies of EUR 1.7 trillion and assuming 15 % of the loans were refinanced by European secured notes. The market for European secured notes for infrastructure was expected to be a multibillion-euro market with an annual issuance volume well above EUR 10 billion.

Moreover, the task force considered the lack of the following as hurdles for the potential issuance of European secured notes:

- standardisation of underlying loans and definitions;
- transparency;
- liquidity; and
- track record and preferential treatment.

To overcome some of these hurdles, the task force recommended that the types of loans for small and medium-sized companies and infrastructure loans that would be eligible for European secured notes be defined and harmonised at EU level. Certain limits would need to be placed on the types of assets that can be considered eligible. The need for flexibility would also need to be balanced by higher levels of required overcollateralisation. Finally, strict eligibility criteria and concentration limits would have to apply throughout the life of European secured notes to ensure that the quality of the evolving cover pool remains in line with that of the initial one.

On the overcollateralisation level, the task force agreed that it should be higher than the one required for covered bonds in the proposed EU Directive for a covered bonds framework. However, they proposed a lower level than the EBA — around 10-15 %. On geographical asset diversification, respondents stated that while it may theoretically reduce the volatility of losses, pan-European loans to small and medium-sized companies and infrastructure portfolios may increase the complexity of the analysis by including country risk if the exposure is to countries having diverse credit quality.

In terms of risk perception, European secured notes are likely to be perceived to be in between covered bonds and STS securitisations. European secured notes are not expected to create a relevant asset encumbrance concern, but a cap on their issuance relative to total assets could be considered if necessary. It is expected that extendable maturities would be the 'de-facto' structure of European secured notes to: (i) mitigate refinancing risks; (ii) lower overcollateralisation requirements; and (iii) significantly increase their rating vs the issuer rating.

Some task force members believed that loan-by-loan data would not be needed for European secured notes due to their double-recourse nature while others insisted on the necessity of such detailed data and quarterly investor reports. Respondents agreed that the supervision and administration for European secured notes should be equivalent to the related requirements in the proposed EU covered bond Directive.

#### 1.4.4. Conclusion

The call for advice, feasibility study and industry contribution identified more investor appetite for European secured notes of small and medium-sized companies than for infrastructure. Respondents from the industry also expected the market size for European secured notes for small and medium-sized companies to be much bigger (potentially around EUR 260 billion) than for European secured notes for infrastructure (potentially around EUR 10 billion).

According to the European Banking Authority (EBA), European secured notes for small and medium-sized companies could be structured as a dual-recourse instrument, but with a more restrictive framework than that for covered bonds. In terms of capital requirement, it is advised that no preferential treatment be granted. However, the Commission could think about having a differentiated risk-weight treatment compared to unsecured notes subject to certain considerations. The feasibility study also concluded that European secured notes for small and medium-sized companies could be structured as a dual-recourse instrument. However, unlike the EBA, the study reasoned that it would be appropriate to extend some of the specific prudential treatments granted to covered bonds under EU legislation. In terms of overcollateralisation, both the EBA and the task force considered that the level should be above the one for covered bonds, with the EBA considering a level of at least 30 % to be appropriate and the task force considering 10 to 15 % to be adequate.

The assessment of European secured notes for infrastructure was not as conclusive as that of European secured notes for small and medium-sized companies. The EBA does not recommend the creation of such European secured notes, because a dual-recourse structure is not appropriate given the lack of granularity in a cover pool, the complexity of the loan structures and the specific and different nature of infrastructure projects. These factors make it very difficult to create a high-quality dynamic cover pool of infrastructure bank loans. However, in contrast to the EBA, the feasibility study found that infrastructure bank loans could be eligible for dual-recourse structures as long as these structures are completely distinct from European secured notes for small and medium-sized companies. In particular, European secured notes for infrastructure should not benefit from the same preferential prudential treatment proposed for European secured notes for small and medium-sized companies or follow the EBA best practices on covered bonds. They should be branded in a way that ensures no contagion to either covered bonds or European secured notes for small and medium-sized companies.

#### 1.5. SUPPORT FOR LOCAL CAPITAL MARKETS

One of the main priorities of the Capital Markets Union is to boost local capital markets, allowing for more productive and innovative use of private capital and ensuring more diversified funding for small firms. Developing local capital markets effectively requires complementary efforts at national, regional and EU levels.

Developing and integrating local capital markets should go hand in hand. Capital markets in several EU countries, in particular countries in Central, Eastern and South-Eastern Europe, lag behind Western European countries in terms of size and liquidity. EU countries in Central, Eastern and South-Eastern Europe account for 8 % of the EU's gross domestic product, but only 3 % of the EU's capital market<sup>20</sup>. To create a properly functioning single capital market across the EU, those local capital markets have to catch up. The Commission recognised this challenge in the Capital Markets Union action plan launched in 2015 and further elaborated the case in the mid-term review of 2017.

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<sup>20</sup> See the European Financial Stability and Integration Report 2018.



The Commission assessed how to support local capital markets in the EU by building on the work of the Vienna Initiative, which is an international private-public policy coordination platform focusing on the financial sector in Central, Eastern and South-Eastern Europe<sup>21</sup> and which established a dedicated working group on the Capital Markets Union. This report is also based on the relevant experience of the Commission's Structural Reform Support Service<sup>22</sup>.

#### 1.5.1. Economic rationale

Economic research confirms that deep and liquid capital markets contribute to economic growth as they improve the availability of capital for long-term investment and lower its costs<sup>23</sup>. Several benefits of capital market development are particularly relevant for catching-up economies. Strong institutions, a stable legal system and observing the rule of law are prerequisites for expanding local capital market ecosystems. Transparency requirements imposed by public listing have positive effects on local business standards. Well-functioning capital markets also help attract foreign investors, which puts additional pressure on receiving countries to continue to improve their business and regulatory environment. This, in turn, helps local companies to expand, setting off a 'virtuous cycle'.

Local capital markets are especially important for medium-sized companies, which are large enough to tap local capital markets, but too small to look for capital across borders. For such companies, access to national public equity markets is more important than access to centralised regional hubs. Geographical proximity lowers transaction costs, helps overcome cultural barriers of entrepreneurs and helps investors understand the business(es) that they are financially supporting. Local stock markets can also attract the interest of private equity and venture capital funds that find in these markets either an exit for their investments or information on the risk premia. As companies grow, they may turn to markets with a regional and European dimension.

Better-developed local capital markets can fully reap the benefits of participating in the EU Single Market. Pursuing cross-border financial integration requires adequate market infrastructures, a strong regulatory environment and market participants that are ready for international business. Such foundations can help broaden the channels for cross-border listing and trade of securities and establish connections between market infrastructures. An integrated EU capital market should offer easy access both to the large pools of assets and investors at European level and to market financing at local level.

#### 1.5.2. Vienna Initiative working group on the Capital Markets Union

The Vienna Initiative recognised the importance of capital market development for converging the economies of Central, Eastern and South-Eastern Europe. On 6 March 2017, the Vienna Initiative's Full Forum in Luxembourg decided to set up a working group on the Capital Markets Union. Members of the Vienna Initiative, representing public authorities from the Central, Eastern and South-

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<sup>21</sup> [www.vienna-initiative.com](http://www.vienna-initiative.com)

<sup>22</sup> The Commission created the Structural Reform Support Service in 2015 to help Member States prepare, design and implement growth-enhancing reforms. The support is tailor-made, available to all EU Member States upon request, requires no co-financing and mobilises experts from all over Europe and beyond, from the public and private sectors. Following the request by a Member State, the Commission's support covers the entire project cycle throughout which the ownership of the reforms remains with the Member State.

<sup>23</sup> The economic arguments presented in this section were analysed in the 2018 European Financial Stability and Integration Report.  
[https://ec.europa.eu/info/sites/info/files/european-financial-stability-and-integration-review-2018\\_en.pdf](https://ec.europa.eu/info/sites/info/files/european-financial-stability-and-integration-review-2018_en.pdf).

Eastern Europe countries, international institutions<sup>24</sup> and commercial banks, were invited to participate. The Commission was entrusted with coordinating and chairing the meetings.

The working group's objective was to provide an overview of the level of development and challenges faced by capital markets in the Central, Eastern and South-Eastern Europe countries. A broad range of stakeholders from the region actively participated in the working group's discussions. Their contributions led to the formulation of recommended policy measures at the national, cross-border and European level. The working group's report<sup>25</sup> was endorsed by the Vienna Initiative Full Forum in London on 12 March 2018.

### 1.5.3. Structural Reform Support Programme

The Commission's Structural Reform Support Service provides country-specific technical support to requesting Member States under the Structural Reform Support Programme. Since the Capital Markets Union action plan's adoption in 2015, the Structural Reform Support Service has been supporting Member States to implement reforms to develop capital markets. Furthermore, the Structural Reform Support Service has closely followed the Vienna Initiative work on Capital Markets Union from the outset. Some of the policy measures identified by the Vienna Initiative have been presented to the Structural Reform Support Service in the form of applications for technical support from the participating Member States. By working directly with national authorities, the Structural Reform Support Service has gained practical experience in the area of local capital market development.

Numerous technical support projects in the financial sector address policy priorities of the Capital Markets Union. In 2017, the Structural Reform Support Service agreed to support Member States with projects on: (i) capital market diagnostics; (ii) national development strategies (the Czech Republic, Estonia, Italy, Poland and Portugal); (iii) increasing small and medium-sized companies' access to financing (Estonia, Cyprus, Latvia, Lithuania and Slovenia); (iv) developing central securities depositories (Ireland and Hungary); (v) evaluating market barriers for developing Fintech (Estonia, Slovakia); (vi) strengthening insolvency frameworks (Estonia, Greece, Croatia, Cyprus and Lithuania); (vii) regional harmonisation of some financial instruments (Estonia, Latvia and Lithuania); (viii) removing specific national barriers to capital market development (Bulgaria, Latvia, Lithuania and Romania); and (ix) increasing capital market supervision (Croatia and Romania). A test-case project on financial literacy has also recently begun in Belgium.

### 1.5.4. Policy directions taken

The policy measures taken to support local capital markets need to fully observe the subsidiarity principle, i.e. at the lowest possible level that still ensures the efficiency of the planned measures. Many measures to support local markets are carried out at national level. Regional cooperation may also be encouraged to open up markets and promote cross-border links. The staff working document outlines national best practices and examples of regional cooperation, and discusses targeted initiatives taken to enhance the Single Market.

#### 1.5.4.1 *National level*

##### i. National strategies for capital market development

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<sup>24</sup> The European Investment Bank, the European Bank for Reconstruction and Development, the International Monetary Fund and the World Bank Group.

<sup>25</sup> <http://vienna-initiative.com/wp-content/uploads/2018/03/VI-Capital-Markets-Union-Working-Group-Final-Report-March-2018.pdf>

Several Member States have either recently adopted or are preparing national capital market strategies. These strategies set out the problems that need to be addressed and the policy initiatives to boost local capital markets. They are usually prepared by the government and incorporate the views of public authorities (e.g. the markets regulator, the ministry of finance) and private partners (e.g. business and investors associations), reflecting the specific needs of the local market. Some strategies also set out accompanying measures such as communication or education initiatives, for instance to raise awareness about capital market opportunities to attract foreign investors.

The Structural Reform Support Service has helped several Member States develop strategies. One of the first such initiatives was launched in the Czech Republic. The World Bank published a report on the country in 2017<sup>26</sup> providing an independent analysis of the current Czech capital market to underpin and inform a strategy for its further development. The report concludes that the Czech market has a high growth potential that should be exploited given that at its current level of operation the market cannot support the country's economic growth so that it enters the upper tier of EU economies. Capital market diagnostic studies sponsored by the Structural Reform Support Service are now being extended to other EU countries. Studies are under way for Poland, Portugal and Italy and one has recently been completed for Estonia. They often draw on the prior work undertaken by the government and local stakeholders.

Some Member States also take stand-alone measures to boost their national capital markets. In Lithuania, a series of regulatory amendments designed to encourage the growth of the local equity and debt market, venture capital and crowdfunding were passed in recent years. The Latvian government is implementing the financial sector development plan adopted in early 2017, which includes a revision of the legal framework for pension funds. The Danish government has launched a package of reforms to strengthen the equity culture among entrepreneurs, targeting various tax incentives and the transparency of pension funds' equity investments. An investment-savings account<sup>27</sup> based on the successful Swedish model is being introduced in some countries.

Financial education is of key importance and should be tackled in every national strategy. Surveys show that the level of financial literacy of small entrepreneurs has a direct impact on their readiness to access capital markets to find funding. Both investors and companies need to better understand capital markets to use them more actively. Most Member States have developed national financial education strategies and their common challenge is to expand programmes aimed at capital market participants. The measures set out in the 2017 joint Member States/Commission roadmap<sup>28</sup> on removing national barriers to capital flows included ones on financial literacy. There was also a report published in April 2018 on promising financial literacy initiatives in Member States for consumers and small and medium-sized companies<sup>29</sup>. The Structural Reform Support Service also supports some projects in this area. For example, Czechia is developing a new communication strategy on financial literacy. Belgium will also develop innovative and easily accessible educational tools for financial education. In general, national authorities show great interest in this policy area.

## ii. Improving the business environment

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<sup>26</sup> [www.mfcr.cz/assets/cs/media/Zprava\\_2017-10-02\\_CZ-CM-Assessment-Report-Final.pdf](http://www.mfcr.cz/assets/cs/media/Zprava_2017-10-02_CZ-CM-Assessment-Report-Final.pdf)

<sup>27</sup> It allows the account holder to buy and sell shares actively without being taxed at every transaction. Instead, a holding tax is calculated and collected.

<sup>28</sup> [https://ec.europa.eu/info/files/170519-roadmap-national-capital-barriers\\_en](https://ec.europa.eu/info/files/170519-roadmap-national-capital-barriers_en)

<sup>29</sup> The financial literacy report presented to the Financial Services Committee on 13 April 2018 and is available at:

<http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=37326&no=1>

A business-friendly environment is essential for developing capital markets. Creating such an environment typically involves a number of elements that, taken together, help and encourage companies and investor to participate in capital markets. These include: (i) stable legal and judiciary systems; (ii) an efficient administration; and (iii) insolvency regimes that allow for seamless and efficient liquidation of bankrupt companies. Promoting employee share-ownership schemes, particularly in a favourable legal and fiscal environment, may also help to increase corporate efficiency and to develop local stock markets (see Section 3.3 of this paper for more information on employee share-ownership schemes).

The Commission issued recommendations to several Member States to reform their insolvency frameworks, improve the efficiency of their judicial systems or adjust incentives in their tax regimes (e.g. Belgium). Furthermore, the Structural Reform Support Service has agreed to provide technical support to several Member States for their insolvency frameworks (Estonia, Lithuania, Croatia, Cyprus and Greece). The Structural Reform Support Service also helps some countries design modern regulatory solutions that will help their innovative financial services and Fintech industry to grow (Estonia and Slovakia). Lithuania has recently completed a Structural Reform Support Service supported project to improve the investment environment for institutional investors and is taking measures based on the recommendations.

Prudential supervision is a vital part of the overall business environment. Adequate oversight of market participants and their operations is an important prerequisite for building stable and trustworthy capital markets. The available supervisory capacity and expertise does not always match the expansion of financial markets, especially in smaller countries. Supervisors should be encouraged to recruit candidates with market experience and arrange for short-term study visits for some of their staff in firms they oversee. An alternative could be to organise exchange programmes with firms abroad or other supervisors within the EU to avoid conflicts of interest with monitored market participants. The Structural Reform Support Service supports projects – such as one carried out in Romania and another one under way in Croatia – that aim to increase the risk-based supervision of capital markets.

### iii. Public support for access to capital markets

The high costs of preparing an initial public offering and complying with the related legal requirements are a significant barrier for small and medium-sized companies. However, they may make targeted use of public funds — either from the national budget or EU structural funds — to overcome this barrier.

For instance, in Poland a programme entitled ‘4 Stock: facilitating small and medium-sized companies’ access to capital markets’, implemented by the Polish Agency for Enterprise Development and the Warsaw Stock Exchange, is co-financed by EU structural funds. It reimburses 50 % of the small and medium-sized companies’ costs incurred for preparing an initial public offering. Since 2011, the programme has facilitated access to NewConnect stock and Catalyst bond markets of the Warsaw Stock Exchange for numerous companies.

Several other Member States are about to undertake similar projects, often co-financed by public or EU funds. The Structural Reform Support Service sponsors projects aimed at creating small and medium-sized companies’ equity support instruments in Estonia, Latvia, Lithuania, Slovenia and Cyprus. The equity support instruments will co-finance the issuance of equity or debt and will cover the costs of the initial public offering, such as consultancy, drafting of documents, legal advice, etc.

Public funds can also support other costs for small and medium-sized companies’ participation in capital markets. The support provided for analytical reports is a notable example as they are expensive

for small companies to prepare. Some stakeholders point out the effectiveness of public support for creating private equity / venture capital funds that invest in the equity of local companies. Tax relief is also considered relevant, for example on any compensation granted to listed small and medium-sized companies for their listing expenses.

The full or partial privatisation of some state-owned companies through the local stock exchange gives a boost to capital market development. Examples include the initial public offerings of Tallinn Port and Eesti Energia planned on the Estonian stock exchange in 2018. Furthermore, companies with a majority public stake, including at municipal level, tend to give preference to raising funds through capital markets. Another successful example of raising funding was the 2017 issuing of green bonds by Altum, the Latvian development financing institution.

#### 1.5.4.2 *Regional level*

##### i. Facilitating foreign listing and investment

Cross-border cooperation has already started among the capital markets of Central, Eastern and South-Eastern Europe. There are three regional alliances of stock exchanges with more or less advanced integration of services: (i) the Nasdaq Baltic Market; (ii) the ‘CEESEG’ holding (including Vienna and Prague); and (iii) the SEE Link platform<sup>30</sup>. However, cooperation between national stock exchanges could be increased, as many small stock exchanges in the region do not have enough investors and issuers.

To broaden the scope of instruments available to local investors and to help local issuers list on other EU markets, national stock exchanges can create markets dedicated to foreign trading. They may attract new members to local stock exchanges by offering them direct access to liquid instruments in Europe and the rest of the world. These new markets may help overcome some of the barriers related to small market size. One concrete example in this area is BSE International, a joint project of the Bulgarian Stock Exchange and Deutsche Börse to grant local investors access to foreign markets, including foreign listing. The project has set up a new regulated market for instruments with EU-compliant prospectuses and established a new multilateral trading facility for all other instruments. It will allow financial instruments that have already been admitted to trading in other EU Member States.

Cooperation among stock exchanges may also extend beyond regions. One example is the London Stock Exchange ELITE programme, which helps selected small and medium-sized companies access various long-term financing opportunities, dedicated training and professional networks. It was first implemented by Borsa Italiana and has expanded all over Europe. The Budapest stock exchange, for example, has implemented ELITE since 2017.

##### ii. Leveraging EU legislation to facilitate cross-border access to infrastructures

Central security depositories (CSDs) carry out the post-trade settlement of security transactions and, in that role, provide crucial financial infrastructure services. The Central Securities Depositories Regulation introduced an internal market for the operations of what were traditionally national CSDs. It makes it possible to set up links between CSDs to support cross-border trading, clearing and settlement of securities.

One example of regional cooperation in this area is the ongoing ‘SEE Link’ project to facilitate settlement procedures for the participating stock exchanges. The proposed solution includes settlement in the respective local CSDs based on standardised instructions exchanged between investment firms

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<sup>30</sup> A technology-based integration project including the stock exchanges of Bulgaria, Croatia, the former Yugoslav Republic of Macedonia, Slovenia, Serbia and Bosnia and Herzegovina.

and regional CSDs through SEE Link brokers. Another example of regional cooperation, which builds on the possibility of setting up CSD links under the Central Securities Depositories Regulation, is a project supported by the Structural Reform Support Service in Hungary. The project aims to link KELER, the Hungarian central security depository, to the CSDs of selected Member States from the region to provide investors with access to the linked CSDs with the full range of custodian services.

Some market infrastructure organisations, such as the central counterparties, are costly and complex to create. Central counterparties place themselves between counterparties of a derivative contract, becoming the buyer to every seller and the seller to every buyer for clearing derivative transactions, which are costly and complex to create. As derivative trading is still nascent growing in many markets, there is not necessarily a case for creating national central counterparties in every country. The existing central counterparties, which the European Securities Markets Authority has already authorised or recognised as compliant with the EU standards in accordance with EU law, could further develop their clearing services and provide them to other stock exchanges in the region.

### iii. Creating regional markets by harmonising regulation

Some market segments could benefit from a harmonised legal framework at regional level that complies with EU law. The coordination within clusters of national regulators may support the development of new asset classes and increase the pool of investment instruments. The ongoing harmonisation of laws on covered bonds and securitisation in the Baltic countries, aided by technical support from the European Bank for Reconstruction and Development is a relevant example.

A reform of the legal framework for the issuance of covered bonds and securitisation was first launched in Lithuania. Latvia and Estonia have joined the initiative, carrying out the compatible reforms with the support of the Structural Reform Support Service. In November 2017, the Ministers of Finance from Latvia, Estonia and Lithuania signed a joint Memorandum of Understanding on cooperation for regional capital market development in the Baltics<sup>31</sup>. Objectives include creating common asset classes, market infrastructures and index labels. Ultimately, the initiative may increase the size of selected market segments and attract investors to the region. The new regional products will have to be compliant with emerging EU legal frameworks, e.g. for covered bonds.

#### 1.5.4.3 *European and international financial instruments*

Financial support instruments may help the development of local capital markets. For instance, specific support schemes may partially cover the costs of listing small and medium-sized companies' shares. Public investment funds may also buy a part of small and medium-sized companies' equity directly, thereby helping build the demand for those shares. EU financial aid may come from the European Structural and Investment Funds, the European Investment Bank or the European Investment Fund. It may need to be explored how targeted EU financial support, e.g. in the form of a public-private investment fund, could contribute to addressing the funding gap faced by small and medium-sized companies at the stage of initial public offering.

The European Investment Bank and the European Investment Fund, and international financial institutions including the European Bank for Reconstruction and Development and the World Bank Group, also facilitate the development of capital markets, especially in the Central, Eastern and South-Eastern Europe region. Their investments bring liquidity to local capital markets and help them grow. Subject to their investment strategies and the supervisory framework, they could invest in the debt

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<sup>31</sup> Press release: [https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/baltic-states-create-pan-baltic-capital-market-joint-initiative-supported-european-commission-and\\_en](https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/baltic-states-create-pan-baltic-capital-market-joint-initiative-supported-european-commission-and_en).

instruments issued by banks in the region to meet their ‘minimum requirement for own funds’ and ‘eligible liabilities’ in accordance with EU legislation. International financial institutions also offer products such as venture capital investment, securitisation and credit guarantee schemes or project bonds. Designated local institutions, such as development banks, may contribute to the successful deployment of these products, for example by providing guarantees. There is also scope to combine better products from international institutions with EU grants and other EU financial instruments. In some countries, potential recipients of EU funds find it difficult to obtain regulatory relief, in particular capital relief, as set out in the EU regulatory framework.

#### 1.5.5. Conclusion

Many measures can be introduced at national, regional and EU levels to boost local capital markets and give greater impetus to economic development and convergence in the EU as a whole. This paper sets out a selection of those measures, to inspire and motivate public and private market players to further grow and integrate capital markets in their respective Member States and regions. Under the Capital Markets Union, the Commission’s departments will closely follow and support progress in building an interconnected ecosystem of strong, transparent and accessible capital markets in the EU, including through continued technical support.

## 2. RETAIL INVESTMENT

Retail investment is a direct source of alternative funding for the real economy when channelled through capital markets in the form of direct investments in financial instruments. The EU has one of the highest saving rates in the world<sup>32</sup> with households holding financial assets of almost 220 % of gross domestic product. While savings generally facilitate the availability of funding for the economy, the savings of EU households are predominantly held in cash or deposits, and only a small part is held in direct market instruments, i.e. financial securities. Listed shares and bonds each represented 4 % of households’ financial assets. Investments in funds represent 6 % of households’ financial assets. The largest proportions of household savings are held in the form of bank deposits (30 %), pension entitlements (20 %), and claims against life insurance.

Encouraging retail investment in capital markets is one of the key objectives of building the Capital Markets Union. Already in the 2015 *action plan on building a Capital Markets Union*<sup>33</sup> the Commission sets out several measures to address the challenge of fostering retail investments.

Several factors prevent people from investing in capital markets instruments, such as: (i) costs; (ii) the complexity of the financial products offered; (iii) lack of access to quality information; (iv) the paperwork needed to open and run separate investment accounts; and (v) tax-related issues<sup>34</sup>. Several

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<sup>32</sup> Retail investors are the main providers of funding for the economy, with total holdings of financial assets close to EUR 34 trillion in 2016 (Eurostat).

<sup>33</sup> Communication ‘*Action Plan on Building a Capital Markets Union*’, COM(2015) 468, 30.9.2015.

<sup>34</sup> According to a recent study ‘*most households do not invest at all on capital markets or do so very infrequently across their lifetime as an average consumer is overwhelmed by the sheer complexity of, and uncertainty associated with investment products which is partly due to the generally low familiarity with basic financial concepts. When searching for the most suitable investment seeking advice from non-independent advisors (at banks and insurers) remains the norm for the average investor, except in the United Kingdom and the Netherlands. However, research indicates that financial institutions almost exclusively offer in-house packaged products to retail investors.*’, [https://ec.europa.eu/info/publications/180425-retail-investment-products-distribution-systems\\_en](https://ec.europa.eu/info/publications/180425-retail-investment-products-distribution-systems_en)

measures in the Capital Markets Union action plan and mid-term review seek to overcome these issues.

## 2.1.REPORTS BY THE EUROPEAN SUPERVISORY AUTHORITIES ON COSTS AND PERFORMANCE OF RETAIL INVESTMENT PRODUCTS

On 10 January 2019, the European Supervisory Authorities published the results of their first comprehensive analysis of costs and performance of the main categories of investment products: (i) undertakings for collective investment in transferable securities; (ii) alternative investment funds sold to retail investors; (iii) structured retail products; (iv) investment based insurance products (unit linked and profit participation); (v) pensions products; and (vi) structured deposits.

The reports contribute to the Capital Markets Union action to foster retail investment and follow up on the Capital Markets Union mid-term review. The requests to the European Supervisory Authorities complement other measures to improve the functioning of retail investment markets, such as the study on distribution systems of retail investment products across the EU and the study on options for online tools supporting retail investors.

The reports show major differences in the costs and performance of retail investment products and their transparency across different Member States and different product categories. The differences in net performance are primarily due to the impact of ongoing fees. The reports also include information on different market segments and regions where investors appear to be in a sub-optimal situation and identify those issues that call for careful analysis

The report shows that for undertakings for collective investment in transferable securities funds the total costs of a fund presents a significant drain on fund performance, affecting retail investors to a much higher extent than institutional investors. On average, retail clients pay twice as much as institutional clients. The impact varies across asset classes, with costs on average accounting for 25 % of gross returns in 2015-2017. Ongoing costs such as management fees constitute over 80 % of the total cost paid by customers, while entry and exit fees are less significant.

For retail investors in alternative investment funds and structured retail products, market transparency is particularly limited. There is practically no up-to-date data available on costs and performance and the size of structured deposits is too small to assess its features.

For investment based insurance products and pension products the report concludes that the differences between products make comparing their performance very challenging, for example in view of the values of guarantees, the impact of smoothing mechanisms and terminal bonuses of profit participation products, and the impact of risk and volatility. Given the insufficient data available from market providers on past performance, the European Insurance and Occupational Pensions Authority (EIOPA) requested additional data from insurance undertakings. Similar requests were necessary for personal pension products. The report shows that costs vary depending on the type of product, premium, risk category and jurisdiction. Variations in asset management costs related to different risk categories are a major factor.

For structured deposits, the report includes a mapping of the specific regulatory requirements on pre-contractual disclosure and/or reporting applicable to structured deposits at European and national level. It also identifies the data sources that would be required to fulfil the request. The report concludes that the market for structured deposits in the EU is limited in size and that data on costs and performance is not widely available. It therefore sets out steps for the EBA to take to obtain more accurate and standardised data in the future and therefore improve the reliability and overall quality of its response.



Due to data limitations, the reports do not cover all products. There are also still some methodological issues that have to be dealt with. Due to availability and comparability of data, the three European Supervisory Authorities (ESAs) applied different methodologies and used different sources of information when preparing the reports. While the European Securities and Markets Authority (ESMA) used private data vendors, the EIOPA sampled the data from the industry. The EBA based their analysis on information received from the national competent authorities. In addition, the time horizon was different, such as 10 years for undertakings for collective investment in transferable securities and 1-2 years for insurance-based investment products.

While the coverage for some categories of products may not yet be sufficient, the situation should improve in the next years thanks to the full implementation of the pre-contractual disclosure and reporting requirements introduced through recent legislative measures, e.g. for undertakings for collective investment in transferable securities, Markets in Financial Instruments Directive/Market in Financial Instruments Regulation, Insurance Distribution Directive, Institutions for Occupational Retirement Provision Directive (IORPSII) and packaged retail and insurance-based investment products (PRIIPs). Specifically in the insurance sectors, before the PRIIPs Regulation started to apply, data on some categories of products were not collected in a way that could be used by the European Supervisory Authorities.

The difficulties in achieving complete and comparable data for some categories of products re-confirm the need for uniform requirements for pre-disclosure information of the main characteristics of products at EU level. In spite of all the difficulties, there are common trends in the level of costs and their impact on performance across Member States for products of similar characteristics, for example undertakings for collective investment in transferable securities and unit-linked insurance products.

The results of the reports were presented by the European Supervisory Authorities and discussed with stakeholders at a technical workshop organised by the Commission on 21 January 2019. The differences in the scope and granularity of data of the three reports were considered to be problematic.

In the coming months, the Commission will discuss with European Supervisory Authorities and national authorities the results of the first reports, the reasons for differences between Member States or similar categories of products, the difficulties faced during the process, the completeness of the reports and the European Supervisory Authorities' suggestions for improvements to future report cycles.

These first results provide a baseline for future assessments and to further develop the reporting, including, where appropriate, possibly extending the scope for improvements in the methodology.

## 2.2. MAPPING INVESTMENT SAVING ACCOUNTS IN THE EU

Capital market instruments, in particular equity, have historically generated higher returns than other liquid asset classes. More retail participation in this asset class could, as part of a diversified portfolio and in case of sufficiently long holding periods, help to increase returns on households' savings. Reviving the culture for investing in capital markets in the EU is therefore an important goal of the Capital Markets Union. As one of the measures to achieve this goal, the 2017 Capital Markets Union mid-term review<sup>35</sup> sets out measures to examine the potential of investment saving accounts and map the Member States experiences with such accounts. Based on this mandate, this section explores

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<sup>35</sup> Communication on the mid-term review of the Capital Markets Union action plan, COM(2017) 292, 8.6.2017.

different characteristics of investment saving accounts, as currently implemented in the Member States. The information is based on a survey carried out among the Member States.

There is no common definition of an investment saving account. However, the core objective of investment saving accounts is to make it easier and more rewarding for households to save in the long term in financial instruments such as shares, bonds and investment funds. To this end, investment saving accounts generally provide several benefits:

- a) They enable users to diversify risk and income channels. By regularly adding to their investment saving account over long periods, users mitigate the investment timing risk. In addition, there are often fiscal incentives linked to investment saving accounts, such as an exemption from capital gains tax on all individual purchases or sales of securities.
- b) Investment saving accounts can sometimes lower the cost for investors, particularly as these accounts can make it simple for an investor to invest in individual capital market instruments, rather than buying packaged products like investment funds or life insurance products. Contrary to such packaged investment products, individual instruments purchased through investment saving accounts are directly owned by investors, which could for example grant them the right to attend and vote at shareholder meetings.
- c) The experience in some Member States shows that investment saving accounts have been instrumental in increasing the share of equity finance available to small and medium-sized companies.

#### 2.2.1. Investment saving accounts schemes in Member States

Although investment saving account schemes have emerged only recently, they are now offered in an increasing number of Member States: 12 Member States have already established investment saving accounts and 13 have no such regimes<sup>36</sup>.

*Table 1: Investment saving accounts in the EU*

No	Member State	Name of scheme	Entry into force	Total value in EUR	Number of accounts (% adult population)
1	Estonia	Investeerimiskonto	2011	N/A	5 000
2	Finland	sidottu pitkäaikaissäästäminen	2010	N/A	N/A
		(osakesäästötili) <sup>37</sup>	2020		
3	France	Plan d'Epargne en Actions (PEA)	N/A	N/A	N/A
4	Hungary	tartós befektetési szerződés	2010	N/A	N/A
5	Ireland	Special Savings Investment Accounts (SSIA)	N/A	N/A	N/A

<sup>36</sup> There are no individual savings accounts (ISAs) in Austria, Cyprus, the Czech Republic, Germany, Greece, Lithuania, Luxembourg, the Netherlands, Portugal, Romania, Slovenia and Spain. Information is missing for Croatia, Latvia, Belgium and Bulgaria.

<sup>37</sup> The Ministry of Finance of Finland has launched a proposal for a law on investment saving accounts that should be tabled in 2019 and, if adopted, enter into force from the beginning of 2020.

6	Italy	PIR — Piani individuali di risparmio a lungo termine	2017	17.5 billion	797 000
7	Malta	No information	2014	283 906	268
8	Poland	Indywidualne Konto Emerytalne (IKE)	2004	1.9 billion	951 600 (<10 %)
		Indywidualne Konto Zabezpieczenia Emerytalnego (IKZE)	2012	0.4 billion	691 000 (<10 %)
9	Slovakia	Dlhodobé investičné sporenie	2016	N/A	N/A
10	Sweden	Investeringsparkonto (ISK)	2012	50 billion	2.3 million
11	United Kingdom	Individual Savings Accounts (ISA) Cash ISA Junior ISA (JISA) Child Trust Fund (CTF)	ISA 1991	655 billion	(42.8 %)
12	Denmark	Aktiesparekonto	2019	N/A	N/A

### 2.2.2. Main characteristics of investment saving accounts

The specific structure of an investment saving account depends on their individual purpose as defined by the Member State in question. The purpose of the investment saving account influences the characteristics of the account as regards fiscal incentives, the structure of the account, the eligible providers of investment saving accounts and permitted financial instruments. Other distinguishing features include the distribution of supervisory responsibilities among national competent authorities and the legal basis for the establishment of these schemes.

#### 2.2.2.1 Purpose of the accounts

The purpose of investment saving account schemes differs across Member States. While they differ in form, most investment saving accounts aim to encourage long-term investment in securities and the accumulation of retirement savings. Some of them also aim to encourage people to develop good saving and investment habits, to accumulate capital for buying a house and to save for their or their children's education. Some Member States also use investment saving accounts to channel retail investor savings into small and medium-sized companies' financing.

As these schemes are fairly new, there is a lack of data on their effect. However, those Member States that have carried out research in the area have noted encouraging results. In Ireland, the special savings investment accounts scheme achieved its aim of encouraging people to save for at least 5 years. A survey showed that 55 % of policyholders continued their saving habits after the scheme's initial term and 77 % of those who continued to save, saved the same amount or more<sup>38</sup>.

<sup>38</sup> Special savings investment accounts. <https://taxpolicy.gov.ie/wp-content/uploads/2011/04/0613.pdf>

#### *2.2.2.2 Legal basis and supervisory authority*

In most Member States, the investment saving account schemes are put in place through a legal act, a tax law or both. Member States that provide tax incentives for investment saving accounts usually include specific references to investment saving accounts in their tax laws.

In most cases the tax authority is responsible for supervising the investment saving account schemes which corresponds to the schemes' link with tax incentives. However, the financial supervisor often also plays a role and Member States argue that their involvement is necessary given that investment saving accounts, as any other financial product, fall under the remit of their competence.

#### *2.2.2.3 Eligible instruments*

The range of eligible instruments in an investment saving account differs between Member States depending on the purpose of the scheme and considerations about the variety, liquidity and potential risk of the portfolios to be put together.

Less than half of Member States with investment saving account schemes allow investment in a broad range of financial instruments. Eligible financial instruments most frequently include: (i) securities admitted to trading on a regulated market (including corresponding non-European Economic Area markets and those of OECD countries); (ii) instruments traded on a trading platform and units in investment funds, e.g. listed shares and bonds; (iii) undertakings for collective investment in transferable securities (UCITS); and (iv) bank deposits.

In some countries, the tax incentives of the investment saving accounts were contingent on the account being used to invest in national instruments. Such a characteristic could be an obstacle to the cross-border flow of investment in EU.

#### *2.2.2.4 Eligible account holders*

There can be certain restrictions on a person's eligibility to benefit from an investment saving account scheme. In most Member States, only natural persons can open an investment saving account. However, although no Member State excludes individuals who are not nationals of that country, if the investment saving account provides tax incentives – which is usually the case – the account holder would only benefit if they are a tax resident of the country in question.

Some Member States have no age restrictions for people opening an investment saving account. In Ireland, Malta and the United Kingdom (for stocks and shares, innovative finance investment saving accounts and lifetime investment saving accounts) account holders must be at least 18 years old. Poland has a minimum and maximum age requirement for people opening an investment saving account – 16 years old and under 60/65 respectively. In the United Kingdom, a lifetime investment saving account can be opened only between the ages of 18 and 40.

#### *2.2.2.5 Investment saving accounts providers*

Various financial institutions may offer investment saving accounts, including credit institutions, investment firms, asset management companies and insurance companies. All Member States allow credit institutions to offer investment saving accounts and more than half allow investment firms to offer them. As this is primarily seen as a retail investment product, few countries extend the distribution network beyond this remit. However, in some Member States it is also possible for asset managers and insurance companies to offer products under the national investment saving account scheme.

#### 2.2.2.6 *Fiscal incentives*

##### *Types of incentives*

All the Member States with investment saving account schemes have established tax incentives sometimes in combination with state contributions. Tax incentives may take three forms: (i) an exemption or limitation of tax; (ii) a tax deduction; or (iii) a deferral of tax liability.

Nine Member States offer either a tax exemption or a reduced tax on interest, gains and dividends received on money or investments inside an investment saving account. However, some of these nine Member States make the tax exemption or reduction conditional on a certain holding period of the investment saving account and apply a scaling determined by the holding period. For example, in Hungary, after 5 years of holding, the tax rate is 0 %, after 3-5 years it is 10 % and within the first 3 years, the normal tax rate of 15 % applies. Three Member States have put in place a ‘tax wrapper’ in which gains are not taxed. For example, Sweden has an annual tax on investment returns that is calculated by taking the market value of the securities in the account and multiplying it by a standardised interest rate. The amount is calculated on the basis of the market value at the start of each quarter and deposits and withdrawals during the quarter.

Two Member States offer a deduction to investors in the form of an amount of savings per year that can be deducted from taxes. For example, in Finland, savings of up to EUR 5 000 per year can be deducted.

One Member State offers a deferral of tax liability, though the difference between contribution and disbursement is still subject to income tax.

The United Kingdom and Ireland pay a bonus on savings in form of contributions. In the United Kingdom the lifetime investment saving account gives a 25 % bonus on savings, while in Ireland the exchequer contributes 25 % of the amount saved up to a limit of EUR 2 500.

##### *Minimum and maximum amounts*

Eight Member States set a maximum amount that can be deposited in an investment saving account, either overall or per year. In cases where the investment saving account scheme runs for a limited period only, e.g. 5 years, Member States combine the annual limit with an overall limit during period in question. For example, in Italy, where the investment saving account scheme runs for a minimum of 5 years, investors can deposit up to EUR 30 000 a year and not more than EUR 150 000 in total.

In Poland, the maximum annual amount for one investment saving account scheme is 1.2 times the estimated average monthly salary in the country for a given year (around EUR 1 200 in 2018). For another scheme, it is three times the average estimated monthly salary for a given year (around EUR 3 000 in 2018).

Two Member States have a minimum amount that must be paid into the investment saving account. In Hungary the minimum amount to open an account is HUF 25 000 (around EUR 80). In Ireland a minimum monthly contribution of EUR 12,50 in the first 12 months is required.

#### 2.2.2.7 *Restrictions on withdrawals*

Investment saving account schemes may have different restrictions on the withdrawal of funds. This normally depends on the purpose of the scheme (whether it caters for retirement or other long-term savings) and the views on how harmful such a restriction would be on the participants.

In most Member States, it is possible to withdraw money from the investment saving account at any time. In five, however, investors lose their tax benefit if they withdraw money earlier than the scheme intends. For example in France, when investors withdraw money before the 8th year, they cannot

make use of the whole tax benefit. Two Member States apply a charge or an exit tax in cases of early withdrawal.

Three Member States restrict withdrawals before the investor reaches a certain age or before maturity of the scheme. For example, in Finland withdrawal is only possible at the age of 68 or in case of death or divorce. In Slovakia, investors can withdraw money after 15 years. Withdrawals from a United Kingdom lifetime investment saving account before the age of 60, for any purpose other than the purchase of a first home or terminal illness, leads to a 25 % charge on the amount withdrawn.

#### *2.2.2.8 Number of accounts allowed and possibility to switch provider*

A limit can be placed on the number of accounts permitted per person for technical reasons such as simplification for taxation purposes or due to the structure of the tax benefits. Six Member States restrict the number of accounts per person. In most cases, only one account per person is allowed, unless the Member State in question offers multiple investment saving account schemes, in which case a person can hold one of each. Five Member States have no limits to the number of accounts per person.

There do not appear to be any barriers to switching investment saving account provider within a Member State.

#### *2.2.2.9 Cross-border activity*

Although investment saving accounts are generally offered to residents of a given Member State, there are situations where they could take on a cross-border dimension, for example, when an investment saving account holder moves to another EU Member State.

According to the survey, an individual would not be able to transfer their investment saving account balance to an investment saving account in a different Member State. However, in most cases they would be able to maintain their existing accounts even while being residents abroad. This would still entail implications for the holder of the investment saving account, given that tax benefits related to the scheme could be lost due to the individual no longer being a tax resident of the Member State in which the investment saving account is held.

### **2.2.3. Conclusion**

The development of investment saving accounts in the EU is still at an early stage and the characteristics of national accounts differ from one Member State to another. However, most investment saving accounts aim to encourage long-term investment in securities and the accumulation of retirement savings. They may therefore help to strengthen a culture of investing in capital markets in the EU.

It is worth noting, that the development of investment saving accounts in Member States could potentially be supported by technical support from the Commission's Structural Reform Support Service.

## **2.3. MAPPING OF EMPLOYEE SHARE-OWNERSHIP SCHEMES IN THE EU**

Employee share-ownership schemes are a type of employee benefit plan that allocates or allows employees to acquire shares in their company. Employee share-ownership schemes serve as a tool to motivate and reward employees and potentially help tackle issues such as high labour turnover or the retention of key employees. Employee share-ownership schemes usually run through a collective legal

vehicle or foundation that is set up by a company to periodically allocate some of the company's shares to the employees.

In Europe, 8.5 million employees have access to an employee share-ownership scheme. They are widespread particularly among large companies, with 86.6 % of all large European companies offering employee share-ownership schemes. Their number has increased by 3 % to 4 % on average each year since 2006.

Employee share-ownership schemes provide a number of benefits to employees, companies and the economy as a whole. They have a positive impact on the economy of Member States as they support companies, including small and medium-sized companies and the job market. For workers, financial participation in their company can contribute to job satisfaction, a sense of ownership, mutual respect between employers and employees, overall performance and can help employees find opportunities in their home countries. Aligning the interests of employees and management can also lead to higher productivity.

Employee share-ownership schemes gives workers rights to be consulted and involve them in decision-making have proven beneficial for both employees and the company. Benefits include sustainable governance, transparency, social dialogue, mutual respect between employers and employees, and other aspects such as recruitment, retention, motivation, job satisfaction and skills development, as well as overall performance and profitability.

Some research indicates that companies partly or entirely owned by their employees are more competitive and profitable, and face less absenteeism<sup>39</sup>. Also, experience in the United States shows the significant impact financial participation can have in terms of economic growth, fostering industrial change and making sure that all workers participate in this growing prosperity.

On the other hand, narrow-based plans for selected groups of employees, such as performance shares and stock options granted as a form of remuneration conditional on meeting certain performance goals, need to be well designed to ensure that the incentives provided are properly aligned with the company's long-term interests.

Also, for employees, holding shares in their own company might be a poor portfolio decision, involving the 'double risk' of becoming unemployed and losing their savings — which are invested in the company — if the company experiences financial difficulties. Moreover, the employees may have difficulties in selling their shares.

Employee share-ownership schemes can be relevant for small and medium-sized companies for which one of the biggest challenges is to attract and retain experienced managers and other personnel. Small and medium-sized companies typically lack the well-developed and extensive internal labour force found in many large firms<sup>40</sup>. Opportunities for promotion can also be limited or non-existent. In this case, employee share-ownership schemes might bridge the gap between the need for greater employee effort and commitment on the one hand, and potential labour turnover on the other.

By enabling individuals to familiarise themselves with investing in equity, employee share-ownership schemes have the potential to increase people's general understanding of investing in shares. This could lead people to participate more broadly in capital markets – one of the objectives of the 2017

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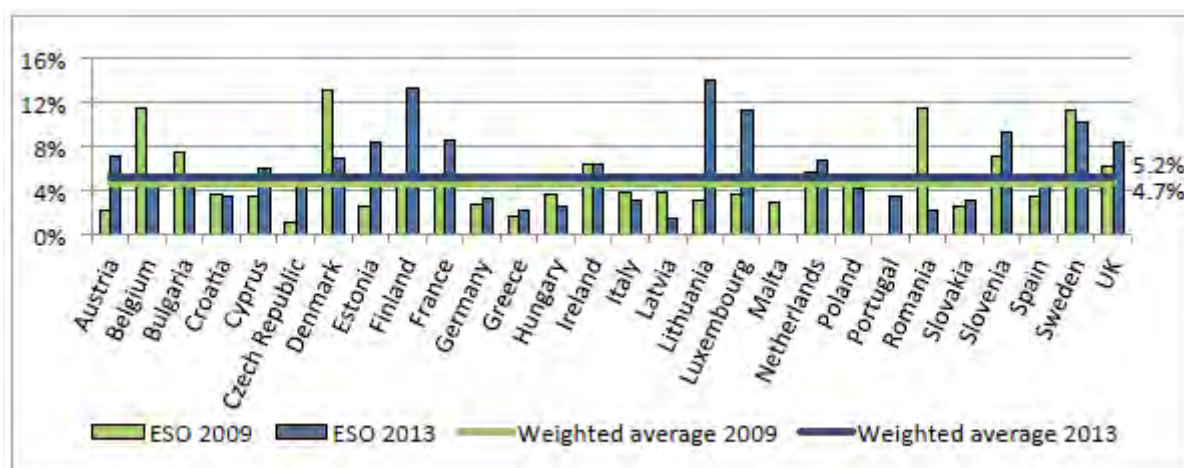
<sup>39</sup> For example, according to the Centre for Strategic Analysis of the French Republic the absenteeism rate decreases by 52 % and the social performance of a company having a scheme in place is 52 % higher than other companies that do not have an employee share-ownership scheme or a employee savings plan.

<sup>40</sup> In the EU, employee share-ownership schemes are mainly developed in large and listed companies while they are used considerably less by small and medium-sized companies.

Capital Markets Union mid-term review. Companies providing employees with investment accounts that they could use to buy shares of other companies would bring additional benefits to employees and capital markets in general.

### 2.3.1. Economic landscape in the EU

The development of employee share-ownership schemes differs across Member States. These differences are influenced largely by the specific features of national rules and fiscal incentives and by other factors such as individual preferences. In some countries, employee share-ownership schemes do not play a major role in the economy.



Source: ECS 2009 and 2013.

Figure 1: Proportion of private companies offering employee share-ownership schemes in EU-28 in 2009 and 2013 %

Overall participation in employee share-ownership schemes is still relatively low. Despite the increases in interest, 68 % of firms in the EU do not provide any type of employee share-ownership scheme.

Although many large European companies offer employee share-ownership schemes, the majority only offer narrow-based plans, i.e. only the management benefits from these plans<sup>41</sup>. Of the 2 709 largest European companies only 1 401 offered broad-based plans, open to all employees<sup>42</sup>. On average, 51.7 % of EU companies have broad-based employee share-ownership schemes.

<sup>41</sup> There are two classes of employee share plans in the EU. The first one is the 'broad-based' employee share plan which is available for all employees. In such a plan employees usually invest their own money into shares of the company they work for at a discounted price. The second type of plan is a 'narrow-based' plan, which is dedicated to selected staff, e.g. executives, senior managers and core employees. They usually receive shares for free as a result for achieving pre-defined performance goals.

<sup>42</sup> EFES, Economic Survey of employee share ownership in European Countries, 2017, page 152.



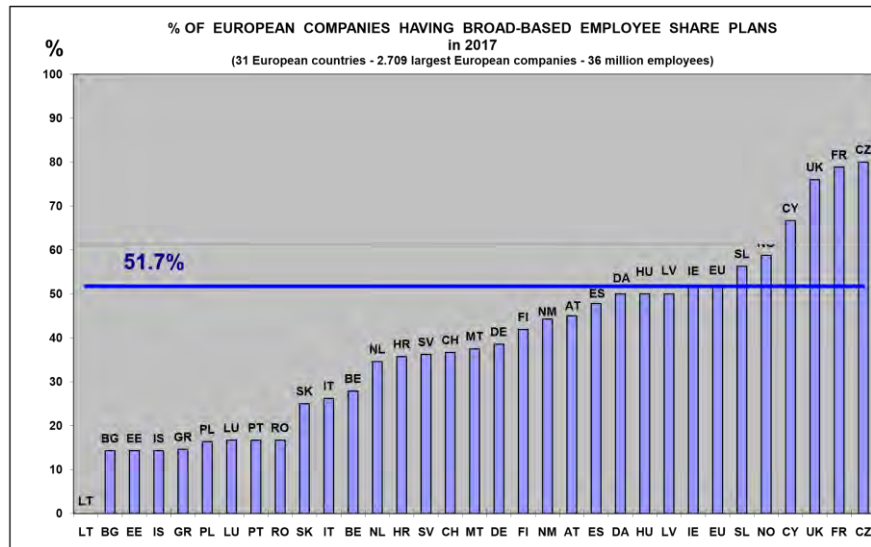


Figure 2: The % of EU companies having broad-based employee share plans in 2017

Source: Annual Economic Survey of Employee Ownership in European Countries in 2017, EFES

## 2.3.2. Main characteristics

### 2.3.2.1 Persons eligible

Companies handle the way employees acquire shares in different ways, with either the company or the employee taking the initiative. In case the company takes the initiative, shares are given to an employee as part of their salary or as a bonus. It is also possible for a company to give employees the option to acquire shares or not. Some companies offer shares to employees at a discounted rate or as a ‘buy three get one free’ opportunity.

There are two main categories of employee share-ownership schemes: narrow-based plans, which are for selected staff such as executives, senior managers and some core employees only<sup>43</sup>, and broad-based plans, where all employees<sup>44</sup> are eligible to buy shares of the company at a discounted price<sup>45</sup>. In the latter case, the number of shares that can be bought at favourable conditions per year is usually limited, for example to one-half of the gross monthly salary. Furthermore, a discounted price is conditional upon a certain holding period<sup>46</sup>.

Narrow-based plans intended for selected groups of employees are typically performance shares and stock options. As such, they are a form of remuneration and usually conditional on achieving certain performance goals. In most cases, such schemes are not linked to any fiscal incentive. Therefore, they do not face particular mobility barriers except those that arise from various tax regimes in the EU.

Broad-based plans intended for all employees are typically share purchase plans. Employees are encouraged to buy shares through a discount of usually 10-20 % of the market share price. The discount can be regarded as a form of remuneration, while the remaining 80-90 % are the employees’

<sup>43</sup> These selected people usually receive shares for free but only if they achieve defined results.

<sup>44</sup> Employee share-ownership schemes may also be opened to ‘third parties’ like in Austria where the beneficiaries of leveraged plans enjoying tax concessions can also be retired employees and family members (spouse, children) of employees.

<sup>45</sup> Some companies offer shares to employees at a discounted rate or they offer shares in a ‘buy three get one free’ way.

<sup>46</sup> EFES, Employee Share Ownership Benefits and Risks, Facts and Policies, July 2018, page 25-30.

personal investment. The success of such schemes depends essentially on fiscal incentives, the usual fiscal incentive being that the discount is free of tax and of social contributions<sup>47</sup>.

Most Member States' policies aim to give all employees access to employee share-ownership schemes. Nevertheless, many businesses have a share-ownership plan for some employees only. A certain difference in treatment between staff members may be justified to meet employees' different needs and interests. For instance, in Spain, some plans are for all employees and some are restricted to selected employees. As an example, long-term incentive plans, restricted shares plans and unapproved option plans are predominantly confined to executives. But employee share-ownership schemes may also be opened to 'third parties' like in Austria where the beneficiaries of leveraged plans enjoying tax concessions can also be retired employees and family members (spouse, children) of employees.

Companies usually start with employee share plans for executive directors (concerning an average of four individuals in large European companies). At a later stage, they introduce employee share schemes for senior managers (up to 1 % of employees). The schemes are then introduced for middle-management and selected employees (up to 5 to 10 % of employees) and then finally rolled out to all employees.

In 2017, 86.6 % of large European companies had employee share plans as detailed in the below table.

Table 2: % of large EU companies having employee share plans in 2017

Plan type	Target	Usual number of employees	% of large European companies	% cumulated
1	Executive Directors	1 to 10	4.0%	4.0%
2	Senior Management	Up to 1%	21.0%	25.0%
3	Selected employees	Up to 5-10%	10.0%	35.0%
4	All employees	100%	51.7%	86.6%

### 2.3.2.2 Size of companies

In the EU, employee share-ownership schemes are mainly developed in large and listed companies and used considerably less by small and medium-sized companies. Only one million employees have access to employee share-ownership schemes in small and medium-sized companies<sup>48</sup>. Small and medium-sized companies might also be especially reticent about employees' involvement in company decision-making which employee share-ownership scheme schemes can entail, depending on the specifics of the scheme in question.

By comparison, in the United States, *Employee Stock Ownership Plan (ESOP)*<sup>49</sup>, are more widely developed. The ESOP is specifically designed for small and medium-sized companies and holds USD 1 300 billion for around 14 million employee shareholders of small and medium-sized companies. This plan is very advanced and works as a 'leveraged buy out' to encourage small and medium-sized companies' transmission to employees. In the United States, this scheme is an alternative way to receive financing via equity. For instance, in 2014, the 10 000 companies offering an ESOP in the United States counted some 10 million employee owners holding total asset of more than USD 1.3 billion. The plan serves as a form of life insurance by accumulating company assets.

<sup>47</sup> EFES, About employee share ownership, 22 September 2018.

<sup>48</sup> EFES, Economic Survey of employee share ownership in European Countries, 2017.

<sup>49</sup> United States ESOP function as a form of life insurance through the accumulation of company assets. They can roll the amount over into an individual retirement account (IRA), as can participants in any qualified plan. Shares are allocated to employees and may be held in an ESOP trust until the employee retires or leaves the company. As in every other form of qualified pension plan, employees do not pay taxes on the contributions until they receive a pension from the plan when they leave the company.

Companies provide their employees with stock ownership often without upfront costs to the employees; they are, however, part of employees' remuneration for work performed. There is also a link between the plan and pensions.

The recent development of employee share-ownership schemes across Europe was mostly observed in listed companies. However, many unlisted companies also have some form of employee share-ownership scheme. For instance, in Austria, although most employee share-ownership schemes are in large companies listed on the stock exchange, there are some models for smaller companies. In addition, employee share-ownership schemes can be developed in public companies as well as in private companies, as observed in Spain. In Sweden, to facilitate small, young and innovative companies in recruiting and retaining key personnel, specific rules on easing the taxation of employee stock options were introduced on 1 January 2018. For company's shares, that are not admitted to trading on a regulated market, the benefit of an option may not be taxed as employment income.

Table 3: Proportion of private companies offering employee share plans by employee representation and size class in EU-28 in 2009 and 2013 (%)

	2009			2013		
Size-class	All companies	Without employee representation	With employee representation	All companies	Without employee representation	With employee representation
10-19	3.8%	3.6%	4.7%	3.7%	3.10%	6.50%
20-49	4.6%	4.3%	5.1%	5.2%	4.70%	6.40%
50-249	7.3%	5.2%	8.6%	8.9%	6.90%	10.50%
250-499	12.0%	10.8%	12.3%	12.5%	8.90%	13.40%
500+	16.2%	10.0%	17.0%	18.0%	16.70%	18.40%
Total	4.7%	3.9%	6.3%	5.2%	4.10%	7.90%

### 2.3.2.3 Fiscal incentives

Employee share-ownership schemes can be linked with tax-advantages, but not always. In some cases, employee share-ownership schemes can be introduced at the employer's discretion, but provide no special tax incentive. Such schemes may be used for granting shares, options or cash equivalent without conforming to the requirements imposed on tax-advantaged plans.

Fiscal incentives favouring employee share-ownership schemes have been observed in 20 Member States in 2018 (up from 15 in 2015). For instance in Spain, the '*Sociedades Laborales*' are exempted from taxes in connection with company formation and transformation, as well as capital gains. They are also exempted from notarial deeds on transfers to the company, from notarial deeds on bond debts and from debenture bonds.

However, providing a suitable fiscal incentive is generally assumed to promote employee financial participation. Member States' strategies indicate that fiscal benefits lead to more employee share-ownership schemes. For example, France – which has a long tradition of employee financial participation – has some of the highest fiscal benefits and the most developed employee share-ownership schemes in the EU. In contrast, in Germany fiscal benefits are low as is the use of employee share-ownership schemes. Also, in Denmark, fiscal incentives were phased out in 2012 and most companies decided to no longer offer employee share-ownership scheme plans following the changes in legislation.

Beyond the fiscal incentives, employee share-ownership schemes benefit employees by giving them direct access to capital markets. However, the benefits received through such schemes in the form of

company shares may have otherwise come through regular monetary remuneration. In this case, locking employees into non-liquid savings could be considered as negative unless they perceive it as a ‘compulsory savings’ mechanism.

#### *2.3.2.4 Administration of employee share-ownership schemes*

Small and medium-sized companies regularly cite the administrative effort as an obstacle to introducing employee share-ownership schemes. It can be difficult for a company to know what the best structure for an employee share-ownership schemes is and, in general, administering employee share-ownership schemes can seem a complex and time-consuming task. A company wanting to set up an employee share-ownership scheme and then administer it may need access to outside experts. In most Member States, it is possible to fully or partially outsource employee share plan administration to professionals. An important consideration is employees’ lack of knowledge of how to deal with shares. In most Member States, companies cooperate with financial advisory firms, providers of integrated financial services and consulting firms to administer employee share-ownership scheme plans.

When employees join employee share-ownership schemes they normally have online access to information about the scheme and their holding. However, these are not brokerage accounts. The online access is limited to the company’s stock. Furthermore, even though employees have access to online information about their share, they have limited discretion on what they can do with them, i.e. sell their shares or exchange them for other shares.

#### **2.3.3. Conclusion**

Building on previous work carried out by the Commission and other EU institutions, the Commission’s departments will continue to work closely with industry stakeholders to promote best practice for employee share-ownership schemes to provide opportunities for individuals to get familiar with capital markets and give them a first insight into equity investment.

### **3. CONCLUSION**

The Commission has delivered almost all of the non-legislative measures of the Capital Markets Union action plan and mid-term review. The measures outlined in this document along with the many initiatives undertaken by the Commission in the past 4 years, contribute significantly to more efficient and liquid capital markets in the EU.

While the Commission’s measures are already starting to bear fruit, it will take a few years before their full impact is felt throughout the EU. It is up to the next Commission to decide on future policies that will complete the work on the Capital Markets Union. The Commission’s departments will continue to monitor and assess the market situation and the results of the several studies planned or already under way will provide further input to help guide the work of the future Commission.

