Financial Integration, Capital Markets Development and Risk Sharing in the Euro Area

Frank Lierman, Chairman editorial board journal Bank- en Financiewezen/Revue bancaire et financière

It is certain that macroeconomic stabilisation of economies benefits from risk sharing for three reasons: cross-sectional because regions in an economic downturn receive income streams from regions in an upturn; inter-temporal due to the fact that saving in an upturn is followed by dis-saving in a downturn; complementary between both because it is not optimal that each region saves and dis-saves on its own. So, saving and dis-saving contribute to the smoothing of aggregate consumption. And more important is also that both public and private sector can be involved: the public is doing it via cross-regional transfers, automatic unemployment insurance, counter-cyclical fiscal policy while the private is implied via cross-regional asset holdings, households and firm saving and dis-saving. The literature of matured federal states such as the US and Germany suggests that private financial risk sharing tends to go a long way in smoothing consumption. But this requires financial integration and development of financial markets.[1]

[1] Report on the presentation given by mister Philipp Hartmann, Senior Manager and Policy Adviser of the European Central Bank, to the Belgian Financial Forum in Brussels on the 14th of May 2018. Report written by mister Frank Lierman, Chairman Editorial Board of the Revue bancaire et financière/Bank- en Financiewezen.

Is the risk sharing in the euro area beneficial and how can it be improved?

The European Economic and Monetary Union (EMU) is characterized by constraints on some important macroeconomic adjustment mechanisms: while the ECB monetary policy is area-wide, and the nominal exchange rate is fixed, the fiscal policy is primarily national with very limited cross-country transfers, labour is relatively immobile due to culture and language and there is no area-wide unemployment insurance. The Five Presidents Report of 2015 indicates that macroeconomic stabilisation in EMU would benefit from well-functioning risk sharing. Meanwhile discussions on the completion of EMU are launched, focusing on a central fiscal capacity, completion of the Banking Union (e.g. deposit guarantee scheme) and the launching of the Capital Markets Union.

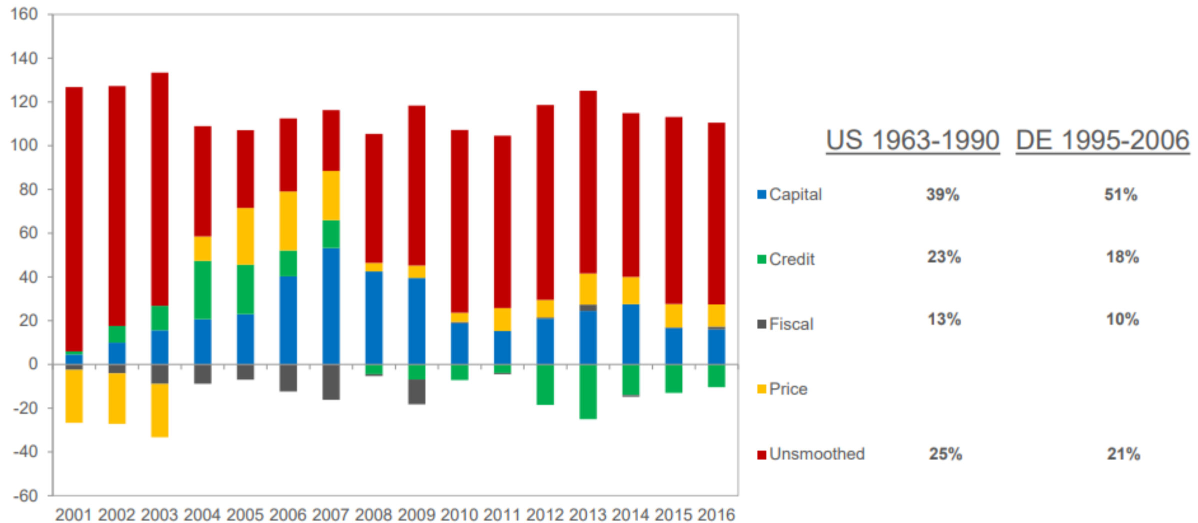
The focus of the speech was on **private financial risk sharing**.

A widely used literature measures risk sharing with the degree to which aggregate regional or national consumption is insulated from fluctuations in regional or national income. In fact, there are four risk sharing channels which limit the transmission of domestic GDP shocks to domestic consumption growth, also known as consumption smoothing:

- capital channel: net factor income payments from abroad (interests, dividends, profits, wages);
- credit channel: net borrowing from abroad (private and public);
- price channel: net valuation effects of domestic relative to foreign produced goods on consumption;
- fiscal channel: net transfers from abroad (fiscal transfers, remittances).

Residuals of the estimation reflect the parts of GDP shocks that continue to be transmitted to consumption. This is an indicator of lack of risk sharing. The actual situation shows us that cross-country risk sharing in the euro area is limited.

Cross-country risk sharing in euro area is limited, including via (private) capital and credit markets



Notes: ECB staff calculations applying the Asdrubali and Kim (2004) approach enhanced for relative price adjustments. 10-year rolling estimations up to the year indicated. Bars add to 100%. Memorandum item on the US from Asdrubali et al. (1996), on Germany from Hepp and von Hagen (2013).

- Note that not well-functioning risk sharing can also make some channels amplify consumption fluctuations

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Graph 1 underlines the huge importance of the fiscal channel in the euro area while it is only 13% in the US and 10% in Germany. The capital channel is the most important in the US (39%) and in even higher in Germany (51%) while it is fluctuating strongly in the euro area. The credit channel is about 20% in the US and Germany but very weak in the euro area where it becomes even negative in the recent years. The not well-functioning of risk haring can also make some channels amplify consumption fluctuations.

The ECB estimates which factors foster risk sharing and assess which could be improved in the euro area. It is clear that the Banking Union and the Capital Markets Union are important policy programs. Both have also the potential to improve private financial and public risk sharing. The approach followed is to start from factors and variables that emerge from the literature. The policy proposals on how risk sharing can be improved are derived from two main criteria: the euro area econometric evidence that a chosen factor leads to economically and statistically significant enhancements in the capital and credit channel of risk sharing and secondly indicators of factor levels suggesting that there is room for improvement in the euro area or its member countries.

This leads to ideas that go beyond the present Banking and Capital Markets Union policy programs. The intention is to help making these programs more powerful over time by encouraging a sustained effort in integrating and developing credit and capital markets and in contributing to a long-term vision for the single market for financial services.

Capital channel is boosted by asset ownership, financial literacy and insolvency frameworks

		Mutual funds	Pensions and life insurance	Resolving insolvency	Financial literacy	General trust
EA-12	1996—2015	0.008	0.006	**0.009***	0.669	-0.215
	1996—2007	**0.051***	**0.014***	---	**3.380*****	**-1.625****
	2008—2015	-0.018	-0.005	**0.016****	-0.874	**0.701****
EA-19	1996—2015	-0.006	0.001	-0.003	0.129	-0.167
	1996—2007	0.001	**0.013***	---	0.265	0.059
	2008—2015	**0.024***	-0.010	-0.001	1.306	-0.228

Notes: Estimations by Giovannini, Hartmann, Imbs and Popov (in progress). The results of the first two columns are derived from different estimations than results in the last two columns.

- Focus in what follows on pension reforms, financial literacy and insolvency frameworks
- But note also the relevance of the asset management industry

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As is shown in table 1 the capital channel is boosted by asset ownership, financial literacy and insolvency frameworks. The indicated estimations show the importance of the indicators. Green figures are statistically significant. General trust will not be developed further in this speech.

Credit channel is boosted by financial literacy, insolvency frameworks, foreign bank penetration, trust

		Mutual funds	Pensions and life insurance	Foreign bank share	Financial literacy	General trust
EA-12	1996—2015	**0.028*** **	0.002	**0.483*** **	**1.162*** **	0.146
	1996—2007	0.016	-0.005	**0.387*** **	0.683	0.415
	2008—2015	-0.018	-0.005	**0.571*** **	**1.371** **	-0.179
EA-19	1996—2015	**0.031*** **	0.003	**0.066* **	0.407	**0.562*** **
	1996—2007	**0.048** **	-0.010	**0.178*** **	0.331	**0.652** **
	2008—2015	-0.009	0.010	-0.033	-1.130	**0.676* **

Notes: Estimations by Giovannini, Hartmann, Imbs and Popov (in progress). The results of the first two columns are derived from different estimations than results in the last two columns.

- Focus in what follows on financial literacy, insolvency frameworks and cross-border bank consolidation

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Table 2 underlines the factors boosting the credit channel: financial literacy, insolvency frameworks, foreign bank penetration and general trust. The resolving insolvency has been omitted in this table.

Looking to the **retirement savings in pension funds** with adequate equity components it is sure that a major effort to increase those savings is needed. As is shown in table 3 the low private savings for retirement are still very low in important euro area countries. The same is sure for equity shares. Furthermore, demographics require that citizens save more. For Belgium, not on the table: the private pension investments represent only 7% of GDP, but the share of equity is some 45%, which is huge.

Private pension investments (all pillars)

Country	Total (% of GDP)	Equity Share (%)
Australia	122	51
Japan	32	11
Switzerland	123	30
United Kingdom	97	20
United States	133	44
Finland	58	39
Ireland	56	N/A
Netherlands	178	38
France	9	N/A
Germany	6	5
Italy	9	20
Spain	14	11

Notes: End-2015 data from OECD (2016) and World Bank. France end-2014. Equity share available only for pension funds.

A simulation of additional euro area equity investments (in % of current equity market capitalisation) is very clear and an important challenge as is shown in table 4. Taking the Finnish level as benchmark the effort to be done is tremendous: more than 40% for savings and equity shares. This represents a big potential for capital markets.

Simulation of additional EA equity investments (in % of current equity market capitalisation)

Increased Equity Shares	Increased Savings and Equity Shares
To Euro Area median	
1.2 – 1.3	1.3 – 1.4
To Finnish level	
3.6 – 3.7	41.9 – 44.9
To US level	
6.0 – 8.4	180.1 – 198.9

Notes: Authors' calculations using the same sources as in the upper right-hand table. Increased total savings are simulated assuming that pension investments per capita reach benchmark level.

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Pension reforms would make a big difference, complementary to CMU PEPP. Of course, it is a difficult social choice, but without it an important supporting factor is missing compared to countries with larger capital markets.

A lot of other measures are needed for the full effect of pension reforms on capital markets.

First equity demand effects may have to be complemented with efforts fostering equity supply. This can be done via tax advantage of debt, firm size and firm growth, more harmonized information about medium –size firms (e.g. the Prospectus Directive in CMU).

Second a revision of regulatory constraints on pension investments: e.g. no or very limits restrictions on cross-border holdings within the EU, as has been proposed by the Commission already in 2016; no or very limited quantity restrictions on listed equity as put forward by the OECD last year; some restriction on unlisted equity. Of course, this should also be possible for insurers who must follow now very strict equity treatment in Solvency II.

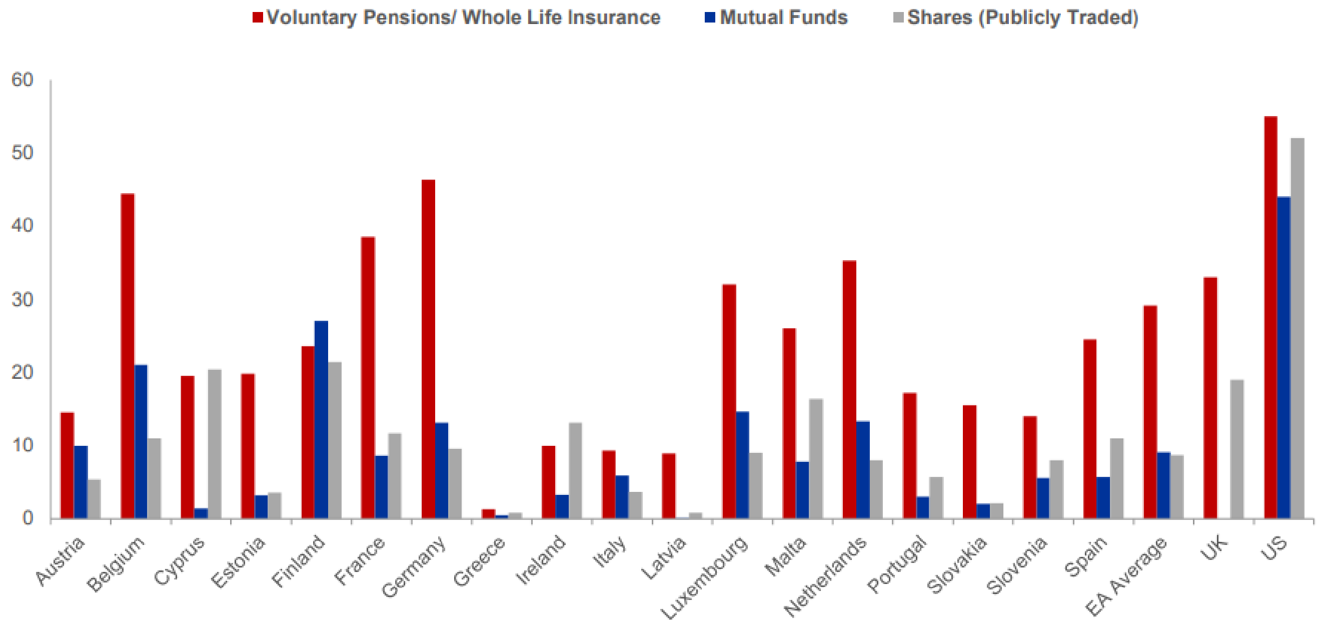
Third a revision of the self-imposed constraints in parts of some countries' pension systems such as no "equity culture", risk aversion, asset-liability management of insurers and the desire of defined benefits.

Of course, some caveats have to be taken into account knowing that pension systems are complex to change: design of pension systems have many other dimensions than risk sharing; full effect can take decades; more equity and lesser demand for government bonds could imply higher funding costs for governments; reduction of deposits is not neutral for banks and people with high pension savings may take on debt.

Financial literacy stimulates investment in more productive assets than bank deposits and can be improved in a number of countries.

Table 5 shows the discrepancies between countries for the holdings of different asset classes. The contrast with the US is pronounced, mainly for mutual funds and publicly traded shares.

Share of households holding different asset classes (in %)

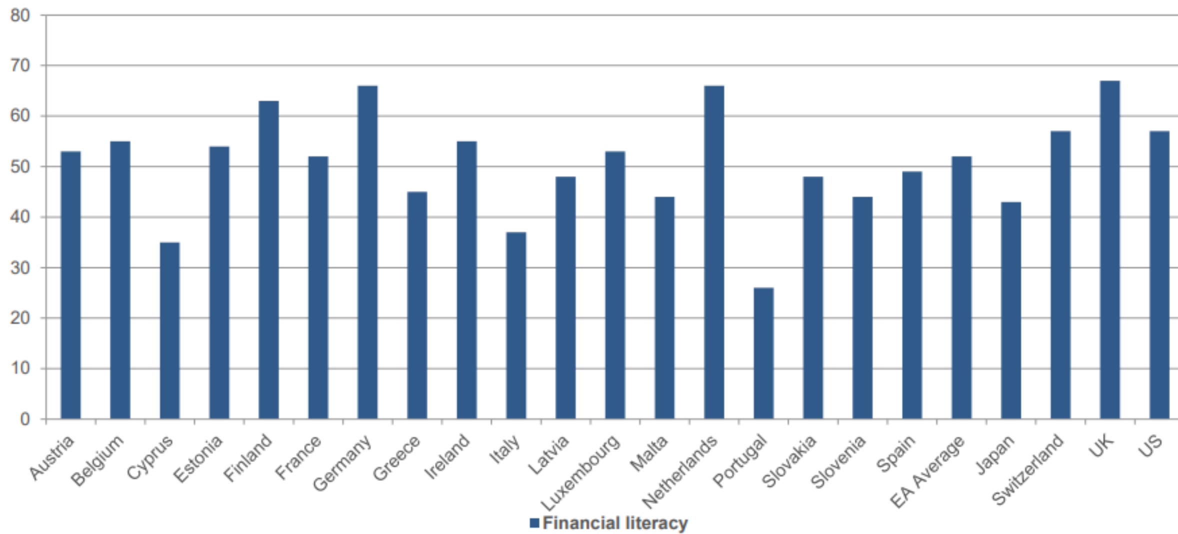


Notes: ECB Household Finance and Consumption Survey. Data for 2014, except for Estonia, Ireland, Malta, Netherlands, Portugal, Finland (all 2013) and Spain (2011). Mutual funds for UK not available.

In order to be effective, probably stronger financial and economic education would have to be introduced in secondary school curriculums as is shown in graph 2. On average some 50% of the adult of the euro area are considered as financially literate. The Netherlands, Finland and Germany are in a much stronger position.

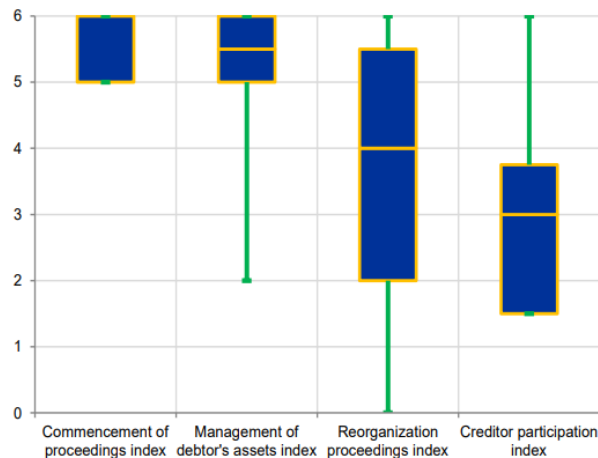
... can be improved in a number of countries

Share of adults who are financially literate (in %)



Notes: Standard and Poor's Global Financial Literacy Survey (2014) and ECB staff calculations. Financial literacy is defined as understanding the following four concepts: interest rate, cumulative interest rate, diversification, and inflation. Data for Lithuania not available.

The shortcomings and divergences of **insolvency frameworks** in the euro area should be addressed further. Graph 3 shows the big dispersions mainly for the reorganization proceeding index and the credit participation index.



Notes: Giovannini, Hartmann, Imbs and Popov (in progress) using World Bank (2017) resolving insolvency data.

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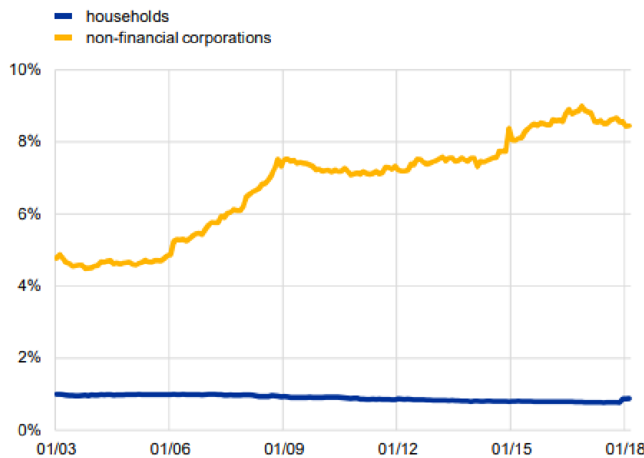
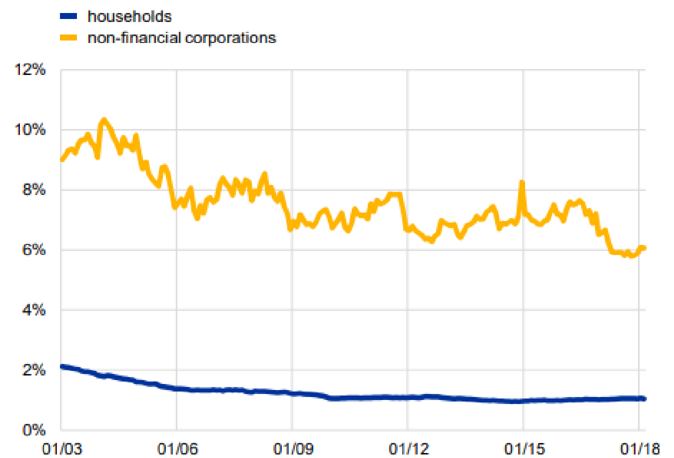
The CMU draft directive on restructuring and second chance does not cover a number of problematic areas: efficient re-organisation proceedings reduce failure rates and liquidations of profitable businesses; adequate creditor roles and harmonised creditor rankings help cross border investors. There are also complementary insights from OECD research on capital reallocation linked to SME procedures and early warnings. This implies improving judicial efficiency and introducing out-of court settlement systems. The functioning of insolvency frameworks relies on the efficiency of courts and the competence of the judges. So timely procedures are essential for recovery. Incentives for cross-border investments must be enhanced. But legal systems are very slow and difficult to change. Out-of-court procedures could complement courts and vice versa. In fact, two European policy options are disposable: non-binding EU guideline and a formal EU regime.

Integrating **retail lending and deposit markets** more would foster the credit channel of risk sharing. Some studies have shown that cross-border lending delivers better and more resilient risk sharing than cross-border wholesale lending. But both lending and deposit markets are little integrated in the euro area. The share of cross-border loans and deposits of households is lesser than 2%. For the non-financial corporations, the share is fluctuating between 6 and 8%, as is shown in graph 4 and 5.

Share of cross-border loans in euro area total loans



Share of cross-border deposits in euro area total deposits



Notes: ECB and ECB staff calculations.

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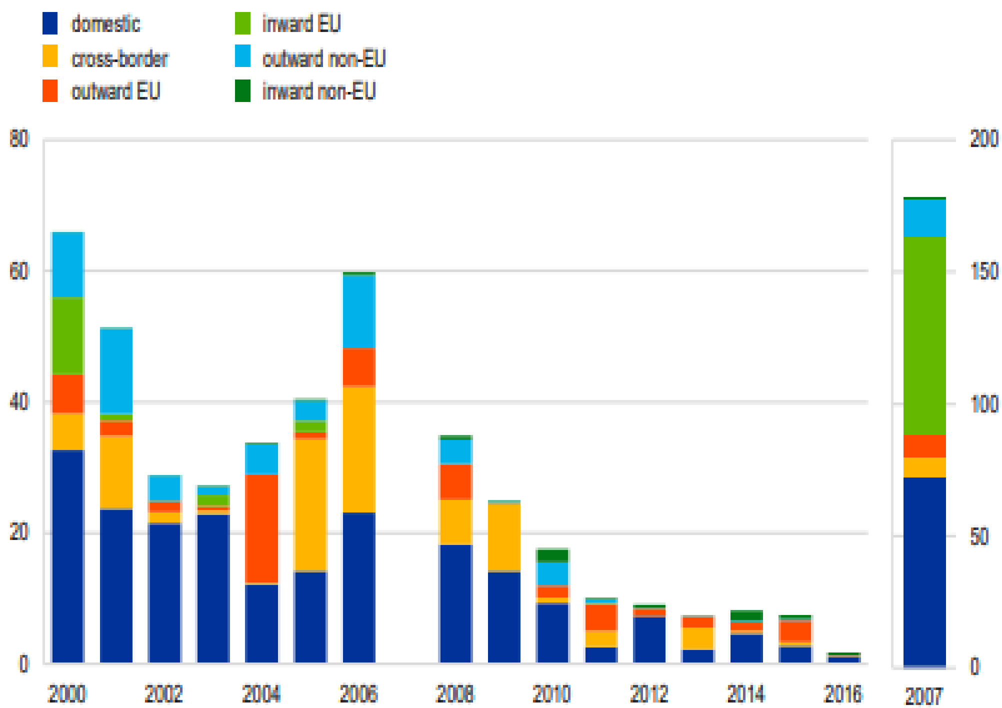
A more realistic option would be an enhanced **cross-border bank consolidation**. It was a special feature in the 2017 ECB report on “Financial integration in Europe”. It should be possible to reap the benefits while safeguarding against potential risks via the single supervisory and resolution mechanism. But cross-border M&As are at historical lows as is shown in graph 6. Therefore, a broader macroeconomic context must be taken into account: growth and reduction of political uncertainties.



The targeted financial sector policies are numerous:

- completion of the banking union;
- removal of options and national discretions in financial regulations;
- considering euro area as single area for calculating Basel systemic surcharges;
- harmonisation of bank insolvency laws;
- harmonisation of consumer protection;
- addressing non-performing loan problems;
- streaming of supervisory merger reviews;
- harmonisation of taxation.

Conclusion

More private financial risk sharing has the potential to materially improve consumption smoothing in the euro area and thereby the functioning of EMU. But there are significant obstacles to lifting it to another level: many related to the absence of a historically grown European nation state and the complementarity between private and public risk sharing.

A number of policy initiatives would nevertheless have the potential to lead to material improvements: pension reforms towards funded systems involving equity investments; enhancing financial literacy in the population; further ameliorating insolvency frameworks and the judicial systems supporting them; policies facilitating cross-border bank consolidation. Most of these are not reflected in the current Banking and Capital Markets Union programs or only to a limited extent. But it could become a part of a sustained effort and a long –term vision on integrating and developing banking and capital markets.

Progress with improving private financial risk sharing cannot be expected to be quick. Many measures would take a long time to unfold their effects. There may be other avenues for developing and integrating European capital and banking markets to promote risk sharing, which have not been addressed in this speech. There are other goals that can be pursued with developing and integrating particularly capital markets: innovation and economic growth and stability of governments, households' or firm' funding, e.g. substituting between loans, bonds and equities.