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# The Capital Markets Union in light of Next Generation EU

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In the comparative analysis of financial systems, there is a widely held theory that the European (and, in particular, the Spanish) system displays a clear predominance of bank intermediation as the primary mechanism for financing economic activity, compared to the Anglo-Saxon (and, in particular, the US) model, in which capital markets play a far greater role in such financing.

Based on this insight, the European institutional framework is clearly in favour of diversifying the sources of business finance, to reduce the excessive banking bias that currently prevails, especially in the eurozone. Along the same lines, many commentators are absolutely convinced that the different configuration of financing in the United States is one of the reasons for the country's greater business dynamism and innovative mindset compared to Europe. This is obviously not the only reason, with the lower rate of entrepreneurship in Europe being another key factor.

In view of these points (diversification of finance sources and greater reliance on capital markets, in the belief that they are more inclined to finance innovative activities and ventures that involve assuming greater risk), since 2015, the European Commission has been working towards the construction of a Capital Markets Union (CMU) in Europe. The date of the launch of this initiative is far from random, as it coincides with the effective rollout (albeit, as yet, incomplete) of the Banking Union (BU), to which the CMU will add the link of the chain required for full financial integration in the eurozone.

In its initial configuration, the CMU project focused on three main lines of action:

- The development of alternative financing sources.
- Giving support to SMEs, particularly those of a more innovative nature.
- Strengthening the capital levels of companies.

These fundamental goals of the CMU become even more valid and justified within the context of the ambitious recovery and production restructuring plan approved by the European Union in July 2020 in response to the pandemic: Next Generation EU (NGEU).

The two key sector focuses of the plan (sustainability and digitisation/innovation) will require investments for which bank financing –and, in general, any financing based on loans with an explicit cost and maturity- is far less suitable. In contrast, equity financing is much more appropriate, with the risks and returns generated by such investments being shared.

Against this backdrop, the objective of this Policy Brief is to review the degree of development achieved by the CMU to date and, more specifically, the need to boost it and align its priorities and strategic axes with the maximum amplifying effect of the NGEU. Within the current context of rising finance costs and changing monetary policy, an analysis such as the one undertaken here may also contribute towards minimising future risks, as long as the approach is not underpinned by increasing regulation.

## 1. The Capital Markets Union (CMU): foundations and progress achieved

### 1.1. The CMU as a complement of the Banking Union (BU)

After the rollout of the Banking Union (BU) (albeit gradual and, as yet, incomplete), European financial integration is striving to take a further important step forward with the construction of another large project intended to complement the BU: the Capital Markets Union (CMU).

Perhaps the main difference between the two unions is the degree of specificity of their respective goals. The BU was created as a solution to a very definite problem, the fragility of the banking systems in the eurozone, and the self-feeding impact that this vulnerability has with respect to the sustainability of the public finances in the respective countries, giving rise to the renowned "diabolic loop" or "vicious circle" between banking and sovereign risks.

In the case of the CMU, in contrast, the problem is far less specific and involves less defined profiles, resulting in the proposed solutions also being far more varied and less visible in terms of the progress of their implementation and effectiveness. Moreover, in this case, the fact that there are numerous supervisors in the capital market is an important point that continues to restrict meaningful progress at an EU level.

In any case, it should be highlighted that the banking system and the capital markets are two key components of the financial system, which evidently complement each other in various ways. In the former case, the financial intermediation function undertaken by banks enables small amounts of short-term savings (deposits) to be grouped together into larger longer-term loans. By performing such an intermediary role, on behalf of the depositors, banks perform a permanent "monitoring" role of the borrowers for the lenders. As a result, banks are better placed than capital markets to resolve agency problems between debtors and creditors, developing relationships of trust that will underpin this bank financing.

Despite these advantages, bank financing is less suitable when the companies looking for financing have not got any collateral, a history of a good credit rating nor predictable and stable financial flows. This is the case of newly created companies or ventures with a large innovative component and high growth potential, for which financing based on the diverse range of instruments available on capital markets is obviously far more effective than borrowing from banks.

## 1.2. Progress in the CMU: considerable but insufficient

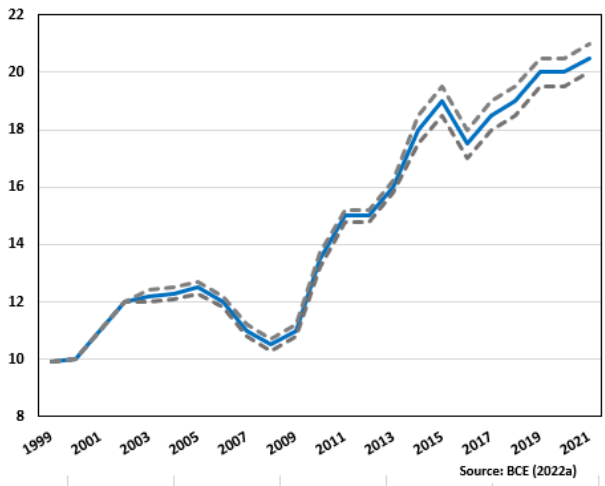
The aim of the CMU was primarily to incentivise the diversification of financing sources for the business sector in order to reduce its excessive dependence on bank financing, as well as developing sources of long-term financing for infrastructures, which were a particularly important feature within the framework of the Juncker Plan, launched almost simultaneously with the CMU. In the words of its main advocate, the British politician Jonathan Hill (at the time, the European Commissioner heading the initiative, until he resigned from his post the day after the Brexit referendum), the CMU aimed to reduce the weight of bank financing in a process that could be described as 'unbanking Europe'.

It should be acknowledged that significant progress has been made in the process of diversifying sources of business financing, with a growing relative weight (albeit still a minority) of market-based financing, to the detriment of bank financing. Adapted from the European Central Bank (2022a), Graph 1 shows that the proportion of this market-based financing has doubled over the decade and a half since the financial crisis, from 10% to almost 20%.

The ECB itself, in its interpretation of this trend, argues that companies used market finance as a "spare tyre" to tackle the lack of bank credit options following the financial crisis, and this went on until their bank balances improved and they shored up their solvency.

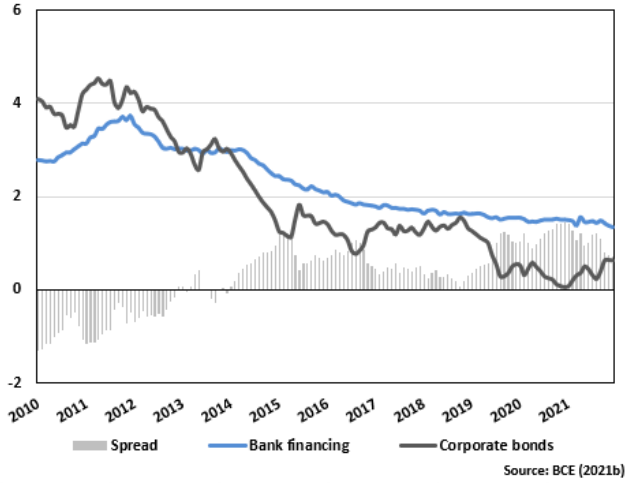
As well as the increased aggregate weight of market finance, there is also a notable increase in the number of companies that resort to using these markets, with the incorporation of smaller companies issuing bonds for the first time, as observed by Darmouni and Paputsi (2022). According to their study, between 2014 and 2018, over 10% of the bonds issued each year were from first-time issuers. Moreover, according to OECD statistics, in the capital market, the volume of corporate bonds issued by small companies rose by 20% in 2021. In Spain, for instance, in 2021, the BME's Alternative Fixed-Income Market (MARF) designed for smaller companies reached a total of 100 bond issuers, since its creation in 2013. Nevertheless, specific support is still needed for these smaller bond-issuing companies.

**Graph 1. Market finance for companies in the eurozone**



This growing use of market finance by European companies has, at the same time, benefitted from financing conditions that have tended to improve gradually, both in absolute terms and in relation to bank financing, as observed in Graph 2, taken from the ECB (2021b). The graph shows how the spread between the cost of market financing and bank loans went from negative (loans were cheaper) in the first few years after the financial crisis, to systematically positive throughout the second half of the decade.

**Graph 2. Cost of market finance (bonds) compared to bank finance**




While certainly noteworthy, these advances do not eradicate the perception of the financial system of the eurozone relying excessively on bank intermediation for business financing, to the detriment of market-based financing sources, including both borrowed resources (bonds) and equity (shares), a fact that we will examine in greater depth later in the report. For a global overview of the financial system of the eurozone (and Spain within it), Table 1 shows the approximate sizes of the main segments of the European and Spanish financing system, and how they compare to the equivalent figures in the case of the United States, both in absolute terms (in euros) and as a percentage of the gross domestic product in the two economic areas.

**Table 1. Financial system of the United States, Eurozone and Spain: distribution by segments at the end of 2021** (approximate figures in billion euros and as a % of GDP)

| | USA | Eurozone | Spain |
|---|---|---|---|
| Bank assets | 22 (120%) | 24 (200%) | 2.5 (200%) |
| Treasury bonds (outstanding balance) | 22 (120%) | 11 (95%) | 1.3 (115%) |
| Corporate bonds (outstanding balance) | 8 (40%) | 1.5 (18%) | 0.2 (15%) |
| Equity (capitalization) | 46 (220%) | 10 (80%) | 0.8 (65%) |

*Source: Prepared by the authors based on data from the Federal Reserve, Eurostat, ECB, European Stock Exchange Federation.*

In the case of Spain and Europe, which share a very similar structure, a high reliance on banking assets still prevails, exceeding 200% of GDP, almost double the proportion they account for in the United States. In contrast, in the United States, capital markets play a far greater role in all segments, but particularly with respect to private issuers, with the relative weight of treasury bonds being fairly similar on both sides of the Atlantic, which is more related to the government debt accumulated in the various jurisdictions.

When it comes to corporate shares and bonds. The difference between the United States and the eurozone is really astounding, both in absolute terms (with the former using this option four times more than the latter) and as a proportion of GDP, with the United States tripling the relative weight in Europe. This quantitative difference acquires even greater potential if we bear in mind that the US capital market operates as a completely integrated entity (despite there being different trading platforms), while the European market still comprises seventeen markets with, as yet, a low degree of integration.

This difference between a single capital market in the United States and seventeen relatively segmented markets in the eurozone also applies to the government debt segment, which makes the NGEU far more relevant as a debt-market integration tool, as we will discuss further

## 1.3. CMU 2020 Action Plan

The European Commission has strived to make new efforts to boost the CMU with the aim of accelerating its effective implementation and closing the gap that still persists between the European and US financial systems.

It took its first institutional support measures in September 2020 with the launch of a new CMU Action Plan with a triple goal, which takes the form of three key objectives and seventeen actions, as shown in the table in Annex 1.

- Objective 1 (SMEs) Making financing more accessible to companies, especially smaller ones.
- Objective 2 (Individuals). Giving better opportunities for individuals to invest their savings.
- Objective 3 (Single Market). Achieving greater integration of the financial markets.

The effective implementation of this new updated action plan aimed to generate tangible progress in the development of an integrated and far-reaching integrated European capital market better suited to fostering growth based on innovation and sustainability, which are fundamental principles of the NGEU, as we will discuss in Section 2 of this report.

One significant step forward within the framework of this new action plan is the creation of the ESAP (European Single Access Point), a digital platform to store harmonised company information, particularly open to small and medium enterprises, as an initial step towards bringing such companies closer to the investor ecosystem, and eliminating (or at least reducing) the information asymmetries that have traditionally prevailed as the main barrier preventing them from accessing capital markets.

Another key feature of the plan is the review of all the regulations on trading on organised markets, with the aim of facilitating and reducing the cost of floating smaller companies. One important step in this direction will be the definitive regulation of the so-called SME-IPO Funds or, in other words, investment finds especially designed to specialise in investing in companies launching their Initial Public Offerings. This will generate new investor demand for these stock launches which, in turn, will make it more attractive for new companies to go public and diversify their financing sources, which are currently excessively biased towards bank finance, or self-financing by reinvesting profits.

This boost to the capital markets, and most importantly all the forms of capital injection in the initial phases of the company (venture capital, seed capital, growth capital), takes on a certain sense of urgency within the context of the NGEU that we will analyse in the following section. Of course, it does so in contrast to the situation in the United States, which Europe uses as a role model when designing a financing system particularly suited to promoting the goals of digitisation and sustainability on which the NGEU focuses its greatest efforts.

## 2. The need to align the CMU with the financial demands of the NGEU

### 2.1. NGEU: huge amounts and their allocation

Adopted by the European Union as a key element of its pandemic recovery strategy, the Next Generation EU (NGEU) constitutes an unprecedented effort in the construction of Europe. It also provides an historic opportunity to align the development of the financial markets (particularly capital markets) with the programme's objectives, which certainly entails closing the gap between the role played by capital markets in Europe compared to in the United States, as discussed in the previous section.

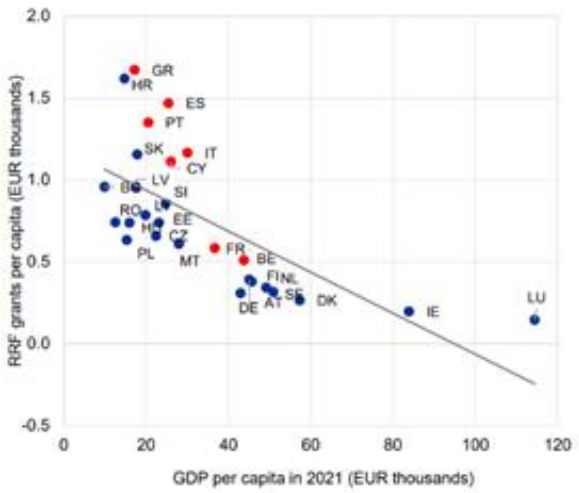
The NGEU amounts to a total of 750 billion euros, of which the main instrument is the Recovery and Resilience Facility (RRF), accompanied by other smaller instruments, some of which existed prior to the pandemic.

As well as the huge size of the NGEU (slightly over 5% of the GDP of the European Union), other characteristics also ensure its unprecedented scale in terms of its role in dynamising and transforming European economies and contributing towards greater economic and financial integration, a goal that will be a clear side effect of progress towards the Capital Markets Union.

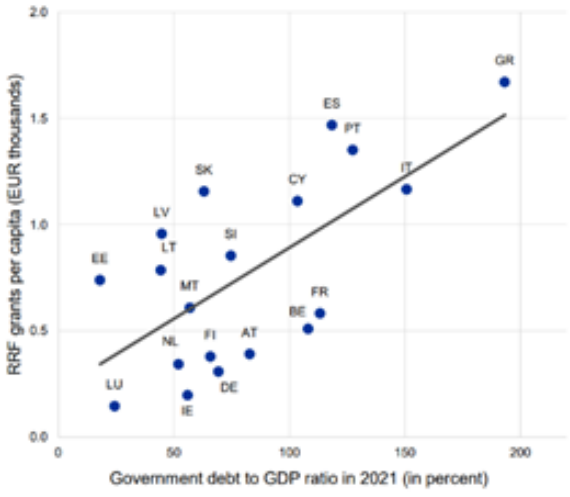
Firstly, the fact that, for the first time in history, the European Commission as an issuing body, rather than the Member States separately, will make recourse of the financial markets to raise the required funding, which will certainly give a significant boost towards an integrated European capital market, as well as creating an "anchor" financial product (known as a safe asset in the financial literature), in the form of the bonds issued by the Commission.

**Graph 3. NGEU allocation by country based on GDP per capita and government debt to GDP ratio**

**a. RRF grants per capita and GDP per capita**



**b. RRF grants per capita and government debt to GDP ratio**



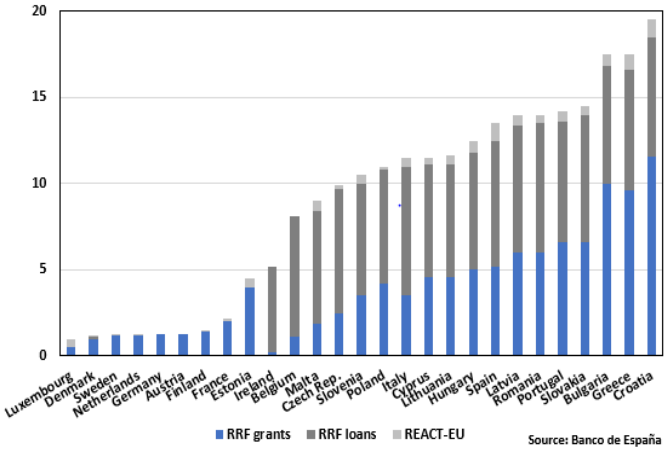

**Source: Schnabel (2022)**

With an average issue volume of around 150 billion in the five-year period from 2022 to 2026, the European Commission has become the biggest issuer in the European capital market. In view of the high volume planned in its recourse to the market, the Commission has taken particular care in the planning and governance of the whole issuing process, and has strived to diversify the instruments used (promissory notes, bonds, green bonds) and issuing procedures (auctions and syndications), as well as establishing a transparent and well structured framework of relations with the primary dealers (Primary Dealer Network), which are all key aspects in reinforcing the Capital Markets Union.

Secondly, the allocation of these funds to the Member States is not proportional to their weights in the European Union, but rather focuses on the damage caused by the pandemic, as well as needs in terms of convergence. As such, the worst-hit States will receive allocations that, in some cases, may exceed 15% of their GDP, while others will receive less than 2%. Graph 3 shows the solidarity and convergent nature of the NGEU/RRF, insofar as the allocation of the funds between the different countries is inversely related to the GDP per capita, and directly related to the ratio of government debt to GDP in each case.

Moreover, Graph 4 shows the distribution of the NGEU by country in terms of the proportion of GDP it represents, with a breakdown of the structure of the funds in terms of loans and grants. Spain ranks among the biggest beneficiaries in relative terms, with the total allocated (around 140 billion, only exceeded by Italy) being equivalent to approximately 13% of GDP.

**Graph 4. NGEU by country. Distribution between loans and grants**




Thirdly and just as importantly, a significant proportion (almost half) of the funds allocated to the countries are grants that need not be repaid, with the rest being loans that the Member States must pay back, although with a long repayment schedule and an extended grace period. This also encourages the countries to allocate the funds in a repayable format, which will increase companies' investment capacity by offering a wider range of financial instruments that assume a greater risk.

## 2.2. Green and Digital Transitions: bias towards market financing

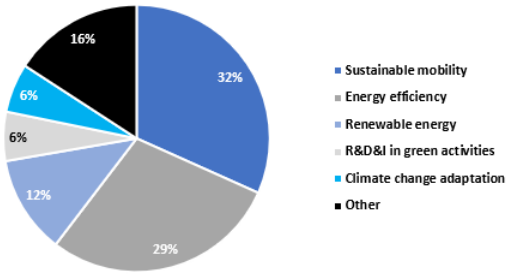
With respect to the sectors that receive the NGEU funds, the two main areas are linked to the two key pillars established by the Commission: the green transition and the digital transition. These two pillars will consume almost two thirds of the entire NGEU programme. It is worth highlighting that both sectors are intensive in terms of technology and employment quality, which endows them with a significant multiplier effect on the quality of economic growth. The distribution between these two pillars is shown in Graph 5.

However, without detracting from the quantitative and qualitative importance of the NGEU, the investments for the recovery and transformation of the production sector needed by Europe are so huge in scale that they must be underpinned by a complementary relationship between public and private sources of financing. It is not only the magnitude of the required investments, but also the nature of these investments, with a very high proportion needed in certain sectors or activities, making equity-based and capital financing essential in

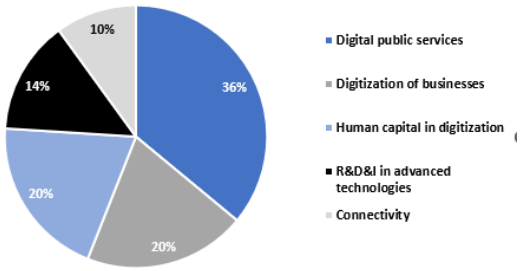
the initial phases of the launch and growth of the business venture.

**Graph 5. NGEU (RRF) Use of funds allocated to the Green and Digital Transition**

**a. Green transition**




**b. Digital transformation**




Source: Lannoo-Tomadakis (2022)

In total, the European Commission estimates that the investments required to reach the goals related to digitisation and sustainability could exceed 600 billion euros per year by 2030, of which less than a third will be contributed by the public investment associated with the NGEU, while the lion's share of these investments must come from private investment, with a high component of risk.

Faced with such a challenge, the question is whether the European financial markets are prepared to provide financing of this scale to digitisation and sustainability, sectors in which the risk involved is very high, so the required financing must primarily come from capital markets, especially with recourse to private equity and venture capital, as highlighted by the European Investment Bank (European Investment Bank, 2021). However, it should also be taken into account that the workload entailed in issuing securities on capital markets is high, which hinders smaller companies from doing so and restricts their capacity for diversification.

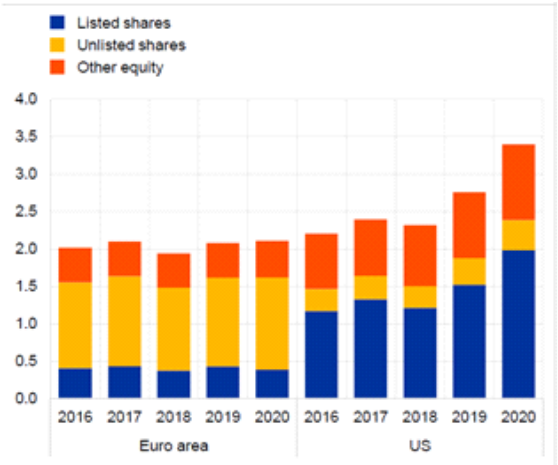
It should be noted that the venture capital market in Europe grew significant after the 2008 financial crisis, practically doubling in since between 2012 and 2020 (from 10 to 20 billion), according to the figures of the European Venture Capital Association. However, this relative growth still amounts to no more than a residual role compared to the United States, which is without doubt the country that places the greatest relative importance on this form of financing, making it a role model to emulate when promoting the use of this type of capital instruments and boosting the progress of the CMU.

In this respect, the Graph 6 clearly highlights the large gap that separates the United States and Europe in terms of the relative weight of listed shares (Graph 6*a*) and even more so with respect to the use of appropriate capital instruments for the launch and growth phases of a business venture (Graph 6*b*).

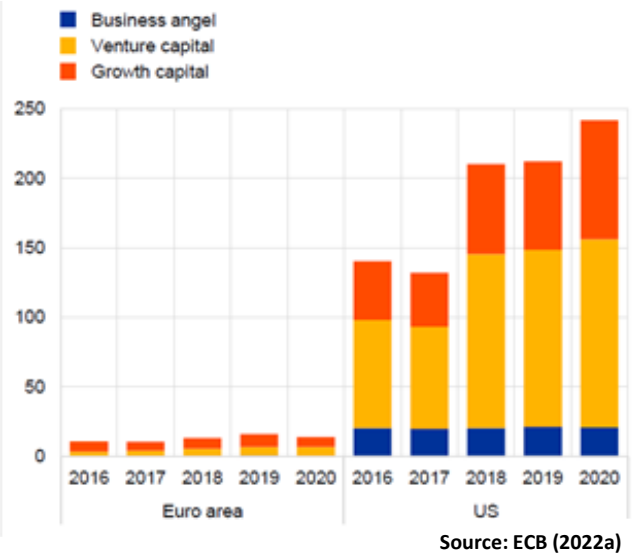
With regard to these phases, financing offered by business angels would be the most suitable source for the very initial phase of business development, when there is little more than an idea, without yet having specified any products or services. In a second phase, when these products or services are being developed but they have still not been rolled out on a mass commercial scale, the most appropriate is considered to venture capital, while growth capital will take the baton in the phase that is strongly focused on the full commercial deployment once the products or services have proven their potential. As the graph shows, the United States' lead over the eurozone is astounding in these categories of capital suitable for the launch and growth of a business.

**Graph 6. Equity Financing and Venture Capital - Eurozone compared to United States**

**a. Equity financing through capital**



**b. *Business angel*, *venture capital* and *growth capital***




**Source: ECB (2022a)**

Furthermore, the repayable part of the NGEU programme has significant potential for the development of the CMU, insofar as it can act as an incentive for the European venture capital ecosystem, making it an opportunity that should be capitalised on. Specifically, the Member States take on an obligation to repay the European Commission approximately 50% of the NGEU funds received as they are granted as a loan, as shown in Graph 4.

The logic behind this argument can be seen in the proposal for using repayable funds defined by the Spanish Government at the end of 2022. The proposal allocates the second part of the funds obtained from the Recovery and Resilience Facility, the main programme for channelling the NGEU funds, to implementing repayable financial support initiatives, a significant part of which will result in capital investments.

In this case, the 84 billion euros have been shared between 12 funds, focusing on the industrial sector and regional projects, some designed to reinforce existing initiatives and others to create new ones (See Graph 7). It includes the creation of financial instruments to support social investments and ventures in the audiovisual sector, promote investments in renewable energies, energy efficiency and circular economy, and create general financial support measures for the business community.

**Graph 7. Funds to channel repayable financing in Spain**

**Source: Ministerio de Asuntos Económicos**

In short, the process is designed to give a clear double boost to one sector in particular: green and digital growth, which, to a large extent, will be funded by financial products that will expand companies' financing capacities in this area through alternative non-bank finance, the wholesale market or venture capital. Combined with the growth of the European bond market generated by part of the funds, this should trigger a change in risk financing for companies in Europe.

## 2.3. Towards a "Green" Capital Markets Union

In contrast to the clear European disadvantage in terms of financing new innovative companies (greater technological intensity), the situation is completely different in relation to the green transition, an area in which Europe has taken a firm lead as the original home of issuers on the green bond market.

To recap, green bonds are any kind of bond in which the funds, or an equivalent amount, are exclusively used to finance or refinance, partly or fully, new or existing eligible green projects. This is the definition widely adopted by the market and established in the Green Bond Principles coordinated by the International Capital Market Association (ICMA).

Europe's position in this regard is increasing considerably and it concentrates a significant part of the green bond market. This fact was already highlighted in mid-2021 by the President of the European Central Bank, illustrated with the following compelling examples:

- Europe is home to public and private institutions responsible for 60% of the green bonds issued in the world.
- Europe accounts for almost 50% of the ESG funds managed around the world.
- The euro is the currency of almost half the green bonds issued in the world.

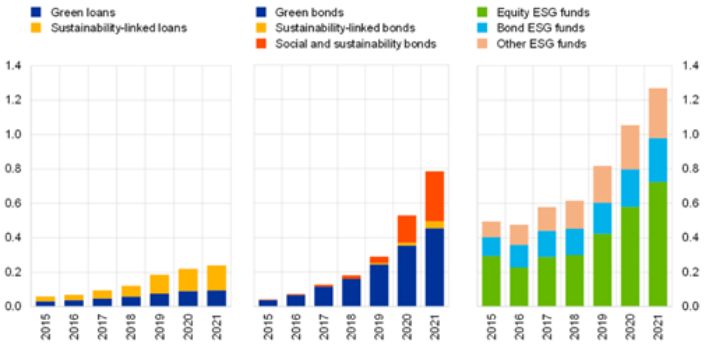
In view of such evidence, the President of the ECB asserted the right and obligation to act as a launchpad for the development of a Green Capital Markets Union (GCMU). To support this assertion, she drew a parallel with the railroad companies in the United States and their role as a driving force in the development of an integrated US capital market, as huge issuers of bonds and shares (in contrast to the previous situation, when business project financing was limited to certain geographical areas where most of the investments were concentrated). This initial boost provided the base on which is built what is certainly the broadest and most extensive capital market in the world, an achievement that the European market wishes to emulate.

This advocacy of ECB's active role in the capital markets to finance the green transition is underpinned by the clear conviction that, for such investments, just as for those specified for digital transformation, market financing is far more appropriate, whether it uses fixed- or variable-income instruments, than traditional bank intermediation. Bank lending depends much more on guarantees and tangible collateral, which newly created companies seldom have, particularly in sectors and activities with a large innovative and intangible component. For such companies, capital market financing is far more suitable, especially in its equity segment or, better still, in its subsegments specialising in companies with growth potential. While it is true that these "official" stock markets may not be particularly appropriate for new companies, which tend to make far more recourse of private unlisted venture capital, such capital later uses the stock markets as an exit route from their investments, once they have achieved their profitability targets.

One study worth highlighting this issue was drafted jointly by researchers of the ECB and the EBRD (EBRD-ECB, 2019), which concludes that the transition towards a low-carbon economy would be better served by a financial system with a greater emphasis on markets than on bank intermediation. Their results lead them to recommend providing support for the development of securities markets, which are far better suited to financing innovative activities in general, as well as projects related to the transition towards a green economy.

This preference of sustainable financing towards stock markets more than bank lending is already a reality in the case in the eurozone, as shown in Graph 8. In terms of both the more general acceptance of sustainability (ESG) and the dimension of green financing in particular, the volume of securities issued (bonds or equity) in the eurozone, which has grown exponentially over the last five years, is more that ten times the corresponding volume of bank loans, which have experienced far more moderate growth.

**Graph 8. Sustainable market financing versus bank lending**




Source: ECB (2021)

However, as well as highlighting the growth of sustainable securities and their dominance in terms of volume, it also shows their better performance. Financial markets, in both their variable- and fixed-income segments, show that financial assets that incorporate a commitment to sustainability and energy transition display a profitability to risk ratio that systematically outperforms all the other securities.

In the stock market, it has been widely documented that there is what is known as a negative "greenium" (an abbreviation of green premium) or, in other words, a premium for negative risk associated with bonds with a great green component in its business activity. This negative risk premium translates to a systematically higher valuation of companies with a larger green component. On this point, according to Alessi et al. (2019), over the past decade, a portfolio of shares of "green" companies would have accumulated an 8% higher yield. If the existence of this share premium is confirmed and becomes more widespread, it may provide an incentive to undertake debt operations of this kind, reducing the capital requirements stipulated for such cases, just as was proposed for SMEs.

Lastly, a critical factor for the success of an authentic Capital Markets Union green is its supranational nature, in contrast to the domestic bias that continues to define bond and stock markets in Europe. Overcoming this obstacle is one of the goals of the CMU.

Currently, the European green bond market displays less home bias than the market for non-green bonds, but this is largely due to the fact that the green bonds in

circulation to date have been issued by institutions and large companies with a high supranational component, with a complete lack of domestic issuers in many countries, Without a doubt, this has increased the investors' participation in bonds issued outside their home countries.

The greater integration of the European green bond market and its relative weight in the global market for such bonds will be increased very strongly with the green bond issuance programme incorporated within the framework of the NGEU funding. Specifically, the European Commission intends for 30% of all the bonds issued with the context of the NGEU to be green. To help achieve this, it has developed the NGEU Green Bond Framework.

In line with the ICMA's best market practices, known as the Green Bond Principles, this bond issuance framework is underpinned by four pillars:

- Use of the proceeds for one of the categories included in the green transition pillar (see Graph 6).
- Evaluation and selection process of the investments to finance.
- Tracking/monitoring spending.
- Accountability, in terms of both how the proceeds are spent and the impact of this spending.

Within this framework, the European Commission first issued its NGEU green bonds in October 2021, issuing 15-year bonds totalling 12 billion euros, the biggest issuance of green bonds ever undertaken in the world. The bonds were very well received, with an order book of over 220 billion euros, the largest demand ever recorded for any issuance in the world.

This first campaign was followed up by three more, with the total outstanding balance of green bonds issued within the framework of the NGEU reaching 36 billion euros by the end of 2022, with new issuance planned to take the total to a target of 185 billion euros in 2026.
With these issuances, the European Commission has established its status as a clear leader in the global green bond market. Without a doubt, this lays the groundwork for the development of a real green CMU. It will provide a green safe asset that will serve as a price reference for other issuers, which will certainly be encouraged by the European Commission's driving role. This will give investors access to reference assets for their sustainable bond portfolios with a supranational scope.

## 3. Overview of the CMU and pending issues

Seven years after the launch of the Capital Markets Union, as a natural complement of the Banking Union, with the aim of promoting the diversification of financing sources through deeper integrated capital markets, it should be acknowledged that significant progress has been made. However, there is still a long way to go, particularly if we compare the situation to the United States, whose financial system is the benchmark that the CMU aspires to reach.

### 3.1. Share and corporate bond markets

The most significant advances include the fact that, in little over a decade, European companies have doubled the proportion of financing sourced from capital markets. Nonetheless, the weight of market financing is still extremely low in Europe, at barely 20%, with the bias towards bank financing remaining strong.

The low proportion of market financing, in terms of both fixed (bonds) and variable instruments (capital shares) is drawn into sharp contrast when compared to the US financial system, both in absolute terms and with respect to its ratio to GDP. In both the corporate bond market and equity markets, the ratio of this market financing to the GDP in the United States is between three and four times the equivalent ratio in Europe or Spain.

Moreover, this huge gap in the size of the capital markets in Europe compared to the United States is amplified by the fact that, in Europe, these markets are extraordinarily fragmented, so that, in effect, they are a long way from forming an integrated market, resulting in very low levels in terms of depth and liquidity.

However, we find the biggest gap between Europe and the United States in relation to the most suitable financing sources for funding innovative or higher risk investments, such seed and growth capital. When it comes to these capital instruments, prior to being listed on capital markets, the volume reached in the United States exceeds Europe by more than ten times. This situation is partly due to the smaller average size of European companies and the greater risk aversion of the investor ecosystem in the EU, but there are other more technical factors involved as well.

A key factor for the greater development and, most importantly, integration of the European stock and private fixed-income markets is the regulation of business insolvency and restructuring. The European

Union is characterised by being very dispersed and inefficient in terms of business insolvency frameworks, which generates a great deal of uncertainty with respect to the recoverability (percentage and timescale) of loans in insolvency proceedings. In a recent report on the impact of a future EU directive on insolvencies (European Commission, 2022), the European Commission itself published some very illustrative figures of this dispersion in the insolvency frameworks in place in the different Member States. The average recovery time ranges from 0.6 to 7 years in the different countries, while the associated judicial costs vary between 0 and 10%.

In view of such a degree of heterogeneity, it is clear that establishing a set of homogeneous or at least harmonised standards in the most critical aspects of the national insolvency regimes would be highly desirable and would certainly have very beneficial effects on cross-border business investment in the EU, which, ultimately, is one of the big objectives of the CMU.

Another big obstacle for an effective CMU that really translates into greater access to capital for companies is the asymmetry that exists in the tax treatment of debt instruments and equity instruments in business financing. The fact that debt interest is tax deductible in most countries, while this is not the case for the cost of equity (dividends and capital gains), provides a clear incentive for funding business growth through excessive borrowing rather than promoting a greater emphasis on equity, which is a more stable and favourable source of financing for business growth.

In response to this need, an initiative known as DEBRA (Debt-equity bias reduction allowance) was launched by the European Commission as a proposal for a new directive that establishes common rules for reducing the debt bias and limiting corporate tax deductions of interest on loans.

The DEBRA proposal incorporates a recognition system, for the purposes of corporate tax, of an implicit cost attributable to the capital increases undertaken by companies –either through recourse to external sources or internal profit retention– that gives this source of financing the same tax treatment as debt. This cost would be the sum of a benchmark interest rate and a market risk premium.

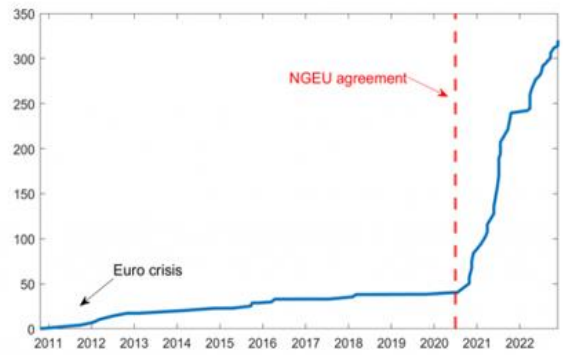
In view of the delicate situation of public finances in most European countries, now may not be the right time to incorporate additional deductions, unless they formed part of an aggregate "package" in which the tax deduction on the new equity was offset by a lower deduction on debt, as an even-handed solution. This is not a new idea and there have been cases of setting a limit on deductible interest (as a percentage of the operating income) to prevent excessive borrowing in leveraged buyouts, which has led to the insolvency of many otherwise healthy companies, crushed under the burden of debt that was unnecessary for the business.

## 3.2. Sovereign and pan-European bond markets

Integration has been substantially better in government debt markets, which have certainly been helped by the measures taken by the European Central Bank through its asset purchase programmes, and the incorporation of preventing the fragmentation of these debt markets as an objective inexorably linked to the efficacy of monetary policy. Moreover, this integration of government debt markets will contribute even further to the European Commission's status as a direct issuer of bonds and promissory notes, within the framework of the plan to finance the NGEU programme.

Graph 9 shows the extraordinary quantitative leap that has happened as a result of the emergence of a common issuer, in this case the European Commission, in the European bond markets.

**Graph 9. EU common outstanding debt (€ billions)**



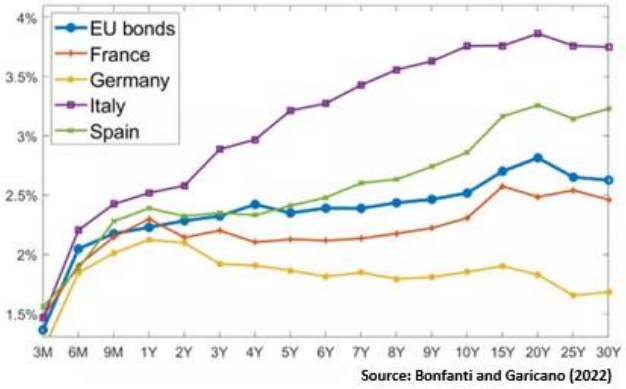

Source: Bonfanti and Garicano (2022)

However, the growing weight of the European Commission as an issuer has not yet achieved the desired goal: becoming the anchor and benchmark of a European sovereign issuer (what is known as a safe asset) insofar as many investors still have a strong preference for their home market, which does not help boost the perception of the European Commission's bonds as the market benchmark.

European bonds are listed at a higher interest rate even than French debt, even though the EU issuer has a triple-

A rating, which is not the case of the French Government, as shown in Graph 10. In the case of bonds with shorter maturities, this debt has a higher rate than bonds from countries such as Spain.

**Graph 10. Yield curves for bonds with different maturities for different EU countries and the European Commission**




Source: Bonfanti and Garicano (2022)

The European Central Bank itself (European Central Bank, 2023) highlighted that, in order for the market to reflect European common debt as a benchmark issuer for the European bond market, more progress is need that embraces greater Europeanisation. The issuances within the framework of the NGEU have been significant (see Graph 9), but they still lack the perception of the markets as being integrated. This prevents them from being seen as a product with good market liquidity, which generate derivatives linked to these issuances, which in turn are included in the sovereign debt indexes. The fact that they are perceived as a "temporary event" considerably harms their price. This perception is an issue that must be overcome in order to create an authentic product of the European capital market.

Most importantly, it will be necessary to reinforce a long-term commitment to recurrence to the market that will enable market agents to see the European Commission as an important and constant issuer, rather than a supranational body that only takes part in such markets on an occasional basis. In addition, it would have a positive impact if the EU budget were less dependent on national contributions and there were a greater emphasis on European taxes, which would enable the "denationalisation" of the EU's income. This would prevent the debt being perceived as a mutualised product, underpinned by the transfer of repayable funds from the Commission to the Member States, which would also incentivise the development of sources of diversification.

### 3.3. Green bond markets green

One ray of hope for the CMU comes from its green or sustainable segment, to which must be incorporated the growing role expected of sustainability-linked bonds, which, as the use of the proceeds from their issuance is not ring-fenced, may be well received among public issuers (Lehmann and Martinc, 2023). The predominant role played by both European issuers (public and private) and investors (particularly institutional) on the worldwide sustainable bond and equity market makes the European Union the main global hub of the sustainable stock market, both as an issuer and as an investor and trading currency. Moreover, because of the lower home bias displayed in this market, mainly due to the predominance of large issuers with a broad geographical scope, to the detriment of smaller issuers with a more local scope, the foundations are laid for the development of a truly green Capital Markets Union, with far greater speed and intensity than in the case of the CMU in general.

Another factor that will contribute to the progress towards a green CMU will be the European Commission's issuance of NGEU green bonds amounting to a total of almost 200 billion euros in 5 years, which will make the European Commission the world's biggest issuer of green bonds. Its bonds will be underpinned by the anchor of an integrated European market for such bonds, which will act as a driving force and stimulant for numerous European issuers to follow the same path.

For the European Commission's role as a driving force to be effective and help to build an integrated market of private issuers that takes over from the European Commission as public issuer, we have to make progress in embracing Europe more, and making Europe a shared challenge.

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## Annex 1

**Capital Markets Union - 2020 Action Plan.**
**List of actions**

| | | |
|---|---|---|
| **SMEs** | Action 1 | Making companies more visible to cross-border investors |
| | Action 2 | Supporting access to public markets |
| | Action 3 | Supporting vehicles for long-term investment |
| | Action 4 | Encouraging more long-term and equity financing from institutional investors |
| | Action 5 | Directing SMEs to alternative providers of funding |
| | Action 6 | Helping banks to lend more to the real economy |
| **Individuals** | Action 7 | Empowering citizens through financial literacy |
| | Action 8 | Building retail investors' trust in capital markets |
| | Action 9 | Supporting people in their retirement |
| **Single Market** | Action 10 | Alleviating the tax associated burden in cross-border investment |
| | Action 11 | Making the outcome of cross-border investment more predictable as regards insolvency proceedings |
| | Action 12 | Facilitating shareholder engagement |
| | Action 13 | Developing cross-border settlement services |
| | Action 14 | Consolidated tape |
| | Action 15 | Investment protection and facilitation |
| | Action 16 | Supervision |

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