TACKLING IMPEDIMENTS TO CAPITAL MARKETS UNION IN THE EU

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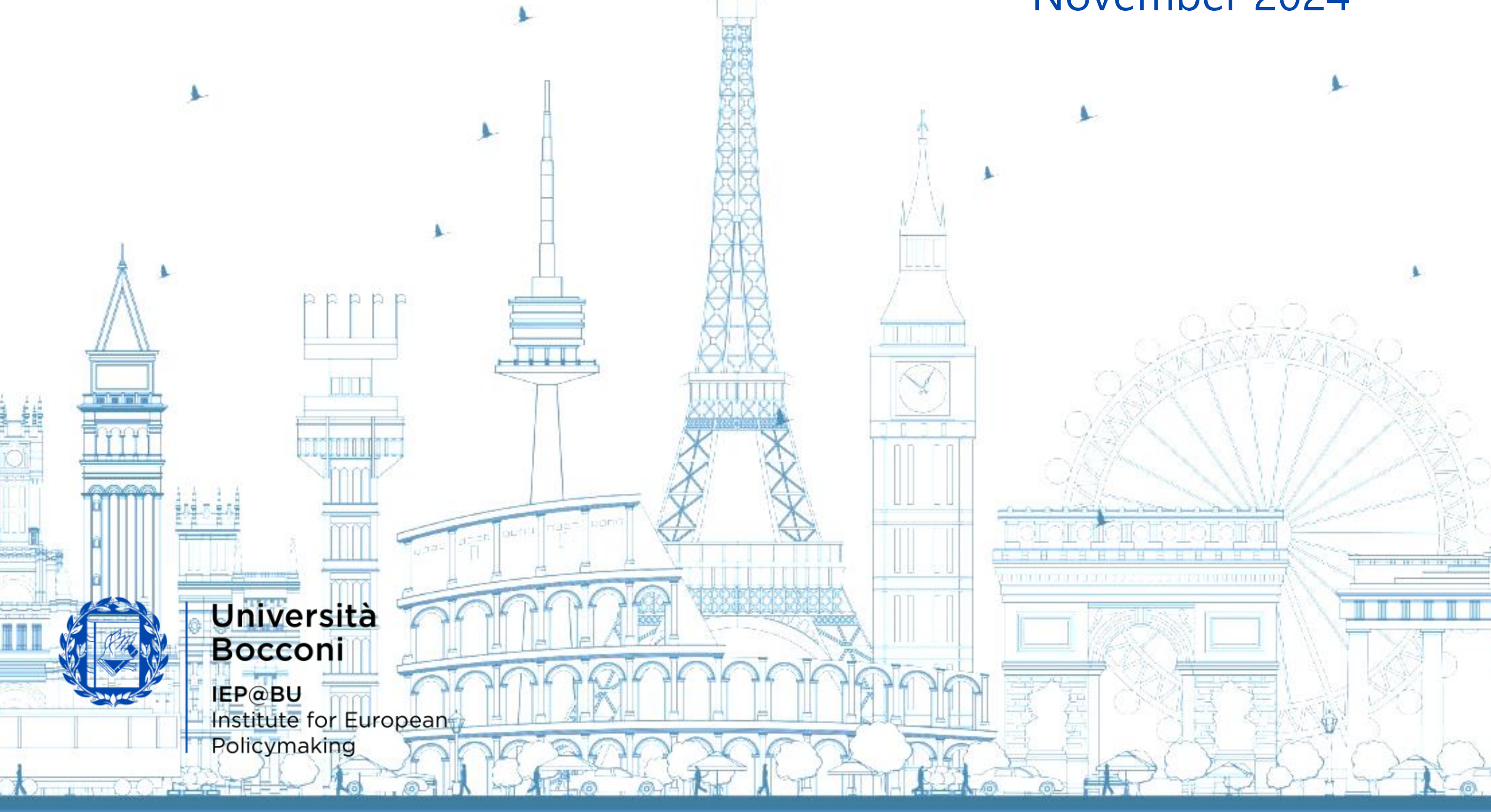
IEP@BU Policy Brief
n.29
November 2024



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1. Capital Markets Union in the European Union

European capital markets are severely underdeveloped relative to the United States and other major capital markets worldwide in terms of market capitalisation and the availability of financial instruments and specialised intermediaries, resulting in strong bank dependence, and are by and large fragmented along national lines (ECB 2024, IMF 2019, Sapir et al. 2018). The financial portfolios of households remain strongly biased in favour of bank deposits, while equity plays a lesser role.

Over-reliance on banks was starkly exposed during the global financial crisis of 2007-2008 and the subsequent Eurozone sovereign debt crisis, which highlighted the vulnerability of Europe's financial system due to its limited availability of alternative channels of financing.

Several projects to relaunch capital markets union (CMU) over the past two decades have somehow failed to achieve critical mass, despite considerable deployment of political capital: the Single Market project of the 1980s, which created the European passport for financial services; the Financial Services Action Plan and the Lamfalussy Process in the early 2000s; the Larosière Report in 2009, which proposed the single rulebook and resulted in the creation of European supervisory authorities (ESAs).

CMU aims to create a more resilient financial system by complementing bank lending with broader access to equity and bond markets. This diversification is expected to reduce the pro-cyclicality of finance, lower the cost of capital, and provide more extensive funding opportunities for businesses, particularly small and medium-sized enterprises (SMEs), which are the backbone of the European economy.

In 2015, the European Commission published the Green Paper on the Capital Markets Union[1] with the aim of establishing a more integrated and resilient financial market across the European Union. The Green Paper identified different actions to establish an effective CMU.

The first one is to lower barriers accessing capital markets. The Commission intended to simplify the prospectus regime by streamlining the approval process and reducing obstacles, making it easier for companies (including SMEs) to raise capital across the EU.

Another action consisted in widening the investor base for SMEs. The Commission sought to improve credit information for SMEs by standardizing credit data, aiming to attract more non-bank investors and facilitate capital market access.

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[1] COM (2015) 63 final.

The Green paper also proposed to enhance the use of European Long-Term Investment Funds (ELTIFs) to attract institutional investors for infrastructure and long-term projects and to develop standardized processes for private placements, removing legal barriers to help medium-sized firms raise capital more effectively across borders.

A central role for the CMU was given to securitization. The Commission aimed at establishing a transparent, simple, and standardized securitisation market to rebuild confidence and promote investments in SME loans.

Among these actions, the need to improve access to finance for small and medium-sized enterprises (SMEs) stood out. SMEs often struggle to secure bank loans, particularly during economic downturns. The CMU could be an instrument to provide SMEs with more avenues for funding, including venture capital and private placements.

The Green Paper also emphasized the need to harmonize regulations between member states. Fragmentation in financial rules and regulatory frameworks has been a significant barrier to the creation of a single capital market. Simplifying these regulations and reducing the associated barriers was seen as essential to fostering a more unified European financial system.

This note discusses the main barriers to free capital movements (Para. 2), national regulations impeding CMU (Para. 3), and the key role of securitization of credits in opening up capital markets (Para. 4). The conclusions summarize our policy recommendation: while waiting for full harmonization of relevant laws, we recommend in the meantime to set up financing arrangements that free the hands of issuers in choosing the financing channels best suited for their needs across the member states financial markets.

2. Main barriers to free capital movements

Historically, the EU's financial markets have been fragmented along national lines, with a prominent role of banking in providing finance to enterprises and households and a limited role of capital markets. This over-reliance on banks was starkly exposed as a source of instability during the global financial crisis of 2007-2008 and the subsequent Eurozone sovereign debt crisis, which highlighted the vulnerability of Europe's financial system. Table 1) shows the differences across EU and the USA, highlighting the underdevelopment of the European capital market.

Table 1) Capital Market Indicators: European Union (EU) vs USA

	EU	USA
Total market capitalization as % of GDP(1)	60%	175%
VC investment to GDP(1)	0,04%	0,63%
% national firms acquired by foreign firms trough M&A(2)	13,40%[1]	4,20%[2]
Non-financial companies (NFC) equity and bond issuance as a % of total NFC annual financing(3)	10,62%	26,87%
Risk capital investment (EURbn)(4)	43,3	259,5
Private Equity Investment (EURbn)(4)	50	260
Pre-IPO risk capital index(5)	3,70%	17%
Household market financial assets (excluding cash, bank deposits and unlisted equity) as % of GDP(5)	90,40%	310,80%

Sources: Demertzis et al. (2021) and Capital Markets Union. Key Performance Indicators – Sixth Edition, November 2023, AFME

Notes: Indicators refer to the following time period: (1) 2019, (2) 2019-2020, (3) Avg 2020-2023H1, (4) 2022, (5) 2023H1.

Definitions: *Risk capital investment* considers VC, Private equity, business angels and equity crowdfunding.

Pre-IPO risk capital index considers investment from VC, growth PE, business angel and equity crowdfunding as % of risk capital and bank lending

The legal frameworks governing financial markets, corporate governance, securities regulation, and taxation vary significantly among the EU member states, creating an uneven playing field for businesses and investors. These disparities in regulation foster a fragmented market structure where financial products and services cannot be uniformly accessed or offered across borders.

Moreover, variations in corporate governance standards, such as shareholder rights and transparency requirements, further complicate the integration process. Companies operating in multiple jurisdictions face significant compliance costs as they adapt to different regulatory standards, which can discourage cross-border listings and mergers. The lack of a unified approach to corporate governance not only hampers market efficiency but also undermines investor confidence in the stability and predictability of investments within the EU.

We describe below the main restrictions on cross-border capital flows, as they have been identified.

[2] 4.2% of US firms targeted by an M&A were acquired by EU firms.
13.4% of EU firms targeted by an M&A were acquired by US firms.

3. Specific barriers to capital flows

The European Commission has made efforts to standardize these regulations through directives and regulations, such as the MiFID II[3] and the AIFMD[4], but full harmonization remains elusive. The main obstacles impeding CMU are listed below.

(a) Bankruptcy and Insolvency Procedures

The diversity in national insolvency regimes is a critical impediment to the CMU's development. Efficient and predictable bankruptcy procedures are essential for reducing risks associated with cross-border investments. In the EU, however, insolvency laws differ widely, with some countries favouring quick liquidation of assets while others prioritize restructuring to save the business.

For example, in Germany, bankruptcy laws are geared towards swift restructuring and rehabilitation of companies, whereas in Italy they tend to favour the recovery of creditor claims, and are cumbersome and lengthier. These inconsistencies make it challenging for investors to assess the risks of engaging in cross-border financial activities, as the recovery rates on distressed assets can vary drastically depending on the jurisdiction.

Efforts have been made to address these divergences through the EU Directive on Restructuring and Insolvency,[5] which aims to harmonize certain aspects of national insolvency laws, particularly concerning preventive restructuring frameworks. However, the directive failed to create a uniform insolvency code, leaving significant differences in place that continue to affect market dynamics and cross-border investments.

(b) Debt Collection mechanisms

Creditors' rights and debt collection mechanisms also vary significantly across the EU, impacting the availability and cost of credit. In some member states, creditors enjoy robust legal protections and efficient debt recovery processes, while in others, enforcement procedures are slow and uncertain. This legal variability can lead to higher borrowing costs for companies in less creditor-friendly jurisdictions, thereby discouraging cross-border lending.

The inefficiency of debt collection in some countries not only increases the risk for creditors but also affects the overall liquidity in the financial system, as lenders may be reluctant to extend credit where recovery is uncertain. Harmonizing debt recovery laws would facilitate a more predictable lending environment, essential for encouraging investments in higher-risk markets and supporting SMEs.

(c) Investor Protection

Investor protection standards are fundamental in fostering trust in the financial system, yet they remain inconsistent across the EU. For example, some member states have stringent regulations

[3] Directive 2014/65 of the European Parliament and of the Council of 15 May 2014
[4] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011
[5] Directive 2019/1023 of the European Parliament and of the Council of 20 June 2019.

that require comprehensive disclosures and offer strong recourse mechanisms for investors, while others have more lenient requirements. These inconsistencies can lead to regulatory arbitrage, where financial service providers choose to operate in jurisdictions with less stringent rules, undermining the overall integrity of the market.

The disparities in rules governing investor rights, information disclosure, and dispute resolution mechanisms create uncertainty and risks for retail and institutional investors alike. A uniform level of protection would be essential to build confidence in cross-border investments, which is critical for the success of the CMU.

(d) Market Infrastructure and Clearing Systems

The infrastructure supporting the EU's capital markets, including trading platforms and settlement systems, remains fragmented. Differences in these market infrastructures lead to inefficiencies and barriers to cross-border capital transactions. For instance, the lack of interoperability between national central securities depositories (CSDs) increases settlement costs and risks, making it more difficult for investors to operate on a pan-European scale.

The implementation of the Target2-Securities (T2S) platform has been a step towards integrating settlement systems across Europe, reducing costs and improving efficiency. However, full harmonization of clearing and settlement processes has yet to be achieved, as many local infrastructures still operate based on their national standards. The challenge is not just technical but also regulatory, as each member state has its own rules governing market operations, which complicates efforts to create a single market infrastructure.

(e) Transparency and Financial Reporting Standards

Transparency is a cornerstone of financial markets that allows investors to make informed decisions based on accurate and comparable data. However, financial reporting standards differ across EU member states, making it challenging for investors to evaluate and compare the financial health of companies in different jurisdictions.

The lack of standardized reporting practices complicates cross-border investments, as investors face difficulties in analysing the risks associated with different markets. While the EU has adopted the International Financial Reporting Standards (IFRS) for publicly listed companies, discrepancies still exist in how these standards are implemented at the national level. Greater convergence towards a unified reporting framework would enhance market transparency and investor confidence.

4. Divergent national regulations

Besides specific restrictions to free capital flows, a main challenge to CMU is the persistence of divergent national regulations across EU member states (Letta, 2024). The legal frameworks governing financial markets, corporate governance, securities regulation, and taxation vary significantly, creating an uneven playing field for businesses and investors. These disparities in regulation foster a fragmented market structure where financial products and services cannot be uniformly accessed or offered across borders. Moreover, The EU's Golden Power regulations, for instance, allow member states to intervene in foreign direct investments (FDIs) that may affect national security or public order. While these rules are designed to protect strategic sectors, they can also act as a barrier to cross-border investments within the EU itself. This protective perspective is sometimes used to block or condition investments not only on national security grounds but also on broader economic considerations, which may sometimes amount to protections of national “champions” that hinder the free flow of capital within the EU internal market.

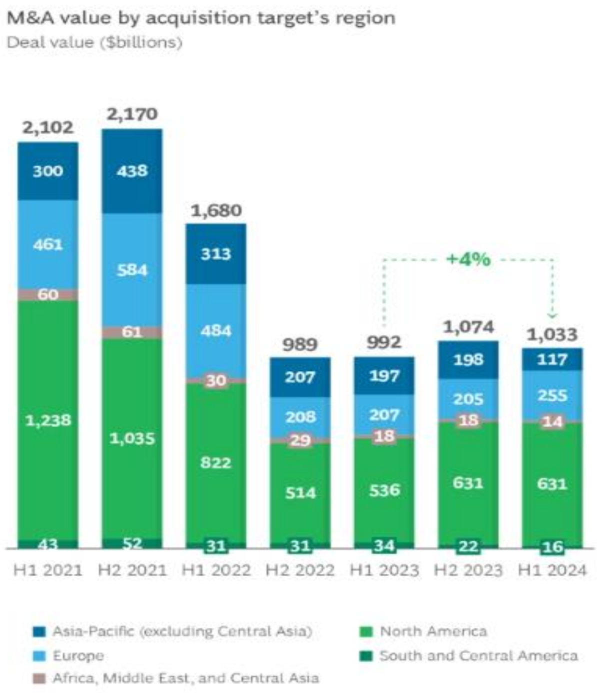
Beyond regulatory and legal obstacles, cultural and political factors also play a significant role in hindering cross-border mergers and acquisitions within the EU. National governments sometimes oppose foreign takeovers of domestic companies for fear of losing strategic assets or local jobs, regardless of the potential economic benefits of such deals (Bini Smaghi 2024).

This picture of resistance to integration is more generally confirmed by the data in Figure 1: as may be seen, in 2023 the value of M&As in Europe is 1/3 of the value in North America.

This resistance to M&A often responds to protectionist attitudes and concerns over national sovereignty, which are deeply embedded in the political landscape of many EU countries. Overcoming these barriers requires not only regulatory alignment but also a shift in political and cultural mindsets towards embracing cross-border business integration as a driver of growth and innovation. A fitting example is what happened recently in the banking sector, when Unicredit move to acquire control of Commerzbank was met by strong union and political opposition in Germany.

Allowing EU companies to scale up within the Single Market in not just an economic imperative but a strategic one. As emphasizes by Letta (2024), the lack of integration in the financial, energy and electronic communication sectors is a primary reason for Europe’s declining competitiveness. There is therefore an urgent need to resume progress in the development of the Singel Market, notably for financial services, energy and electronic communications.

Figure 1: Value of M&As by regions



Source: BCG, M&A Insights H1 2024

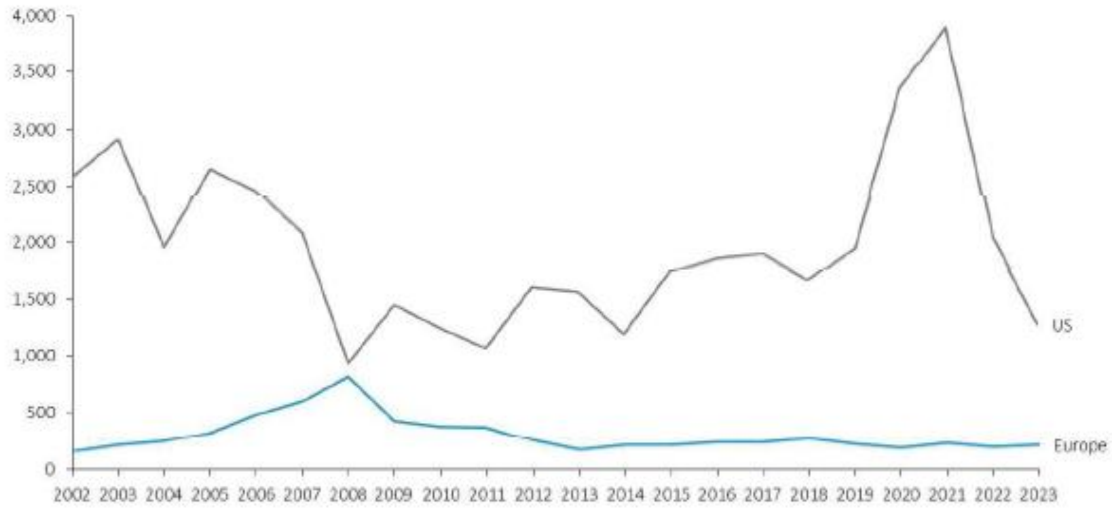
5. Securitisation

A key component of the proposal in the Commission 2015 Green Paper was the promotion of securitisation. Securitisation "enables a lender (often a bank) to refinance a set of loans/assets by converting them into securities that investors can purchase in the market. The lender pools a portfolio of its loans into a set of securities tailored to different investor risk/reward characteristics; end investors are the repaid by the cash-flows generated by underlying loans."[6]

The development of this instrument has followed markedly different paths in the European Union and the United States. In the aftermath of the financial crisis, the US securitisation market rebounded significantly, with the market size now more than three times larger than it was a decade ago. By contrast, the securitisation market in the EU has shrunk. Yearly issuance of securitizations stood at 0.3% of GDP in 2022, while in the USA it amounted to 4% of GDP.

Figure 2 in the Draghi Report (2024) illustrates this divergence, showing the dramatic loss in European securitisation volumes relative to the United States over the past decade. Despite similar levels of private non-financial lending in both economies, securitisation has continued to thrive in the US while stagnating in Europe.

Figure 2: Securitisation volume Europe vs US
(annual issuance of securitisation Europe (including UK) vs US in billion EUR



Source: AFME (2023)

The disparity between the two regions can be attributed to different reasons: the stigma still attached to this instrument; different macroeconomic conditions; availability of cheaper refinancing sources. However, differences in regulatory frameworks must also have played a paramount role.

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[6] https://ec.europa.eu/commission/presscorner/detail/bg/MEMO_15_5733

In Europe, more stringent accounting and prudential rules were adopted following the 2008-09 financial crisis, making securitisation more complex and costly. Moreover, the legal framework in the EU is highly fragmented, with each member state applying its own rules and regulations. This creates severe obstacles for cross-border transactions, hampering the growth of the securitisation market.

Improving the instruments of securitisation will be a key pillar to accelerate the Capital Markets Union and facilitate the free flow of capital across the member States.

In response to the challenges facing the European securitisation market, in 2017 the EU introduced the Simple, Transparent, and Standardized (STS) regulation as part of its broader efforts to implement the CMU. Table 2 summarises the STS criteria.

Table 2: STS criteria

Criteria	Details
Simple	‣ The transfer of assets constitutes a true sale ‣ The assets transferred: – are not encumbered – do not allow for active portfolio management on a discretionary basis – are homogeneous and have full rights of recourse – do not take the form of tradeable securities (including those issued by securitisations) – are originated in a manner that is consistent with the originator's normal standards for originating such assets – are not in default at the point of transfer – have made at least one payment at the point of transfer
Standardised	‣ The risk retention requirements are complied with by the originator or sponsor ‣ Interest rate and currency risk associated with the structure are mitigated (this can involve the entering into derivative contracts) ‣ Interest on the assets and notes are representative of market rates (that is not leveraged) ‣ Principal receipts from the assets shall be payable to the note holders when due in accordance with the structure's pre-established priority of payments and notes' seniority ‣ There shall be no provision that require liquidation of exposures at their market value
Transparent	‣ The originator, sponsor and SPE provide access to historical data on default and loss performance for substantially similar exposures to those being securitised to the investor before investing ‣ A sample of the underlying exposures are externally verified prior to issuance of the notes by an appropriate and independent party ‣ The originator or sponsor provide a liability cash flow model to investors ‣ The originator, sponsor and SPE are jointly responsible for compliance with the documentation requirements over the lifecycle of the securitisation

Source: Binder Dijker Otte (2018)

When properly implemented, securitisation offers significant benefits for all parties involved, potentially contributing strongly to the implementation of the CMU. For banks, securitisation helps free up their balance sheets by transferring the risk of loans to external investors. This allows banks to extend more credit to customers, particularly SMEs, which often struggle to access traditional bank financing. The ability to securitise non-performing loans also helps banks manage risk more effectively, enabling them to redeploy capital towards more productive uses. It can also foster additional real economy financing and transition related lending.

For investors, securitisation provides access to a wider array of investment opportunities. Securitised products allow investors to diversify their portfolios and gain exposure to different types of assets, from corporate credit to residential mortgages. With the rise of green finance, securitisation can also play a pivotal role in supporting investments in sustainable and environmentally friendly projects.

Finally, securitisation benefits the broader economy by providing businesses, especially SMEs, with more funding options. By reducing the reliance on bank financing and encouraging access to capital markets, securitisation can promote greater innovation and economic growth. In a prolonged low-yield environment, securitisation offers a much-needed alternative for both borrowers and investors.

In sum, securitisation creates a “win-win-win” situation for all players and can be a boost for CMU even without further liberalization: banks can free up capital, investors may gain new investment opportunities, and SMEs and other businesses will have much expanded access to funding.

6. In conclusion

Lack of integration of capital markets is a major source of weakness and declining competitiveness of the European economy. While efforts to complete harmonization of capital market legislation in this domain should retain highest priority in the new Commission’s work programme, there is room to advance integration by exploiting the STS regulation introduced by the EU in 2017 as part of its broader efforts to implement the CMU.

The STS regulation seeks to provide banks and non-financial institutions with an effective and less expensive source of funding, and to establish confidence in securitisation by ensuring that transactions are structured in a more straightforward, transparent, and easily understandable manner.

The regulation requires that securitised products meet certain criteria related to simplicity, transparency, and standardisation. These include clear definitions of the underlying assets, better disclosure of risks, and restrictions on the use of excessively complex structures. The goal is to make securitisation a more attractive option for investors while ensuring that it serves as a stable and secure funding mechanism for banks.

By addressing the complexities and risks that contributed to the financial crisis, the STS framework makes it possible to foster a safer and more robust securitisation market in the EU without waiting for full harmonization of capital market legislation.

However, the harmonisation effort is not sufficient to have truly integrated capital markets in the short term. One proposal for speeding up the CMU was recently put forward by both Enrico Letta and Mario Draghi in their Reports for the European Commission: to create a “28th regime” mechanism, which does not envisage regulatory harmonisation between countries but the creation of a parallel legal regime whereby issuers would have immediate access to the most favourable legal regime for their funding already existing in any of the member states.

Of course, borrowers would still have to respect rules of prudent borrowing, as routinely assessed by lenders or intermediaries for direct market funding; and, similarly, lenders and security issues in the market would continue to respect criteria for prudent lending. However, all restrictions to funding operations related to the nationality of the borrowers could be lifted, thus increasing substantially the options for funding available to firms registered in any one of the member states. This approach could also help overcome the restrictions to capital movements within the European Union that have been described.

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