A Capital Market Union for Europe

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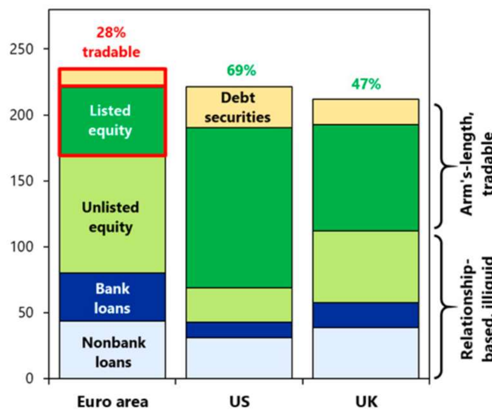
ABSTRACT

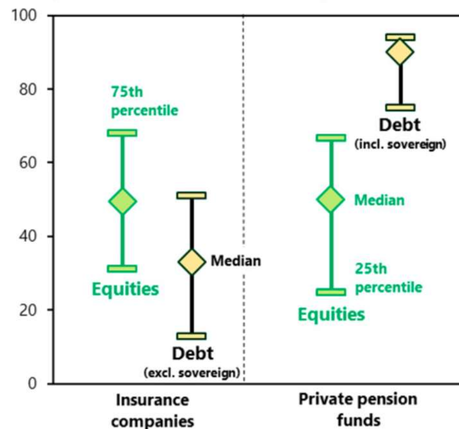
This is the speech given by Ashok Bathia at the IMF – NBB conference “Towards more Capital Markets Integration in Europe” in Brussels on September 10, 2019.

SPEECH

The objective of this intervention is to give a short overview of the discussion paper prepared by a group of IMF economists. This article is set up with comments around 5 charts from the paper.

LOW RELIANCE ON TRADED INSTRUMENTS; PERVASIVE HOME BIAS





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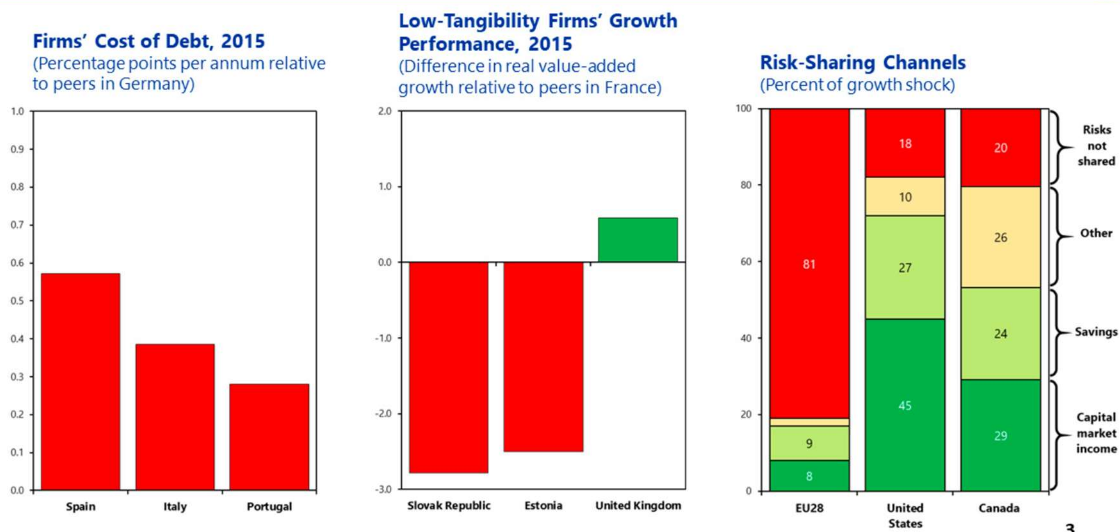
The first chart gives us the context. The left panel shows the funding structure of the nonfinancial corporate sector, in cross-country comparison. Basically, the idea is to distinguish between arm's length, tradable instruments (bonds and listed equity) and relationship-based financing (unlisted equity and bank and nonbank loans). The area within the red borders flags how the tradable share of firm's funding structure in the euro area is only about 28 percent, far less than in the US and the UK, where this share is, respectively, 69 percent and 47 percent. This relatively heavy reliance on relationship-based financing in Europe has much to do with the prevalence of SMEs on the continent. And, on the supply side, Europe's well-developed public pension systems and the lack of a portable pension product result in a relatively small long-term institutional investor base. EU households store about 40 percent of their savings as bank deposits, compared with 10 percent in the US.

The right panel links more directly to the specific issue of capital market integration. The EU's life insurance and private pension fund industries are not only relatively small, they are also very insular. Taking these sectors' portfolios of EU equity securities as an example—the green diamonds in the chart—we see that more than 50 percent is invested in home-country securities. Home bias is pervasive. European capital markets are sharply fragmented along national lines.



These three sub charts show how Europe's capital market fragmentation imposes real and quantifiable costs. The first observation is linked to the left panel. Fragmentation results in a wide dispersion of corporate funding costs. This is from firm-level data, controlling for

characteristics such as firm size, profitability, leverage, and fixed asset endowment: we compare similar firms within the same sectors but incorporated in different EU countries. We see, for example, that a Spanish firm may pay up to 60 basis points more on debt per annum than a comparable German firm. An Italian firm may pay 40 basis points more than its German peer—based only on domicile.

In the middle panel we see that under-developed capital markets can place restraints on innovation and growth. Firms with limited fixed assets tend to grow faster in jurisdictions where capital markets are more developed. We are talking here about firms with limited plant and machinery to pledge as collateral—think of your typical IT start-up. Controlling for firm- and sector-level characteristics, a firm with a fixed asset-to-total asset ratio 10 percentage points below the EU average for its industry will grow almost 3 percentage points slower in, say, the Slovak Republic than in France. Thus, we see significant benefits in connecting “low tangibility” firms to better-developed markets where they can tap into venture capital funds with diversified portfolios that are more willing to take the risk of providing financing without tangible collateral.

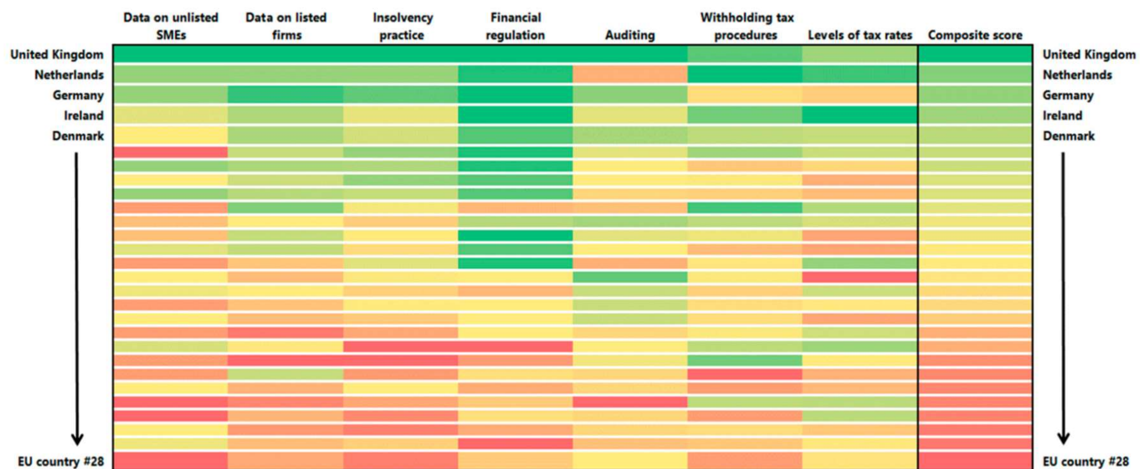
In the third panel we see how financial fragmentation holds back private cross-border risk sharing. If the equity of a firm in country X is owned by investors in country Y, then, when country X is hit by a shock and share prices fall, the valuation hit is taken abroad: this insulates country X’s consumption from the local shock. The red slabs of the stacked bars show the “unsmoothed” element of a local shock. We see that consumption is about four times more sensitive to asymmetric shocks in Europe than in the US or Canada. This is the third cost of not having an integrated European financial market.

To recap: fragmented capital markets lead to:

- A wide dispersion of funding costs for otherwise similar firms based purely on which side of an international border they sit;
- Slower growth for collateral-constrained firms, many of which may be innovative start-ups that would otherwise raise an economy’s growth potential; and
- Forgone macroeconomic smoothing, meaning less resilience to shocks.

This next chart gives an overview of the responses to a survey in which 21 national regulators as well as some of the largest investment, pension, venture capital, and private equity funds and insurance companies in Europe participated. The heat map depicts results from the first part of the survey, which focused on country-specific questions to better understand the relative importance of various obstacles to cross-border financial integration in Europe. Obstacles were grouped into areas relating to disclosure for listed and unlisted firms, efficiency of insolvency procedures, reliability of audits, regulatory quality, delays and difficulties in reclaiming withholding taxes, and levels of tax rates.

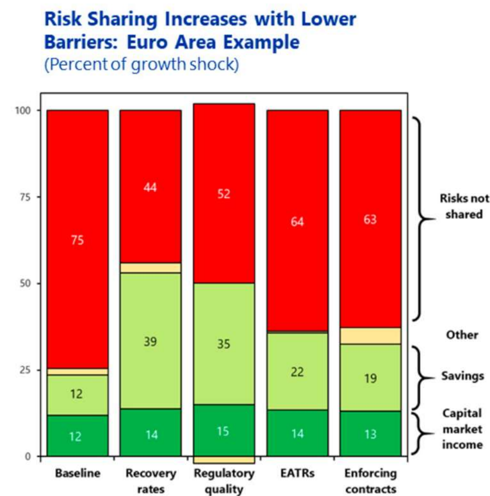
The composite scores are simple averages of the country-specific scores in each of the seven areas. Deficiencies in information availability on both listed and unlisted firms, regarding insolvency practices, and to a slightly lesser extent with respect to capital market



Regulation, are seen as areas of concern for many countries. Some countries are also seen to have weak audit quality, overly complex withholding tax procedures, and unduly high tax rates. Strikingly, we see the UK topping the rankings in almost all areas and thus widely viewed as Europe's leading capital market jurisdiction. In the discussion paper, other concerns such as restrictions on cross-border offerings, administrative burdens, minority investor rights, and legal deficiencies are also analysed.

To investigate the impact of specific actions to lower these identified barriers, we conducted an empirical analysis using readily available "third-party" indicators on the obstacles—time series data.

Better Insolvency Regimes and Regulatory Oversight Can Lower Firms' Cost of Debt and Increase Macroeconomic Smoothing



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The left-hand-side panel shows how firms' debt funding costs can decline if countries can improve their insolvency regimes. Here the recovery rate for secured creditors has been used as a proxy for the quality of national insolvency regimes. We find that firms would enjoy significant savings if their home jurisdictions could improve their insolvency regimes to best- in-class standards. If Italy, for example, were able to improve its insolvency practices along these lines, it could reduce its firms' average cost of debt by some 25 basis points. That is real money.

The right-hand panel summarizes how different reforms could significantly enhance private cross-border risk sharing in the euro area. Improving capital market regulation and insolvency regimes are the most potent steps. If recovery rates rise by 1 standard deviation, for example—equivalent to Portugal improving to the UK standard—risk sharing more than doubles. Other steps matter too: improving audit quality, reducing effective average tax rates, and so on.

In this final slide we summarize our policy recommendations: three policy priorities, focused on the three main areas identified—transparency, regulatory quality and insolvency practice.

Three Obstacles, Three Policy Priorities

Enhancing Transparency

- Centralized, standardized, and ongoing reporting by all issuers
- Streamlined withholding tax procedures

Sharpening Regulation

- Centralize oversight of systemic nonbank intermediaries
- Upgrade ESMA's supervisory convergence role
- Improve new portable pension product
- Pursue close cooperation with non-EU jurisdictions

Improving Insolvency

- Methodically collect information on corporate insolvency cases
- Set EU minimum standards
- Systematically monitor observance of standards

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On transparency, we propose to introduce centralized, standardized, electronic reporting for all issuers on an ongoing basis. This would be a major change to the reporting framework in Europe. But similar steps are already very much established in the US and Canada. In the US, for example, the so-called EDGAR database provides free public access not only to prospectuses, but also to the well-known forms "10K" and "10Q", which are standardized annual and quarterly financial statements for all issuers, irrespective of size. There is also a real scope to harness digital technologies to materially streamline withholding tax refund procedures.

On regulation, we call not for another SSM but instead favour of a more-tailored approach. One of the big pushes is to have more-centralized prudential oversight of large investment firms and CCPs. For investment firms, this is already very much in train. For CCPs, we urge a direct role for ESMA in prudential supervision, jointly with the ECB when it comes to euro clearing. This goes beyond what the ECB itself has been advocating. As regards investor protection, we support proposals to upgrade ESMA's supervisory convergence function, including by adding independent board members. On the new pan-European personal pension product, or PEPP, we suggest some design changes. While we are supportive of the PEPP, some things could be looked at more closely. The initial proposal to require each PEPP to maintain a significant number of national compartments should be revived to achieve meaningful portability. And over time there should be scope to lower the PEPP's administrative costs. Finally—behooves the IMF as guardian of the international monetary system—we stresse the importance of international supervisory cooperation. Close engagement among regulators is essential to maintain ties with important "third

countries” on capital market issues. This is especially the case vis-à-vis the UK, given its tight financial links to the EU27.

Last but not least, on insolvency regimes, we propose a significant role for the European Commission. The Commission should in our view launch a systematic effort to gather information on debt enforcement end corporate insolvency cases. This is a necessary precondition to properly assess effectiveness and identify gaps in an area where the data tend to be unreliable. Second, we recommend the Commission develop a code of EU minimum standards for corporate insolvency and debt enforcement processes. Third and last, we suggest the Commission lead a systematic monitoring process to track how countries progress towards meeting those EU standards. In short, we favour a relatively “soft” approach modelled on the Basel Core Principles process—where our experience suggests real incentives for betterment have resulted, with national banking regulators often viewing their BCP scores as part of a global “beauty contest”.
So: three barriers, and three sets of policy actions.