Developing and Integrating European Capital Markets: CMU Now and Beyond

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(Based on work by:
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DG Macroprudential Policy and Financial Stability
DG Market Infrastructure and Payments
DG Research)

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<td>Impactful policy initiatives in current and future CMU</td>
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Capital markets are critical for growth, private risk sharing, and stable financial integration

- European economy less dynamic than global peers
  - Lower rates of output growth, innovation, and new business creation

- A number of important adjustment mechanisms are very constrained
  - Limited public (fiscal) risk sharing
  - Limited labour mobility
  - Fixed nominal exchange rate in EA

- Private financial markets can partially address these deficiencies
  - Growth benefits from increased public and private equity investment
  - Risk sharing (consumption smoothing) from private cross-border asset holdings
  - Cross-border equity holdings deliver more stable financial integration than debt holdings

- ECB/Eurosystem has been a strong supporter of the CMU project since its inception but it has also consistently called for more impactful initiatives

- “Impact” here regarded as initiatives aimed at enhancing:
  - Innovation and economic growth through a financial structure with a high enough equity share (Special Feature A of the 2018 ECB Financial Integration Report) and/or
  - Private financial risk sharing, notably through capital markets (Special Feature A of 2016 ECB Financial Integration Report) and/or
  - Stability of households’ and firms’ funding (substituting between loans, bonds and equities)
Outline

1 Introduction and objective of the presentation
2 Current state of European capital market integration and development
3 Impactful policy initiatives in current and future CMU
2. Current state of European capital market integration and development

**Equity markets: development and integration still at low levels**

- **Public equity markets smaller** in Europe than in the US
  - Also increasing more slowly since the crisis

- **Implications for long-term growth**
  - Larger equity markets support innovation and productivity growth
  - In EU as well, especially in high-tech industries (Kremer and Popov, 2018)

- **Large home bias** in EA equity holdings
  - Decreasing in recent years
  - Other EA equity holdings increasing slowly

- **Implications for risk sharing**
  - Cross-border ownership of productive assets increase risk sharing through the capital channel (Giovannini et al., 2018)

- **Implications for financial stability**
  - Cross-border equity holdings most stable form of integration (Giovannini et al., 2016)
Risk sharing: Low contribution of private financial markets

Consumption risk sharing in the euro area and its channels

- Almost 80% of a shock to a country’s GDP remains unsmoothed in the EA
- The capital channel eliminates around 20% of a shock to a country’s GDP
  - Considerably less than in countries that are an economic, monetary, and political union
    - 39% in the US (Asdrubali et al., 1996)
    - 51% in Germany (Hepp and von Hagen, 2012)
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3. Impactful policy initiatives in current and future CMU

**CMU initiatives are expected to vary in their overall impact, only a few initiatives have been adopted.**

<table>
<thead>
<tr>
<th>Low impact</th>
<th>High impact</th>
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<tbody>
<tr>
<td><strong>Venture capital:</strong></td>
<td><strong>Debt-equity tax bias:</strong></td>
</tr>
<tr>
<td>EuVECA, EuSEF Regulation</td>
<td>CCCTB Directive</td>
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<tr>
<td><strong>Crowdfunding:</strong></td>
<td><strong>Supervision:</strong></td>
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<tr>
<td>Regulation</td>
<td>ESMA review</td>
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<td><strong>Sustainable finance:</strong></td>
<td><strong>Securitisation:</strong></td>
</tr>
<tr>
<td>Action Plan</td>
<td>STSS Regulation</td>
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<tr>
<td><strong>Investment fund distribution:</strong></td>
<td><strong>Prospectus:</strong></td>
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<tr>
<td>Directive and Regulation</td>
<td>Regulation</td>
</tr>
<tr>
<td><strong>Proprietary effects of transactions in securities</strong></td>
<td><strong>Non-bank supervision:</strong></td>
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<tr>
<td>Communication</td>
<td>Regulation on investment firms</td>
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<td><strong>SME listings</strong></td>
<td><strong>FinTech:</strong></td>
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<tr>
<td>Communication</td>
<td>Action Plan</td>
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<tr>
<td><strong>Local/regional cap. markets:</strong></td>
<td><strong>European pension products:</strong></td>
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<tr>
<td>Communication</td>
<td>PEPP Regulation</td>
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<td><strong>Intra-EU investments:</strong></td>
<td><strong>Covered bonds:</strong></td>
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<tr>
<td>Communication</td>
<td>Directive and Regulation</td>
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<tr>
<td><strong>Insolvency</strong></td>
<td><strong>Assignment of claims:</strong></td>
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<td>Regulation, Communication</td>
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<td><strong>Recovery of collateral:</strong></td>
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<td>Directive</td>
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<td><strong>Preventive restructuring:</strong></td>
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<td></td>
<td>Directive</td>
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- Green: Adopted
- Yellow: Proposed
- Dark Grey: Upcoming
3. Impactful policy initiatives in current and future CMU

**Insolvency frameworks – some initiatives, but not enough**

- Research supports the high relevance of efficient insolvency frameworks
  - ECB: promote risk sharing in the euro area (Giovannini et al. 2018)
  - OECD: improve capital reallocation, prevent firm “zombification” (McGowan et al. 2017)
- CMU Action plan contains a welcome directive on restructuring and second chance, which however does not cover other problematic areas

- Efficient re-organisation plans reduce failure rates and the liquidation of profitable businesses
- Harmonised creditor ranking/clearer roles help cross-border investors

- “Early warning”: training; online tests; debt counselling
- Special procedures for SMEs have been introduced in some euro area countries

Lower NPLs, higher investor certainty, more cross-border investment
Retirement savings in well-designed private pension funds boost equity markets and foster growth and risk sharing

- Supported by ECB research for the euro area (Giovannini et al. 2018)
- **Low private savings for retirement** in important euro area countries
- **Low equity shares** as well
- Already demographics require that citizens save more

### Private pension investments (all pillars)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total (% of GDP)</th>
<th>Equity Share (%)</th>
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<tbody>
<tr>
<td>Australia</td>
<td>122</td>
<td>51</td>
</tr>
<tr>
<td>Japan</td>
<td>32</td>
<td>11</td>
</tr>
<tr>
<td>Switzerland</td>
<td>123</td>
<td>30</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>97</td>
<td>20</td>
</tr>
<tr>
<td>United States</td>
<td>133</td>
<td>44</td>
</tr>
<tr>
<td>Finland</td>
<td>58</td>
<td>39</td>
</tr>
<tr>
<td>Ireland</td>
<td>56</td>
<td>N/A</td>
</tr>
<tr>
<td>Netherlands</td>
<td>178</td>
<td>38</td>
</tr>
<tr>
<td>France</td>
<td>9</td>
<td>N/A</td>
</tr>
<tr>
<td>Germany</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Italy</td>
<td>9</td>
<td>20</td>
</tr>
<tr>
<td>Spain</td>
<td>14</td>
<td>11</td>
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**Simulation of additional EA equity investments (in % of current equity market capitalisation)**

<table>
<thead>
<tr>
<th>Increased Equity Shares</th>
<th>Increased Savings and Equity Shares</th>
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<tbody>
<tr>
<td></td>
<td>To Euro Area median</td>
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<tr>
<td></td>
<td>1.2 – 1.3</td>
</tr>
<tr>
<td></td>
<td>1.3 – 1.4</td>
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<td></td>
<td>To Finnish level</td>
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<td></td>
<td>3.6 – 3.7</td>
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<tr>
<td></td>
<td>41.9 – 44.9</td>
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<tr>
<td></td>
<td>To US level</td>
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<tr>
<td></td>
<td>6.0 – 8.4</td>
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<tr>
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<td>180.1 – 198.9</td>
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**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.

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

- **Pension reforms** would make a big difference (complementary to CMU PEPP)
- **Complex** policy direction
- But without it important supporting factor missing
Financial literacy stimulates asset ownership (part. capital market products) and fosters risk sharing

- Supported by ECB and other research for the euro area (van Rooij et al. 2011, Giovannini et al. 2018)

Notes: HFSC data for 2014, except for Estonia, Ireland, Malta, Netherlands, Portugal, Finland (all 2013) and Spain (2011). Mutual funds for UK not available.

3. Impactful policy initiatives in current and future CMU

Financial literacy in the euro area can be improved: only half of adults in median EA country “financially literate”

- Strengthening basic financial education in schools
  - Saving and borrowing; cumulative interest; risk and return; diversification; inflation

Relationship between financial literacy and the demand for private pension products

Notes: ECB calculations using euro area data on financial literacy from Standard and Poor’s (2014) and on private pension ownership from the HFCS.
CMU has had limited success so far, needs to be considerably more ambitious going forward

- **Much room to grow further for capital markets in Europe**
  - Low current levels of capital market development and integration
  - Low degree of risk sharing through private financial markets

- **ECB/Eurosystme fully supports the CMU project**
  - Would like to see more impactful initiatives in the future

- **Progress on some important objectives**
  - Insolvency frameworks
  - European pension products
  - Taxation (in particular, debt-equity tax bias)
  - Supervisory/institutional architecture for capital markets (ESMA reviews)

- **Need to focus on the most impactful initiatives**
  - Harmonizing further insolvency frameworks around best practices
  - Developing public and private equity markets
    - Pension reform to increase private savings and pension funds’ equity shares
    - Improve financial literacy for market investment
  - Safe asset
THANK YOU!
Annex
Common Consolidated Corporate Tax Base (CCCTB) - Debt-equity tax bias

Scope: mandatory for large firms, optional for small firms

- Aim: reduce the debt-equity tax bias by
  - introducing an equity allowance (COM) or
  - limit interest deductibility for debt (EP)
- Impact: less leverage of firms (incl. financial institutions) due to diminished reliance on debt
- Proposal: Allowance for Growth and Investments (AGI) = increases in firms’ equity to be deductible from their taxable base

<table>
<thead>
<tr>
<th>Benefits of AGI</th>
<th>Caveats of AGI</th>
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<tbody>
<tr>
<td>Less leverage is <strong>beneficial for financial stability</strong></td>
<td>Budgetary implications</td>
</tr>
<tr>
<td>Reduced cost of equity <strong>increases investments</strong></td>
<td>Creates tax planning opportunities for multinationals</td>
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ESAs review

• The proposals aim at:

  • **Improving** the mandates, governance and funding of the 3 ESAs
  • Ensuring **stronger and more integrated financial supervision** across the EU
  • Strengthening the ESAs’ capacity to ensure **consistent supervision** and **uniform enforcement** of the single rulebook.

• **However**, an increased non-bank financial sector should be accompanied by an expansion of the prudential framework for non-bank financial institutions to adequately address systemic risks

• **Therefore**, macroprudential authorities should have **adequate tools to address systemic risks in the non-bank sector** → the CMU work should strive to provide the legal basis for such macroprudential tools

• In the longer term, CMU will warrant an **appropriate supervisory architecture**, leading ultimately to a single European capital markets supervisor
European Pension Products (PEPP Regulation)

Aim: channel more savings into long-term investments
Impact: increase the depth, liquidity and efficiency of capital markets
Proposal: standardised EU-wide personal pension product (as complement to public and occupational pensions)

Harmonisation of insolvency rules (Directive on Insolvency, Restructuring and Second Chance)

Aims: (i) effective preventive restructuring and second chance frameworks in all MS, (ii) make insolvency procedures more efficient by reducing length and costs
Impact: promote cross-border investment. Link to Banking Union (depositor preference, NPLs).
Proposal: (i) common principles for early restructuring, (ii) automatic full discharge within 3 years to give entrepreneurs a second chance
3. Impactful policy initiatives in the current and future CMU

**Insolvency frameworks – some initiatives, but not enough**

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  - ECB: promote **risk sharing** in the euro area (Giovannini et al. 2018)
- CMU Action plan contains a **welcome directive on restructuring and second chance**, which however **does not cover other problematic areas**

**Proposals**
- **Preventive restructuring**
  - Harmonised framework to avoid insolvency (and prevent court involvement)
- **Recovery of collateral**
  - Harmonised framework for out-of-court collateral enforcement
- **Assignment of claims**
  - Residence of “assignor” determines applicable national law
- **Second chance**
  - Full discharge of entrepreneur’s debt after 3 years

**Insolvency timeline**

Source: CEPS, 2016
Efficient insolvency frameworks require judicial efficiency and/or out-of-court settlement alternatives

Improve efficiency of judicial systems

Need out-of-court options, in particular where slow courts are involved in multiple steps

- Timely procedures are essential for recovery and court involvement amounts to a large share of insolvency costs
- Out-of-court procedures can complement courts (and vice versa)
  - Option 1: Non-binding EU guideline
  - Option 2: Formal EU regime

Source: Euro area countries using World Bank data, 2017

Source: OECD, 2017
Safe assets and capital markets union

- Capital markets union could be facilitated with an area-wide low-risk asset in sufficiently abundant supply that is being used as collateral, as a store of value, and as a pricing benchmark.
- **One proposal:** Sovereign Bond-Backed Securities (SBBS), where the senior tranche would serve as the area-wide low risk asset.
- ESRB HLTF on Safe Assets published feasibility study on SBBS.
- COM proposal for regulation to enable market-led development of SBBS with the following **objectives**:
  - Help banks diversify sovereign exposures, further weaken bank-sovereign nexus and enhance supply of low-risk euro denominated assets.
  - Help deepen Europe’s capital markets by being a new source of high-quality collateral for cross-border financial transactions and increasing the number of instruments for cross-border investment and risk-sharing.
- To achieve policy objectives and for SBBS to contribute to financial stability, they must be properly designed and issuance and holdings of the securities must be prudently regulated.