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Policy Brief

Capital Markets Union:
Europe must stop beating around the bush

11 July 2024
#CMU
#Fragmentation
#Competitiveness

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The debate on the Capital Markets Union (CMU) has never been as vociferous as it is now. EU leaders are urging rapid progress and heavyweights such as Enrico Letta and Mario Draghi are putting capital markets integration centre stage. Still, there's no guarantee this political impetus will translate into concrete actions this time. Even now, the measures on the table are not enough to bring about fundamental change. With the Franco-German engine weakened after the elections, there is a serious risk that EU governments will fail to adopt any substantial reforms or will simply agree on measures that de facto reinforce existing market fragmentation and endanger financial stability. Against this backdrop, the new Commission should take EU leaders at their word and champion an ambitious CMU agenda for structural reforms that create a genuine single market for capital. Only transformational changes to Europe's financing landscape will allow the EU to benefit from growth opportunities and safeguard its financial and technological independence from the US and China.

Europe would benefit from deeper and more integrated capital markets. The European financing landscape is centred around banks. Only a handful of EU member states have well-developed capital markets and, with the exception of bond issues, these markets are fragmented. The absence of integrated capital markets increases capital costs for listed companies unnecessarily and deprives the European public of profitable investment opportunities. The lack of risk capital also limits the prospects for innovative firms in green and other technology sectors, reducing productivity growth and maybe even slowing down the transformation of the European economy. As long as the financial sector is unable to channel Europe's savings into new high-tech start-ups, biotech, nanotech, and other innovative firms will search for growth capital in other jurisdictions and Europe will continue to import technology.

The incoming European Commission should build on the current momentum and not shy away from proposing structural changes. EU leaders in April stressed the urgent need to create truly integrated European capital markets and in June reiterated the importance of the CMU in mobilising the necessary private investments to meet future challenges. The leaders of France and Germany have been leading this new push, but their focus, in particular in France, has now turned to domestic policies. There is thus a great danger that the discussion at EU level will either fizzle out or focus on measures that risk financial instability or reinforce current market fragmentation. The measures that the Eurogroup has put on the table so far are insufficient to advance cross-border capital markets significantly. Tweaks to existing financial market regulation such as the review of the Securitisation Regulation will at best deepen national markets but fail to integrate them. For true progress, addressing the big roadblocks will be key. To allow for transformational policies, Europe must overcome the fragmentation of national insolvency and tax laws and work on a truly Single Rulebook for financial firms. For this to happen, the incoming European Commission should take the EU leaders at their word and champion an ambitious CMU agenda. Europe's financing landscape requires structural changes.

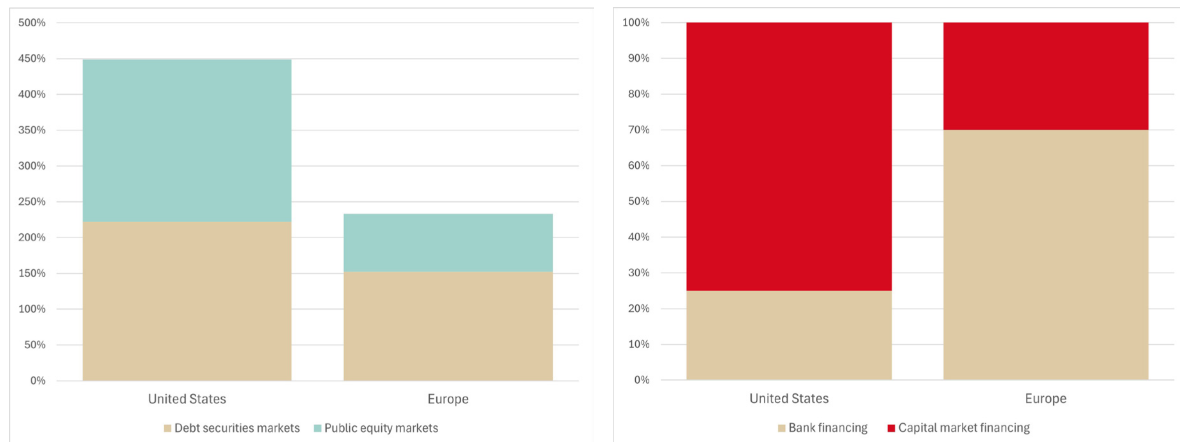
1 State of play

Creating the CMU is a must. The initiative of creating a union of capital markets was initially proposed by President Juncker's Commission in 2014 and can be linked back as far as the Treaty of Rome in 1957 and the objective of free movement of capital. The idea behind the CMU is to deepen and integrate national capital markets in Europe to form a single, large and well-diversified capital market. This should offer companies - regardless of where they are based in Europe - the opportunity to obtain money from the capital market in addition to bank financing. Institutional and retail investors should be able to invest their money cheaply and securely across national borders. An integrated financial market should also attract foreign investors. By exchanging capital across borders, investment risks would be widely spread, which should stabilise the financial system. To this end, the major capital market players should be subject to standardised rules and supervision. A strong European capital market ultimately also includes the creation of a European safe asset that offers investors a liquid, risk-free reserve and provides a reference for other financial market products so that their pricing is decoupled from national sovereign bonds.

In reality, capital markets in Europe remain fragmented and have barely deepened. European capital markets are often organised along national borders and financing conditions for companies vary significantly between the individual member states. Private investors usually invest within their own country, while institutional investors prefer to invest outside Europe, where the returns are higher. The bonds issued to finance the economic recovery package NextGenerationEU (NGEU) retain the potential to become a safe asset, but they will be repaid gradually from 2028, meaning that the German Bund will remain the eurozone's safe asset for the foreseeable future – with all the negative consequences that a flight to safety produces in times of stress.

This is in stark contrast to the US that enjoys a deep and integrated capital market. The lack of progress on the CMU project is reflected in the profile of the market in the EU and the US. In terms of gross domestic product (GDP), the capital market in the US is roughly twice as large. Companies in the US are externally funded to the tune of 25% through bank loans and 75% through capital markets. In the EU, it's the other way round (Figure 1).

Figure 1: Seize of capital market (in % of GDP) and funding sources of companies in the US and Europe.



Source: Eurofi (2023) and Vanguard (2023).

Previous initiatives to strengthen the CMU have brought only incremental progress. Since 2015, the European Commission has presented several action plans and many of the proposed measures have been adopted. The „Listing Act", for example, is intended to make it easier for smaller companies to go public; a new prospectus regulation provides investors with better information about opportunities and risks; and the „ESAP" (European Single Access Point) will pool public financial and sustainability-related information in one place by 2027. These are all useful measures that reduce bureaucracy and ensure greater transparency. However, they were mostly 'low-hanging fruits' and, until now, the EU has shied away from structurally reforming its capital market. Indeed, the harmonisation of member states' diverging insolvency laws remains incomplete, the preferential tax treatment of debt over equity persists, attempts to Europeanise capital markets supervision were blocked, and the recent agreement on accelerating withholding tax relief procedures carves out the EU member states with the smallest capital markets. As a result, the longed-for boost for cross-border capital market financing has so far failed to materialise.

The persistent fragmentation of Europe's capital market reduces competitiveness and productivity while holding back the green and digital transformation. The lack of private money is felt in particular in the area of risk capital, i.e. the financing of youthful companies that want to develop, produce and grow innovative technologies. Start-up and scale-up firms might have a great business model, but no collateral and no credit rating history, so they cannot get a bank loan and need funding from private investors instead. Unlike in the US, institutional investors in Europe rarely put their money into venture capital funds which could then pass the money on to the youthful companies. This puts Europe at a disadvantage because tech companies are crucial for the twin transition and also for productivity growth. According to the International Energy Agency, 35% of the greenhouse gas emission reductions expected by 2050 will be achieved using technologies that are not yet on the market. It is thus imperative for the EU to work on measures that allow its financial sector to channel excess savings towards new high-tech start-ups.

2 New political impetus, but lack of ambition

Over the last twelve months, the CMU debate has awakened from its slumber. Injecting a new sense of urgency, the heads of state or government in March, April and June called for rapid progress to create truly integrated European capital markets, pushing Eurogroup finance ministers to accelerate their work. France and Germany are at the forefront of the debate with their Finance Ministers first launching a joint roadmap, followed by a common effort by the French President and the German Chancellor to make all EU leaders support their agenda. The ECB Governing Council, former Italian Prime Minister Enrico Letta and former French central bank President Christian Noyer provided comprehensive analyses of the problems and put forward concrete proposals to create a "Savings and Investments Union". The most prominently discussed ideas for creating vibrant EU capital markets are 1) Reviving the European securitisation market, 2) Enhancing the participation of retail investors, and 3) Greater centralisation of capital market supervision. The focus on three concrete proposals helps shape the debate and make progress on the CMU front. However, their ability to deepen and integrate national markets is limited, if not combined with a broader agenda. To stop EU savings being invested abroad and European tech companies lacking access to risk capital at home, more political ambition will be required.

2.1 Reviving the European securitisation market

Reviving the securitisation market in Europe features high on the wish-list of EU finance ministers. In a securitisation transaction, banks bundle existing loans so as to issue securities that can be sold on capital markets. This makes room for new business on bank balance sheets and offers professional investors new investment opportunities. During the global financial crisis, opaque securitisation products were at the centre of the storm. In its aftermath, regulatory requirements were strengthened and securitisation activity in Europe fell to a low level. Securitisations can, however, make a positive contribution to integrated financial markets if the underlying loans come from different countries and the securitisations are traded across borders. However, neither is the case at the moment. The European securitisation market is highly concentrated and investor appetite for securities backed by loans originated in other EU countries is muted.

Legal fragmentation stands in the way of an integrated European market. In the US, the generous state guarantee involved in the activities of Fannie Mae and Freddie Mac contributes to ample supply and demand. However, this pair of government-sponsored entities has also driven the standardisation of mortgage loans in the US. As banks are eager to sell their mortgages to these agencies, they follow their uniform criteria and mortgages across the US look very similar. This allows the creation of homogeneous asset pools, to achieve economies of scale and reduce transaction costs. Unlike in the US, the EU introduced a special category of simple, transparent and standardised (STS) securitisation products, but the STS label did not create a product as standardised as US Agency mortgage-backed securities. And while in the US there is only some variation in state level consumer protection and debt collection laws, contract and insolvency law vary substantially across the EU. The co-existence of 27 legal regimes makes it difficult to bundle loans for securitisation purposes and creates considerable legal uncertainty, which is why investors hardly buy any securitisations issued in another EU member state. Establishing a securitisation platform could be a way to support the standardisation of transactions, but it would not compensate for the lack of legal harmonisation.

Weakening prudential requirements will not do the trick. EU governments have lacked the courage to tackle this legal fragmentation so far. Instead, finance ministers are flirting with relaxing capital requirements for securitisations held by banks or insurers. Amending

EU financial market regulation is easier to realise than harmonising national contract and insolvency laws. But if banks and insurance companies hold less capital for securitisations, this will not create a European market for such instruments, but at best deepen a handful of national markets that already dominate the European securitisation market. And since the capital buffers would be lower, this would entail new risks for financial stability.

2.2 Enhancing the participation of retail investors

European savings could be invested more efficiently. European households have one of the world's highest savings rates, but they put large parts of their financial wealth in bank deposits, savings accounts, life insurance funds or foreign debt securities which provide on average lower returns than equity investments. Only in countries that have a market-oriented pension system, like for example the Netherlands, Sweden or Denmark, do retail investors show higher capital market participation. The fragmentation into national capital markets prevents European asset management, pension and insurance funds from reaching the critical mass required to achieve economies of scale. To promote long-term investments across the EU, Letta and Noyer suggest introducing a European savings product for private pension provision. Such a product could take the form of a European company pension, whereby employers offer the savings product to their employees, potentially with auto-enrolment. There could be a single European product sold in all EU member states, for example an improved version of the unsuccessful Pan-European Personal Pension Product (PEPP), or each member state could develop its own product but according to common features agreed at EU level. Following the recommendation of PensionsEurope and other financial industry stakeholders, member states are being asked to offer preferential tax treatment for money invested in such a European savings product.

Enhancing retail investor participation is not an easy task. To address the pension time bomb created by an ageing population, it makes eminent sense to investigate ways for increasing returns on households' savings. A well-regulated pension product, incentivised by tax benefits, could be a boon to savers. However, enhancing retail investor participation will require improved consumer confidence in capital markets that, for several reasons, has been shaken time and again. In the case of Wirecard and similar scandals, auditors and supervisors failed to detect the accounting fraud. Due to pressure from some EU member states, the European Commission shied away from proposing a ban on provisions that would have ensured that consumers receive unbiased financial advice. Another impediment to cross-border investment by retail investors is, again, legal fragmentation. In the absence of a uniform EU-wide insolvency law, investors cannot judge the prospects of getting their money back if things go wrong. Furthermore, the tax systems in the different EU member states vary substantially and discourage investors from investing abroad. A recent agreement on harmonising the treatment of withholding taxes will bring some relief, but fail to solve all issues hindering cross-border investment. Last but not least, savings tend to be invested in US companies as these are much more profitable and benchmark indices heavily overweight US firms.

2.3 Greater centralisation of capital market supervision

A common market requires common supervision. Currently, capital market supervision is almost entirely in the hands of national supervisors. In the banking union, we have installed the Single Supervisory Mechanism (SSM) where the ECB directly supervises the largest, systemically important banks and smaller banks continue to be supervised by national supervisors. Similar to the banking union, a central European supervisor could monitor the major capital market players. Common supervision would indeed be helpful in overcoming national fragmentation and the successful example of the SSM shows how integrated supervision can also reduce regulatory differences. In recent years, the European

Securities and Markets Authority (ESMA) has won a number of direct supervisory mandates, in particular rating agencies, benchmark providers, and central clearing counterparties (CCPs) from third countries. ESMA itself would like to see its role expanded, but there is great controversy over whether stock exchanges, asset managers, EU CCPs or payment service providers should be next.

Entrusting ESMA with additional powers requires changes to its governance. In contrast to the ECB that serves as single supervisor in the Banking Union, it is national supervisors that have the say at ESMA. The 2019 review of the European Supervisory Authorities (ESAs) did not substantially alter the governance structure of ESMA. What's more, the recently concluded revision of the European Markets Infrastructure Regulation (EMIR) came with the creation of a dedicated CCP committee, but member states entrusted ESMA only with supervising CCPs located outside the EU. If ESMA were to be entrusted with additional mandates, its current dependence on national supervisors should be reduced.

Besides further centralising supervision, the EU must work on a truly Single Rulebook for financial firms. The debate about giving additional powers to ESMA should go hand in hand with driving forward the standardisation of rules which is the prerequisite for common supervision. It is true that there are European laws for most products and providers of financial services. Nevertheless, different rules apply in each EU member state. This is because European laws still leave significant gaps and countries like to add their own requirements when transposing European directives into national law. Due to this national "gold plating" of EU rules, a European supervisory authority would have to comply with 27 different rules. As this cannot work, Europe would need to work on a truly single rulebook for capital markets in order to boost integration.

3 Possible scenarios for the future debate

While the CMU debate has never been as vociferous as now, the fresh political impetus must result in concrete action. With the European elections behind us and the beginning of a new Commission term, we see three different scenarios for the CMU project. There is a substantial risk that (i) there are no substantial changes to the status quo, or (ii) EU member states can agree only on measures that increase fragmentation and endanger financial stability. Against this background, the next European Commission should (iii) take the lead on a more comprehensive package that brings transformational change to Europe's financing landscape. The EU must agree on substantial measures to advance the CMU, otherwise it will miss out on growth opportunities and continue its financial and technological dependence on the US and China.

3.1 Plenty of talk, but no walk

There is the risk that no substantial measures are taken. In the first half of 2024, the leaders of the two biggest EU countries, French President Emmanuel Macron and German Chancellor Olaf Scholz, were eager to make progress on the CMU. However, France especially is now preoccupied with domestic politics. Beyond the Franco-German couple, the latest discussions in the European Council revealed that not all EU governments feel the same sense of urgency. Some member states show in fact great resistance against further European integration. A group of smaller countries, led by Ireland and Luxembourg, that mistrust centralised supervision or want to protect their national financial sector from fiercer competition, have so far rejected attempts to entrust ESMA with more powers or harmonise tax policies. Not to mention the reluctance of the justice ministers in all EU member states when it comes to harmonising national insolvency or contract law.

3.2 Wrong progress creating new risks

Deepening capital markets without integrating them poses substantial fragmentation risks. While the current focus on three concrete proposals is helpful and some further steps might be taken, the underlying impediments to integration must also be addressed. Harmonization of legal and tax policies will be needed as well as greater strides towards a truly single rule book and a review of some national social policy choices such as the design of member states' pension systems. It is important to understand that the CMU agenda has two dimensions: the development of capital markets and their integration across borders. A key premise of the CMU idea is the assumption that further integration will bring further development. If measures to deepen national capital markets alone are adopted, Europe would miss out on a fair amount of additional efficiency gains that come only with integration. What's more, neglecting integrationist measures is likely to strengthen the dominance of certain countries and market players. This could even lead to an unhelpful form of regulatory competition and supervisory capture. Actions by individual countries such as France and Germany may in fact exacerbate existing fragmentation of European capital markets if unaccompanied by measures that advance integration.

Moreover, there is a risk that EU governments can agree only on weakening prudential requirements as the lowest common denominator. The financial sector is using the current debate to push for deregulating existing financial market policies. While calls for reducing complexity and streamlining reporting requirements are well merited, it is important to stick with prudential requirements put in force to prevent another financial crisis as in 2007/2008. As shown by recent bank failures in Switzerland and the US, the financial system remains inherently unstable and requires strict safety standards and close monitoring. Still, policymakers have already started to follow the arguments of the financial sector and propose to deviate from global accords by reducing for example capital requirements for securitisation holdings. However, there are strong reasons for querying the notion that weaker prudential requirements will create integrated capital markets that channel investment into new technologies and the most productive sectors. As highlighted by the Franco-German Council of Economic Experts, regulatory relief for securitisation "is unlikely to foster growth and investment in innovative, future-oriented firms".

3.3 An ambitious CMU agenda for the next European Commission

The incoming European Commission should not get lost in technical work but instead use the EU leaders' mandate to push for an ambitious agenda including structural changes. Making progress on the CMU is vital and the three measures currently on the table should serve as a starting point. An integrated European capital market requires a comprehensive agenda. It should be pursued without losing sight of the overall purpose of capital markets integration: a better matching of savings and investments needs.

3.3.1 Harmonise capital market-relevant aspects of national law and tax policies

First and foremost, Europe must intensify its work on legal harmonization, in particular in the field of insolvency law. This requires not only a swift agreement on the Insolvency III proposal of the European Commission, but also common definitions of insolvency and its triggers as well as standardised rules for financial collateral and securities settlement. There is no need to fully harmonise national insolvency laws, but EU investors who want to invest in another member state need more legal certainty in order to better assess the chances of getting their money back. Where efforts to harmonise national provisions fail, the Commission should consider the introduction of separate EU rules, which the contracting parties could choose as the 28th regime.

Further harmonisation of national policies is also warranted for capital gains taxes and for private pension incentives. EU member states must keep their freedom to choose their own social policies, but these should not deter investment in other member states and should promote EU-wide products to support the integration of capital markets.

Moreover, the preferential treatment of debt over equity should be corrected and the Commission proposal on the debt-equity bias reduction allowance (DEBRA) would be a good basis thereto . Risk-averse investors should continue to be able to invest in debt instruments, but equal tax treatment of debt and equity investments would help to establish a more favourable risk culture.

3.3.2 Build a truly Single Rulebook that is effective and efficient

With the aim of ensuring a level playing field and facilitating the cross-border business of financial firms, it should be assessed whether EU financial market policy directives can be replaced or complemented by EU regulations as is the case already within EU banking (Capital Requirements Regulation, CRR) and anti-money laundering (Anti-money Laundering Regulation, AMLR) rules. Likewise, third-country access to the EU internal market should be subject to common rules to prevent forum shopping and ensure a level playing field.

To cut transaction costs and eliminate unnecessary assessment premia, there's plenty of reasons to reduce the complexity of financial market legislation and streamline reporting requirements, but without lowering prudential requirements as this would endanger financial stability. This applies also to securitisation that would benefit from a review of the transparency requirements for private transactions and the collection of relevant data under an integrated system.

3.3.3 Ensure market safety and integrity

In parallel with works on a truly Single Rulebook for capital markets, the EU should reform the governance of the European Supervisory Authorities and entrust ESMA with additional powers to oversee the actions of systemically important market players. Centralising supervision, particularly of the (post-)trading infrastructure, could serve as a catalyst for further market integration. To restore retail investor trust, EU-wide consumer protection should be enhanced to ensure coherent policing of securities markets. Stability and safety are not a hindrance, they are a prerequisite of the CMU.

After concluding the ongoing targeted consultation, the EU should introduce a macro-prudential framework for non-bank financial intermediaries (NBFIs). As financial firms other than credit institutions gain in importance, it will be important to balance the effective safeguarding of financial stability with an openness to new innovative financial firms and competition with established players.

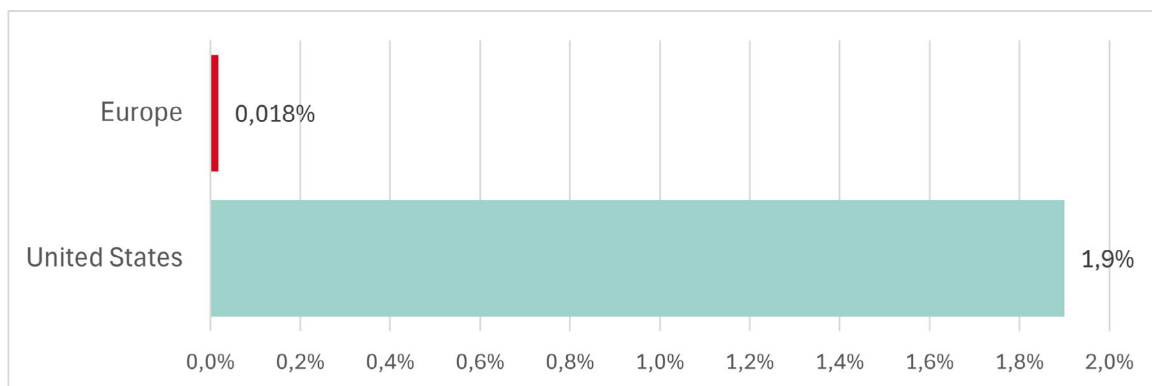
3.3.4 Establish a new risk-taking culture

While safeguarding financial stability must remain the yardstick, measures to encourage a certain risk culture in Europe are warranted. This includes retail investors, whose participation on capital markets could benefit from EU-wide consumer protection measures, a European label for a standardised investment product, and national tax incentives for private pension provision.

Even more important for the productivity and competitiveness of the European economy is the provision of risk capital by institutional investors. Currently, European start-ups

and scale-ups lack access to risk capital at home. This can be attributed to the fact that EU pension funds invest 0.018% of their total assets in venture capital, while US pension funds allocate 1.9% (Figure 2). Changing the risk aversion of institutional investors in the EU certainly requires overcoming current market fragmentation and will probably need support from the public sphere. A promising option would be to use the experience of the European Investment Fund (EIF) in the field of risk capital to build an ecosystem that does not require constant taxpayer support but can run under its own steam.

Figure 2: Pension funds' investment in venture capital (in % of their total assets)



Source: Cleantech for Europe (2023).

4 Conclusion

Advancing Europe's capital markets requires fundamental reforms. As long as our financial sector fails to provide innovative firms with growth capital, Europe will lose out in the global race for transformational technologies. Consequently, there is a strong case for delivering on the CMU project launched ten years ago. However, neither declaratory statements nor deregulation will do the trick. Harmonisation is the key to create deeper and integrated capital markets in Europe – even if this takes time.

At the same time, the CMU is no panacea for all the EU's investment needs. To deliver on its potential it needs to be part of a broader investment package. First, this includes completing the banking union. Since banks play an important role as ports of entry into capital markets, the integration of Europe's banking system is far from completed. Completing banking union will also help advance CMU. Second, the CMU is no substitute for public finances. The twin transitions call for huge capital-intensive investments that necessitate an increase in public expenditures, too. If co-financed via joint borrowing at the European level, this would produce an EU safe asset that provides capital markets with a common reference rate driving forward financial integration.

The incoming European Commission will be crucial to translate the current momentum into an ambitious and effective CMU agenda. With the Franco-German engine now weakened due to domestic politics, the Commission must fill that vacuum at EU level to avoid the risk that no substantial or the wrong measures are adopted. Taking EU leaders at their word when they talk of urgent progress, the Commission should press for real structural changes as a matter of priority for its new mandate.

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This policy brief is part of the Resilient Recovery Project funded by the European Climate Foundation (ECF).

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