On Capital Market Finance in Europe [1]

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Conference on Capital Markets Union
Organized by the Financial Markets Group
The London School of Economics and
Political Science

June 14, 2019

Professor Goodhart—Charles; Professor Vayanos—Dimitri; all of you who have chosen to spend part of your Friday evening here in the Old Theatre: it is a privilege to be invited to speak at the LSE.

I have been asked to share some thoughts on the European capital market union—CMU—including on its macroeconomic benefits and on how it fits into the broader context of European integration.

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[1] The views expressed are mine and do not necessarily represent those of the IMF.

This is very timely from an IMF perspective as we are just about to publish a paper on CMU. This paper lays out our proposals for how to adapt and change the EU's—and not least the euro area's—economic architecture.

Already back in 2013—when the discussion of architecture gained renewed impetus in the wake of the euro area's existential crisis—we published a comprehensive set of proposals for a banking union.

As to euro area fiscal policy and rules, we made detailed proposals for how to reform the Stability and Growth Pact a few years ago. Last year, we followed up with a proposal for a central fiscal stabilization capacity for the euro area.

With the forthcoming paper on how to integrate European capital markets, we will have a full set of papers covering all the main areas of the debate on architecture. The paper is at an advanced stage—we discussed it at our Executive Board last week. While it still needs to be finalized—

with publication expected later this summer—I can share the main ideas with you this evening.

CMU, on the face of it, is a relatively uncontroversial idea, certainly in comparison to proposals regarding a central fiscal capacity and common deposit insurance. There is an understanding that capital market integration could have important economic benefits without involving the kind of concerns about **public** risk-sharing—about creating a transfer union through the backdoor—that rightly or wrongly have proven a formidable obstacle to progress on both a central fiscal stabilization mechanism and deposit insurance.

To put the same point differently: at a time when we appear to be well away from reaching a political consensus on a greater degree of **public** cross border risk-sharing, it might be more realistic to get political support for measures aimed at a higher degree of **private** cross border risk-sharing.

In this regard, let me remind you that the risk to the euro area's stability arising from country-specific shocks—risks that were so violently on display during the euro area crisis—remain serious: the lack of reforms means that little progress has been made on closing productivity gaps across member states, leaving some countries with low potential growth rates and high unemployment.

And highly indebted countries have not taken sufficient advantage of several years of relatively robust GDP growth to reduce debt—in some cases fiscal policy has clearly been procyclical. They are therefore left with even less fiscal space to counter shocks that are country specific—with a correspondingly higher risk that they could be forced into a procyclical tightening in the face of shocks.

Thus, greater **private** cross border risk-sharing through deeper integration of banking systems and capital markets could certainly help increase the euro area's stability in the face of country-specific shocks that cannot be addressed by a response from the common monetary policy.

Here the comparison is often made to the United States, where a much larger degree of private risk-sharing across states means that a much smaller burden of adjustment falls on individual states in the event of adverse local shocks.

In the euro area, listed equity amounts to about 68 percent of GDP—in the United States, the ratio is closer to 170 percent. In the euro area, private sector debt securities stand at the equivalent of about 85 percent of GDP; in the United States, the figure is 100 percent.

This means that less than one-third of nonfinancial firms' liabilities in the euro area are tradable instruments, compared to more than two-thirds in the United States.

The flip side, of course, is banking system size. Total banking sector assets amount to about 300 percent of GDP in the euro area, dwarfing the U.S. ratio of about 85 percent of GDP.

In the EU, as much as 40 percent of household savings are held as bank deposits; in the United States, the share is only one-tenth.

There are several reasons why European capital markets are outshone by the U.S. capital market. One reason relates to the lasting effects of the decades-long separation of securities underwriting from banking under Glass–Steagall in the United States against the tradition of universal banking in Europe.

Another is industry structure, with a much larger role played by SMEs and family-owned firms in Europe, favoring secured bank loans and unlisted equity from friends and family—unlisted equity in the euro area is much larger than in the United States.

Yet another is the high level of development of European mandatory public pension and social security schemes and its concomitantly small private pension fund industry, in sharp contrast to the large volume of defined-contribution “401K” savings plans in the United States.

We can debate whether the United States, with its uniquely high level of capital market development, has the balance right or has swung too far in the other direction. But what is indisputable is that Europe remains in the throes of very strong bank-dependence.

In addition to being small, European financial markets are also sharply segmented along national lines, exhibiting a strong home bias.

Almost half of the equity holdings of EU insurance companies, for instance, are in firms registered in the home country of the insurer, rising to 60 percent in Spain, about 70–75 percent in Germany, the Netherlands, and Austria, and 80 percent in France. We see similar patterns in Europe’s pension fund industry, and indeed in banking.

In other words, Europe is a long way from having a single financial market—and the implications are costly. Fragmentation creates barriers to economic integration, holds back innovation and growth potential, and hurts macroeconomic resilience by reducing cross border risk-sharing. We have tried to quantify these costs.

First, barriers to integration: European firms face sharply divergent financing costs based purely on national domicile. Controlling for firm-specific features such as size, profitability, leverage, and fixed asset endowment, our analysis suggests that the average Italian firm in any given industry pays 100 basis points more on debt than the average French firm in the same industry. For Greek firms, the funding cost disadvantage relative to, say, Germany is closer to 200 basis points. Greek and Italian firms are not alone in facing an uphill struggle relative to their French or German counterparts.

Second, restraints on innovation and growth potential: firms with limited plant and machinery to offer as collateral—think of your typical IT start-up—face immense difficulty accessing bank loans and are thus especially disadvantaged when the home capital market is small. Our quantitative analysis confirms that such firms grow significantly faster in more developed capital markets, where venture capital funds with diversified portfolios are more willing to take the risk of providing financing without tangible collateral.

Third, as to shock absorption, we estimate it to be four times stronger in the 50 U.S. states and ten Canadian provinces than in the EU. Thus, for every 1 percentage point drop in national GDP growth, consumption drops by 80 basis points, on average, if the country is in the EU, compared to only 18 basis points for the 50 U.S. states.

This total breaks down as follows: only an estimated 16 basis points of domestic growth shocks are smoothed through the capital market and credit channels in the EU, compared to 72 basis points in the U.S. states.

Moreover, cross border risk-sharing through fiscal transfers is almost non-existent in the EU, whereas in the United

States it contributes another 10 basis points to consumption smoothing.

Greater financial integration in Europe, therefore, offers the prospect of powerful macroeconomic benefits.

Before getting to our concrete proposals for how to promote CMU, I want to define the issues a bit better by reminding you about some basic differences between bank-based and market-based finance.

Remember that the core funding base of banks is risk-averse depositors while that of the capital markets is yield-seeking investors. Through a long and bitter experience with financial panics we have developed a system where one fundamental difference between banking and the capital markets is the special privileges that banks enjoy under the public financial safety net.

This safety net has multiple strands. Banks enjoy the right to retail deposit insurance, backstopped by the state but funded by the industry. In addition, they enjoy the right to draw liquidity from the central bank against eligible collateral, and the right to place excess liquidity at the central bank—the safest counterparty in the land. All of this makes banks safer, but can also create moral hazard, meaning an incentive to take risk when one knows one is protected from some or all of the downside.

There is more. When banks fail—and fail they still do—the government's promise to stand behind their retail deposits creates a natural role for government in their wind-up: this is why we have state-directed bank resolution, as distinct from private corporate insolvency. And, both to offset the moral hazard effects and to contain the financial stability risks arising from the mixing of leverage and maturity transformation, banks are prudentially regulated and supervised with the explicit mandate of reducing their probability of failure.

Contrast this with a relatively pure form of capital market intermediary: the mutual fund. Where banks focus on taking deposits with a promise to return them on demand and at face value, mutual funds take equity with the prospect of higher returns but also a disclaimer on potential losses. In the mutual fund industry, savers are exposed directly to the end-users of their funds with no public backstop; official oversight is mainly focused on ensuring transparency and good conduct by fund managers, with no explicit mandate to limit losses, and is often of an *ex post* nature, with a heavy emphasis on enforcement, contrary to *ex ante* prudential oversight in banking. Risk-taking here is modulated primarily by market forces.

One more point. Banks lend based on relationships and proprietary information. Given the relatively level playing field among banks—they all benefit from the same safety net—information gathering forms the essence of competition in banking. You collect as much data as you can on your borrowers, you nurture your customer relations in the pursuit of repeat business, and you **never** share your data with others. And information, of course, costs money—when we borrow from banks we pay for a broad range of overheads.

Mutual funds, in contrast, invest at arm's-length. Here, the name of the game is reliable, comparable, publicly available information. The fund buys a tradable security after its managers have skimmed the prospectus—a much less costly endeavor than gathering bespoke information—and they don't know much that other fund managers don't also know. Here, success depends on wise investment choices, proper valuation practices, and portfolio diversification. For the recipients of mutual fund investments—the issuers of debt and equity securities—the benefit lies in being able to access savings with less margin taken by the middleman, and thus a lower cost of funds.

In view of these basic differences between banking and the capital markets, it is not surprising that plans for banking union have focused on the creation of a centralized supervisor of systemically important banks—the Single Supervisory Mechanism; a centralized bank resolution framework—the Single Resolution Mechanism, backed by a central fund soon to be backstopped by the European

Stability Mechanism; and a common European Deposit Insurance Scheme—EDIS.

In contrast, the general principles that I just sketched suggest that the primary focus of efforts to create a CMU should be more on ensuring greater transparency; reducing variability in investor protection regulations; and improving insolvency regimes, both to improve recovery values and to facilitate smooth market exit. One key theme here is to facilitate market discipline, which requires an approach that is distinct from explicitly seeking to reduce the likelihood of failure through intrusive prudential supervision.

The emphasis on transparency, regulatory consistency, and insolvency frameworks suggested by theoretical considerations is very much in line with what we found from a survey of national market regulators and large institutional investors about their views on obstacles to CMU.

The survey results point to three main issues: first, insufficient transparency, including in access to data on listed and unlisted companies and in withholding tax refund procedures; second, deficiencies in some national insolvency frameworks; and, third, variability in regulatory quality across countries. These factors emerge as key obstacles to integration.

I will touch on Brexit-related issues later but let me just note that most respondents in our survey identified the United Kingdom as the EU's most attractive capital market jurisdiction.

With that, let me turn to our concrete proposals for how to advance CMU. I should note that our proposal is broadly consistent with the European Commission's Action Plan—which we find generally well thought out—but that we are focused on key initiatives that we think have a greater chance of gaining political support while offering clear macroeconomic benefits.

First, let me focus on transparency. Here, the European Commission has done good work: its Prospectus Directive mandates a single EU template for prospectuses of larger issuers, with a harmonized approvals process. The result is a standardized, simple-to-produce, easy-to-approve, and understandable disclosure vehicle, bestowing a passport for distribution in all EU member states. The recent Prospectus Regulation tasks the European Securities and Markets Authority—ESMA—with storing all such prospectuses and making them available via a free and searchable online database.

We propose this work be taken one step further with the major additional step of instituting centralized, standardized, and compulsory electronic reporting for all issuers on an ongoing basis.

This would be a major change to the reporting framework in Europe. But we note that similar steps are already very much established elsewhere. The U.S. Securities and Exchange Commission—the SEC—maintains a database that provides free public access not only to prospectuses, but also to standardized annual and quarterly financial statements that have become centerpieces in the marketplace.

Issuers are required to submit their filings directly to the SEC, with the information always structured in the same way regardless of which company filed the information. Canada has a similar mechanism.

The recommendation to bring the European reporting framework on par with those in the United States and Canada is a central element in our proposals to advance CMU. You might perhaps be underwhelmed—for a key measure, you might find our proposal to be timid.

We would disagree. What we are proposing would give investors ready access to company data in a central location in a standardized format, whereas at present reporting is fragmented along national lines and is unstandardized. In our view, mindful again that market-based finance revolves around publicly available information, the direct impact of our proposal on price formation and market efficiency should not be underestimated. We think this could prove to be a powerful tool.

Another important proposal to enhance transparency would be to streamline procedures for cross border refunds of withholding taxes on dividend and interest income. Here one could harness technology to create a single electronic processing portal to simplify tax reclaims.

Second, what about the quality of insolvency practices—another key obstacle according to our survey?

This is probably the most difficult area of all, because it is deeply steeped in national legal tradition. We see a wide—and highly consequential—divergence in the legal landscape, particularly in national bankruptcy laws. Yet we are here at one of the core issues that define countries—one of the issues where diversity of tradition is a key part of Europe's political diversity. Improvements here will take place extremely gradually, at best.

Mindful of this, our recommendations on insolvency practice are admittedly relatively modest. Basically, we suggest an ongoing role for the European Commission along three dimensions: first, to carefully collect data in an area where the existing information is unreliable; second, to develop a code of good standards for core features of corporate insolvency and debt enforcement processes; and, third, to systematically follow up on member states' progress toward observing such standards.

In essence, we propose an approach modeled on the *Basel Core Principles* process, which aims at nudging independent jurisdictions toward higher and more uniform standards in banking supervision.

Third and last, I turn to regulatory oversight. Recall that the main emphasis of public involvement here should be on conduct-of-business oversight to protect investors, *ex post* enforcement to deter misconduct, and insolvency practices to facilitate smooth market exit.

Here, I would like to emphasize the importance of proportionality, of recognizing that there is no one-size-fits-all solution in a space as heterogenous as the capital markets. It is not possible to subject all nonbank financial intermediaries to intrusive prudential supervision.

Many capital market entities are wholly equity funded and do not engage in maturity transformation. For such entities, the restraining hand of market discipline plays an important role.

In such cases, excessive prudential oversight risks creating perceptions of a potential government backstop—staff at the U.S. Federal Reserve used to call this the “halo effect”: the risk that public authorities might create bailout expectations and moral hazard simply by being seen to be talking to certain nonbank financial actors.

This being said, there are a few capital market entities that are so systemic that their failure would pose systemic risks and where, therefore, strict prudential oversight is vital. I refer here to central clearing counterparties in particular—CCPs—but also to large and complex investment firms.

CCPs are critical: their enhanced role in derivative and repo market clearing since the global financial crisis increases safety and efficiency yet concentrates tail risk in a few key nodes. Prudential oversight of CCPs—focused on their margining practices, default funds, and capital—must be deeply intrusive, seeking to reduce the probability of failure to near zero.

Finally, before concluding—and standing here in the long shadow of Brexit—I am acutely aware that my remarks today would not be complete without touching on the critical role of the United Kingdom in the European capital markets. Since 2016, CMU has faced a new reason for urgency.

I need not delve into much detail for this audience. London is a global trading hub for derivatives, foreign exchange, and money market paper, as well as gold, silver, and base metals. It is also a world leader in international debt issuance, international insurance, and international syndicated credit. It has given Europe important capital market links to the rest of the world, including a transatlantic dollar funding pipeline that helps finance large European holdings of U.S. securities. In short, London exemplifies agglomeration effects in finance.

If one were to reduce this reality to a diagram, one could easily characterize the European capital markets, thus far, as a hub-and-spokes system, with London as the hub. The spokes include many important network linkages, ranging from securities and derivative clearing in London to the widespread “delegation” of day-to-day investment decisions by EU-27 mutual funds to London-based fund managers.

Brexit thus poses a major challenge for the European capital markets. On the current course, hub-and-spokes looks likely to give way to a multi-hub CMU inside the EU-27, with some activities concentrated in Frankfurt, others in Paris, and yet others in Dublin or Luxemburg. There is clearly a risk that such fragmentation would reduce market liquidity and increase transaction costs across various market segments. Several network linkages could be disrupted. Significant international business would be carved out of the EU. Some global links could also be affected.

In addition, the prospect of Brexit necessitates urgent upgrades to EU-27 capital market oversight capacities and infrastructure, to cope with a large-scale migration of activity out of London—this is already evident in some areas.

In this regard, there is a concern doing the rounds that as the country with the deepest financial markets and financial market expertise exits the EU, a certain heavy-handedness could take root. You will understand from what I said just a few minutes ago that I think it is very important to be mindful of this concern. Despite my general advocacy of strong capital market oversight, prudential supervision must be fit for purpose and proportionate to the risks.

Thus, there are many ways in which Brexit is a huge issue for CMU. I think it is fair to say that it ramps up both the magnitude of the challenge and the need for urgency.

Reflecting the IMF's mandate as guardian of the international monetary system, I want to stress the importance of international supervisory cooperation. We would argue that 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 United Kingdom given its tight financial links to the EU-27. As a general principle, diversification outside the EU should be encouraged, given the increasingly global nature of capital market finance.

It is time to conclude.

What I have sketched here today is a proposal for CMU that focuses on a number of obstacles that, once overcome, could spur a significant deepening of European capital markets by stimulating market forces. It is a pragmatic and moderate proposal in the sense that its focus is on fairly technical issues, in effect accepting that a number of more fundamental and politically sensitive obstacles can only be overcome in the very long run.

It reflects the view that focusing up-front on much more controversial issues—like a significant integration of insolvency regimes—could risk what we think are relatively important gains from overcoming more technical obstacles.

If you will, our proposal is a medium-term action plan for a currency union that is not a political union—and still far away from being one. It is not a plan for how to soon get to a U.S.-style European CMU.

Circling back to where I started—looking at CMU in the broader context of changes in the eurozone architecture—the CMU together with banking union will not give Europe anywhere close to the level of private cross border risk-sharing that we see in the United States in the foreseeable future. But it will be an important step in that direction.

And, given the lack of broad political support for more public risk-sharing so evident in the discussion of a central fiscal capacity and common deposit insurance, it is safe to conclude that the euro area's stability—its susceptibility to shocks—will continue overwhelmingly to depend on policy actions at the national level, especially structural reforms to lift productivity growth and budgetary policies aimed at securing the necessary fiscal space.