

IMF STAFF DISCUSSION NOTE

A Capital Market Union for Europe

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With detailed input from
Wolfgang Bergthaler and Jose Garrido

Under the overall guidance of Mahmood Pradhan

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EXECUTIVE SUMMARY

This note weighs the merits of a capital market union (CMU) for Europe, identifies major obstacles in its path, and recommends a set of carefully targeted policy actions.

European capital markets are relatively small, resulting in strong bank-dependence, and are split sharply along national lines. About 40 percent of EU households' savings are held as bank deposits, compared with 10 percent in the United States; only 30 percent of EU nonfinancial firms' liabilities are securities; and more than half of EU long-term investors' assets are domestic claims.

This results in an uneven playing field in terms of corporate funding costs, in credit rationing for collateral-constrained firms, and limited shock absorption. Firms in some euro area countries pay up to 250 basis points more on debt than their peers in other euro area countries. Certain types of firms—notably start-ups with few assets to post as collateral—may be denied financing. And consumption is four times more sensitive to local shocks in the EU than in the 50 US states.

The benefits of integration center on expanding financial choice, ultimately to support capital formation and resilience. More arm's-length cross-border finance using tradable instruments would allow firms to tap into a broader investor base, evening out funding costs across the region and improving access to venture capital. At the same time, enhancing savers' ability to diversify their portfolios makes domestic demand less sensitive to local economic outcomes.

Capital market development and integration would support a healthy diversity in European finance. On the one hand, the increased interconnection that comes with capital market integration can channel contagion. On the other, the shock-absorbing properties of equity claims are well recognized. In any event, capital markets would complement, not replace, banking.

Proceeding methodically, this note identifies three key barriers to greater capital market integration in Europe: transparency, regulatory quality, and insolvency practices. A new survey of practitioners highlights informational issues in securities markets and in withholding tax relief or refund procedures. New empirical work finds that the volume of cross-border claims is significantly held back by uneven regulatory quality and deficient insolvency regimes in some countries—and the latter also explains much of the cross-country dispersion in firms' debt financing costs.

Based on these findings, the note urges three policy priorities, focused on the three barriers. *Transparency* can be enhanced by requiring centralized, standardized, and ongoing reporting by all issuers; addressing challenges to the affordability of research on small issuers and unlisted firms; and streamlining cross-border withholding tax procedures. *Regulation* can be sharpened by centralizing oversight of systemic intermediaries; strengthening supervisory convergence tools to buttress investor protection where it falls short; taking further steps to support a cost-efficient, tax-effective, portable pension product; and pursuing close regulatory cooperation with non-EU countries. *Insolvency* processes can benefit from a "name and shame" approach involving the setting of minimum standards and systematic monitoring of countries' progress in observing them.

There is no roadblock—such steps should prove feasible without a new grand bargain.

INTRODUCTION

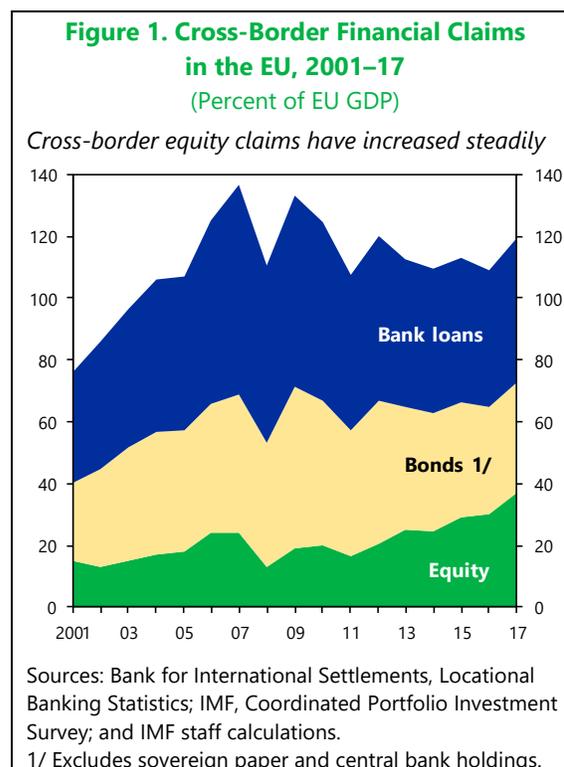
1. Europe provides fertile ground for a regionally integrated capital market. The EU treaties enshrine capital mobility among the “four freedoms,” alongside the free movement of goods, services, and labor. A vast body of EU financial sector legislation puts this in practice.

2. Despite the supportive elements, however, European capital markets are split along national lines. In both banking and the capital markets, the focus is domestic, an insularity that has increased in recent times with a strong homeward retrenchment of bonds and bank loans—although, more encouragingly, cross-border equity claims have risen steadily (Figure 1).

3. Given EU treaty constraints on public cross-border risk sharing, Europe needs more private risk sharing through both banks and the capital markets. Greater private cross-border risk sharing would support economic convergence, growth, and shock absorption.

4. Market integration will also bring risks. Capital markets can be flighty, and interconnection can channel contagion. While banks enjoy a stable funding base backed by deposit insurance, capital markets, by design, have little if any public safety net. And, whereas banks base their lending on relationships and proprietary data, arm’s-length finance relies on public disclosure in a world where perfect investor protection can never be guaranteed and panic thus never ruled out. Financial stability risks will call for vigilance and active macroprudential management.

5. This note focuses on identifying the major barriers to capital market integration in Europe and recommends policy initiatives to tackle them. It starts by touring the landscape and quantifying some of the costs of fragmentation. Then, based on a poll of market practitioners as well as empirical work, it identifies major obstacles to integration. Informed by these findings, it goes on to discuss the theory and practice of capital market oversight. The note concludes by urging a set of policy actions focused on transparency, regulation, and insolvency procedures.



THE EUROPEAN LANDSCAPE

6. European capital markets are small and fragmented, yet enjoy a full complement of intermediaries and infrastructure—although everything currently sits in the shadow of Brexit. European households’ preference for bank deposits over securities, coupled with well-developed

public pension systems, leaves a small corpus of privately managed capital market assets. Money managers focus on domestic claims. Consequentially, Brexit will remove the system’s de facto hub.

A. Size and Home Bias

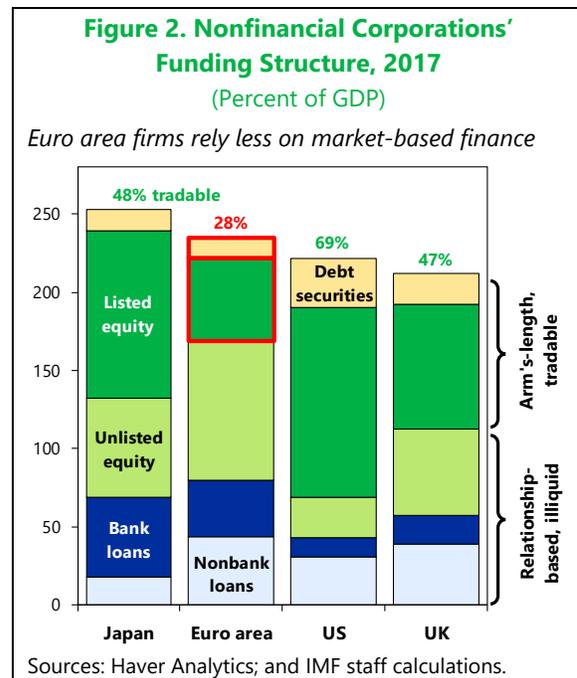
7. Europe has a large banking system and small capital markets. Bank assets are 300 percent of GDP in the euro area, dwarfing the United States’ 85 percent of GDP but below Japan’s 500 percent. Listed equity stands at 68 percent of GDP, well short of the United States’ 170 percent of GDP and Japan’s 120 percent—although the euro area towers above the others in unlisted equity. Private sector debt securities outstanding amount to almost 85 percent of GDP in the euro area, more than Japan’s 65 percent of GDP but less than the United States’ 100 percent.

8. Within the EU, there are wide variations in capital market size. Taking the listed equity and debt securities of financial and nonfinancial corporations together, total tradable claims are more than 200 percent of GDP in France, the Netherlands, and Sweden; about 135 percent of GDP in Portugal; but less than 70 percent in Poland, the Czech Republic, Latvia, and Lithuania.

9. Capital market participation by households is limited, reflecting the large role of mandatory public pension schemes among other factors. Only 20 percent of euro area households hold stocks or investment fund units, and only one-third invest in voluntary pension and insurance schemes (ECB 2016). The latter contrasts sharply with the United States, where over half of households have retirement accounts and one-fifth have life insurance (Federal Reserve 2016).

10. Nonfinancial firms exhibit low reliance on market-based finance. Only 30 percent of the sector’s financing comprises tradable instruments in the euro area, versus some two-thirds in the United States (Figure 2). The comparison may reflect the legacy effects of the decades-long separation of securities underwriting from banking under the Glass-Steagall Acts as well as other US specificities, but it is also skewed by the much larger role played by small or medium enterprises (SMEs) and family-owned firms in Europe, where relationship-based financing favors secured bank loans and unlisted equity. In part, the significant role of nonbank lending in Europe reflects intracompany loans by multinational corporations—some of which are linked to tax optimization—as well as intercompany loans up and down value chains.

11. European capital markets are sharply segmented along national lines. As in other jurisdictions, there is an overall home bias in the EU in that most capital market claims are on issuers within the region. But Europe also displays a



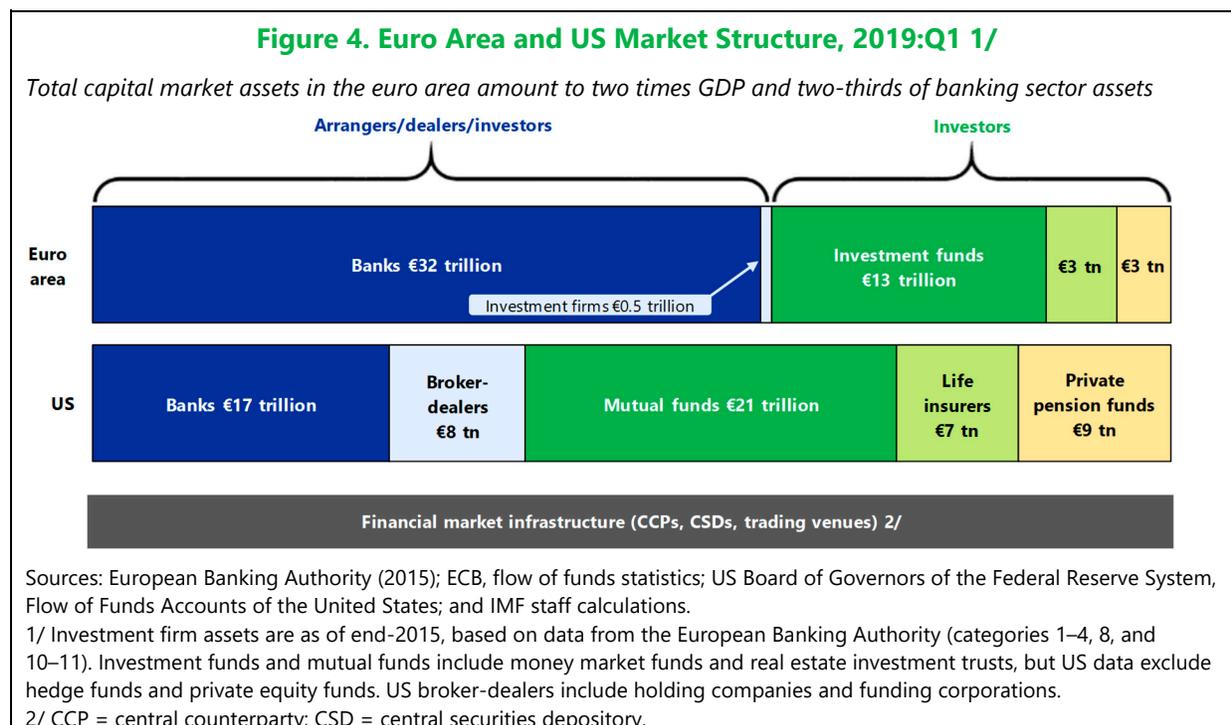
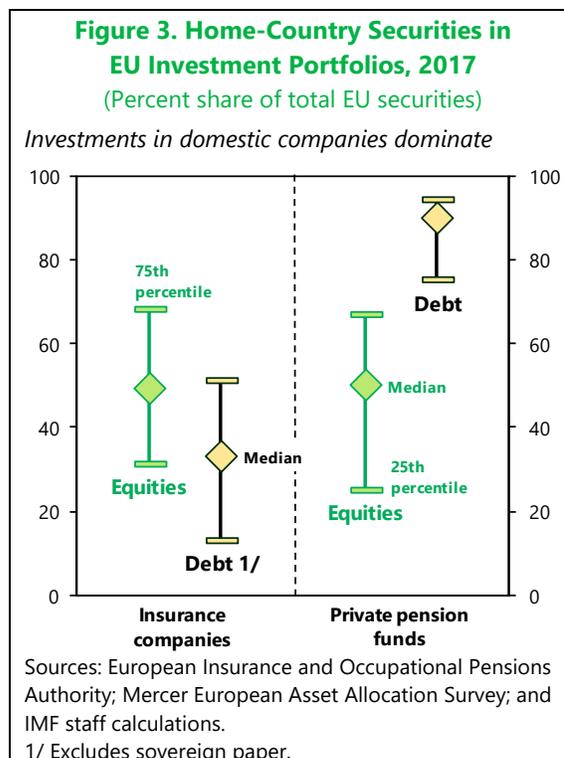
member state bias that tends to be higher in the larger countries, albeit partly offset by exposures to diversified multinationals (Figure 3). Almost half of EU insurers' equity holdings are in firms based in the insurer's home country, rising to 60 percent in Spain; 70–75 percent in Germany, the Netherlands, and Austria; and 80 percent in France. The pattern for debt holdings is similar. For pension funds, equity home bias is highest in France, Portugal, and Spain and generally well in excess of the home-state bias seen for US pension funds. Banks are similarly inward-looking.

B. Institutional Structure

12. Europe's largest capital market segment is its investment fund industry.

Assets of investment funds in the euro area amount to €13 trillion, or 110 percent of GDP (Figure 4). The largest slice comprises funds under the

Undertakings for Collective Investment in Transferable Securities (UCITS) regime, which allows qualifying funds to be marketed to retail or professional investors anywhere in the EU. Other funds fall under the Alternative Investment Fund Managers Directive (AIFMD), which may only be marketed to professional investors.



13. Hedge funds and private equity funds play a relatively small role in Europe. Total assets in the EU of these long-or-short investors—whose activities generally support price discovery—amount to about \$690 billion and \$650 billion, respectively, overwhelmingly managed from the United Kingdom. Such sums are dwarfed by the \$2.6 trillion in hedge fund assets and \$1.5 trillion in private equity assets in the United States (Consultancy UK 2018; Preqin 2019).

14. Europe’s second largest market segment comprises life insurers and private pension funds, although assets under management are far smaller than in peer jurisdictions. At about €6 trillion, investible assets in the euro area amount to about 50 percent of GDP, compared with almost 90 percent in the United States. Reflecting Europe’s well-developed public pension systems and lack of a portable pension product, its long-term institutional investor base is the smallest among major advanced markets (Background Note 1).

15. As elsewhere, investment banks play a vital capital market role. Following a tradition of universal banking, Europe’s largest banking groups typically own investment firms—“broker-dealers” in US terminology. These groups provide underwriting and distribution services to issuers, and depositary and prime brokerage services to funds. Their dealing and proprietary trading activities support market liquidity. They are also key gateways for retail investors to access the UCITS sector.

16. The securities and derivatives markets rely on central securities depositories (CSDs) and central counterparties (CCPs). CSDs provide securities account, safekeeping, and collateral management services to banks, which in turn provide such services to their corporate clients. CCPs reduce counterparty credit risk for their members by interposing themselves between buyers and sellers of securities and derivatives, at the same time harnessing efficiency gains in netting and collateral management. Most new over-the-counter derivatives contracts involving EU counterparties must be cleared through EU-domiciled CCPs or recognized non-EU CCPs.

C. The Brexit Challenge

17. The prospect of Brexit creates a risk that EU capital markets could be transformed from a hub-and-spokes system with London as the hub to a multi-node network structure. This could entail material efficiency losses, both during the transition and in the future steady state.

18. Brexit would shrink the EU capital markets and could disrupt certain intra-European network linkages. The volume of listed equities and private sector bonds in the EU would fall significantly; a large share of derivatives would be carved out; a mass of euro clearing might migrate from the 3 UK-based CCPs to the 13 CCPs in the EU27; and some service-based links could be disrupted. In the fund industry, for example, any disruption to the common practice by EU27 funds of delegating investment decisions to managers in London could prove costly.

19. Losing the United Kingdom could hurt market liquidity. London has exemplified agglomeration effects in finance, with the largest EU27 banking groups tapping into these benefits both as market makers and as investors. The large number and volume of financial transactions executed in one place, across a broad range of instruments, creates economies of scale and scope

and deep market liquidity, supporting price discovery and lowering transaction costs (Kindleberger 1974). Spreading trading and clearing across multiple locations could hurt efficiency.

20. Brexit could also disrupt some channels to other capital market jurisdictions. While London dominates global trading in derivatives, foreign exchange, money market paper, gold, silver, and base metals, New York is the world's main trading center for equity and debt. EU links to New York through London—which include a transatlantic dollar funding pipeline that helps finance large European holdings of US securities—would take time to replicate elsewhere.

21. The prospect of Brexit thus creates a fourfold challenge for EU capital markets. First, a UK departure would shrink the size of EU markets and could disrupt some European network links. Second, it could reduce market liquidity and increase transaction costs. Third, some global channels could be disrupted. And fourth, a large-scale migration of activity from London to the EU27—already underway—requires urgent upgrades to oversight capacity and financial infrastructure.

COSTS OF MARKET FRAGMENTATION

22. Europe's segmented capital markets impose substantial—and quantifiable—economic costs. The absence of a pan-European investor base results in a wide cross-country dispersion in corporate funding costs, leaving firms in some locations at a severe disadvantage. Bank dependence cuts off funding to many dynamic start-ups, which hurts innovation and growth. And limited portfolio diversification opportunities for savers reduce the consumption smoothing that would otherwise make domestic demand less sensitive to local economic outcomes.

A. Uneven Corporate Funding Costs

23. Overreliance on banks when capital markets are thin tends to leave firms facing high and stratified funding costs. Firms in jurisdictions with less-developed capital markets typically have no option but to borrow from local banks that wield market power and can charge higher rates than if they were competing with a broad investor base. Equity too may be listed and traded on local exchanges with limited market liquidity, pushing up the cost of capital.

24. An index developed by the IMF staff finds wide variation in the level of capital market development across Europe (IMF 2015). The index—which aggregates information on stock market capitalization and turnover, the capitalization of smaller firms, the total value and number of issuers of private sector debt securities, and international placements of debt—predictably ranks the United States at the top of the global order. But, importantly, it also shows that there are wide differences in financial market development within the EU and the euro area (Background Note 2).

25. This variation in capital market development by country, coupled with limited cross-border integration, results in a wide dispersion of corporate funding costs. IMF staff analysis conducted for this note shows that, across the euro area, firms within the same sector and of similar size, profitability, leverage, and fixed asset endowment experience wide interest rate dispersion by

country (Figure 5). A Greek firm may pay up to 250 basis points a year more on debt than a comparable French firm; an Italian firm may pay 80 basis points more than a similar Belgian firm. And this dispersion is significantly higher for small or unlisted firms—with, for example, small Greek firms paying on average some 325 basis points more than their French peers.

B. Restraints on Innovation and Growth

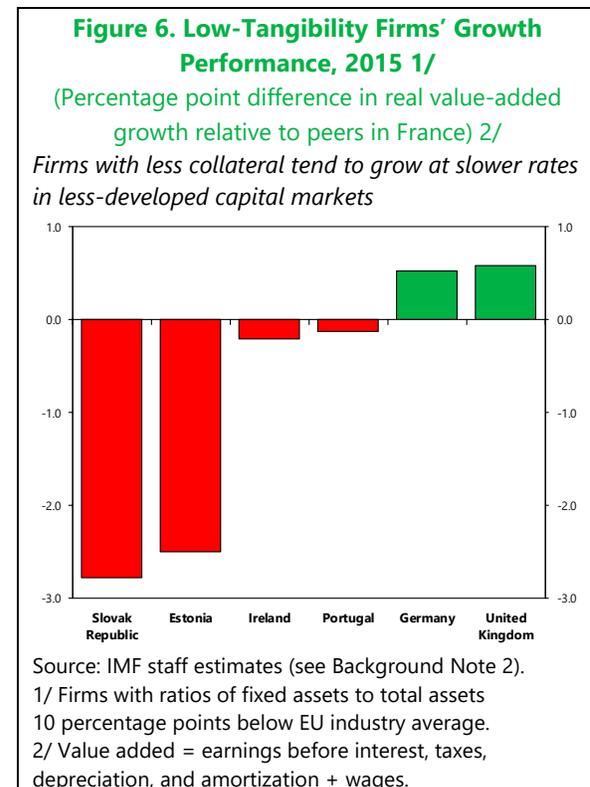
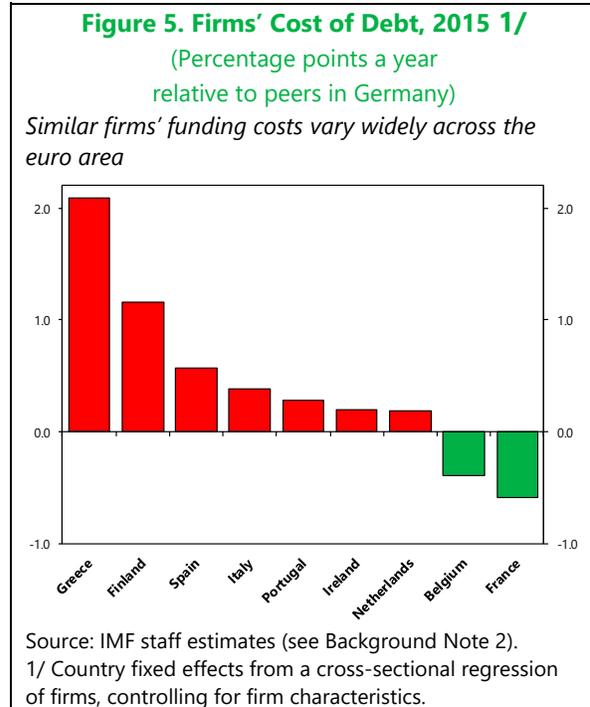
26. Limited funding choices increase exposure to idiosyncratic risks in banking.

More-bank-dependent economies tend to take longer to recover from financial crises when bank-based intermediation is impaired because of legacy asset problems or other issues (Shin 2011; Adrian and Shin 2010). Constraints on weak banks are still affecting firms in some EU countries.

27. Certain types of firms, notably start-ups with limited tangible assets, are especially disadvantaged by shallow capital markets.

Manufacturing firms can and do pledge plant and machinery to obtain bank loans. In contrast, firms with limited fixed assets, such as start-ups and firms in the knowledge-based sectors, often have no surety to pledge. Such firms tend to thrive in more-developed capital markets where they can tap a varied investor base, including venture capital funds with diversified portfolios.

28. Capital market fragmentation thus impedes innovation and growth potential. IMF staff estimates find that real value-added growth of firms with fewer tangible assets increases with capital market development (Figure 6). Controlling for aspects such as firm size and profitability, as well as for sectors and countries, the estimates show that, for every 10 percentage points of lower “tangibility” relative to average, a firm will grow nearly 3 percentage points more slowly in, say, the Slovak Republic than in France.



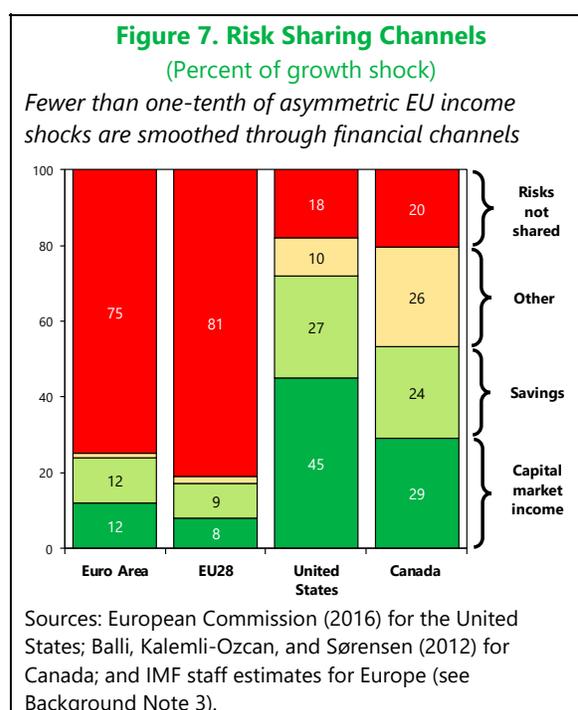
C. Forgone Macroeconomic Smoothing

29. The limited cross-border portfolio diversification that stems from capital market segmentation implies less private risk sharing and more sensitivity to local shocks. Cross-border assets allow firms and households to draw on foreign capital market income to help buffer domestic economic conditions and to dissave by selling foreign assets. IMF staff analysis conducted for this note shows that if such channels work well, alongside cross-border fiscal transfers and labor compensation, domestic demand shocks are absorbed in part by foreign residents. Such risk sharing reduces the sensitivity of private consumption to local shocks (Background Note 3).

30. Private risk sharing works especially well with cross-border equity claims. A negative shock in country A reduces GDP growth, profits, and—through lower profit expectations—firms’ equity valuations. But if foreign investors are active in country A’s equity markets, and if savers in country A are diversified through foreign equity holdings, then part of the domestic equity income loss is transferred to other countries. All else equal, foreign equity income transfers to country A remain unchanged. Debt holdings do not achieve the same degree of smoothing because, barring default, fixed payments to nonresidents must continue even when there is a negative shock.

31. A wealth of empirical literature measures risk sharing as the degree to which aggregate regional consumption is insulated from fluctuations in regional income. The approach splits GDP into its components—net cross-border income from labor and investment, fiscal transfers, foreign and domestic savings, and consumption—and estimates the importance of the various channels (Asdrubali, Sørensen, and Yosha 1996). This note focuses on net cross-border investment income and changes to net cross-border asset holdings—the capital market income channel and savings channel, respectively. If GDP and consumption move one-to-one, there is no risk sharing. If GDP varies while consumption remains unchanged, there is full risk sharing.

32. Consumption is about four times more sensitive to asymmetric shocks in Europe than in the United States and Canada (Figure 7; Background Note 3). Building on the approach above, the IMF staff finds that for every 1 percentage point drop in national GDP growth below the average growth rate of the EU, private consumption in the affected country falls by some 80 basis points, on average, if the country is in the EU, and by 75 basis points if it is in the euro area. In contrast, this consumption variation—and thus the unsmoothed element of local shocks—is only about 20 basis points for the 50 US states and 10 Canadian provinces (Allard and others 2013; Furceri and Zdzienicka 2015; European Commission 2016).



33. Capital market channels contribute little to income smoothing in Europe. Only 10 basis points of domestic growth shocks are smoothed through capital market investment income in the euro area, with another 10 basis points of smoothing attributable to the savings channel, which includes changes in net cross-border portfolio asset holdings. While this can come from both intra- and extra-EU investments, data on bilateral portfolio holdings suggest that 65 percent of EU countries' external claims are on other EU countries. In contrast, some 45 basis points and 29 basis points, respectively, of asymmetric shocks to the US states and Canadian provinces are smoothed through external income (European Commission 2016; Balli, Kalemli-Ozcan, and Sørensen 2012). Estimates for these countries do not separate the labor, investment, and other income channels.

BARRIERS TO CAPITAL MARKET INTEGRATION

34. IMF staff analysis based on a survey and empirical work identifies three main obstacles to CMU and shows that their removal would bring measurable economic benefits. The obstacles are insufficient transparency on issuers and cross-border withholding tax procedures, uneven regulatory quality across member states, and deficient insolvency regimes in some countries.

A. Survey of Regulators and Market Participants

35. A survey of regulators and market participants conducted for this note garnered opinions on obstacles to cross-border capital market investment in Europe. Respondents comprised 21 national regulators as well as some of the largest investment, pension, venture capital, and private equity funds and insurance companies in Europe (Background Note 4).

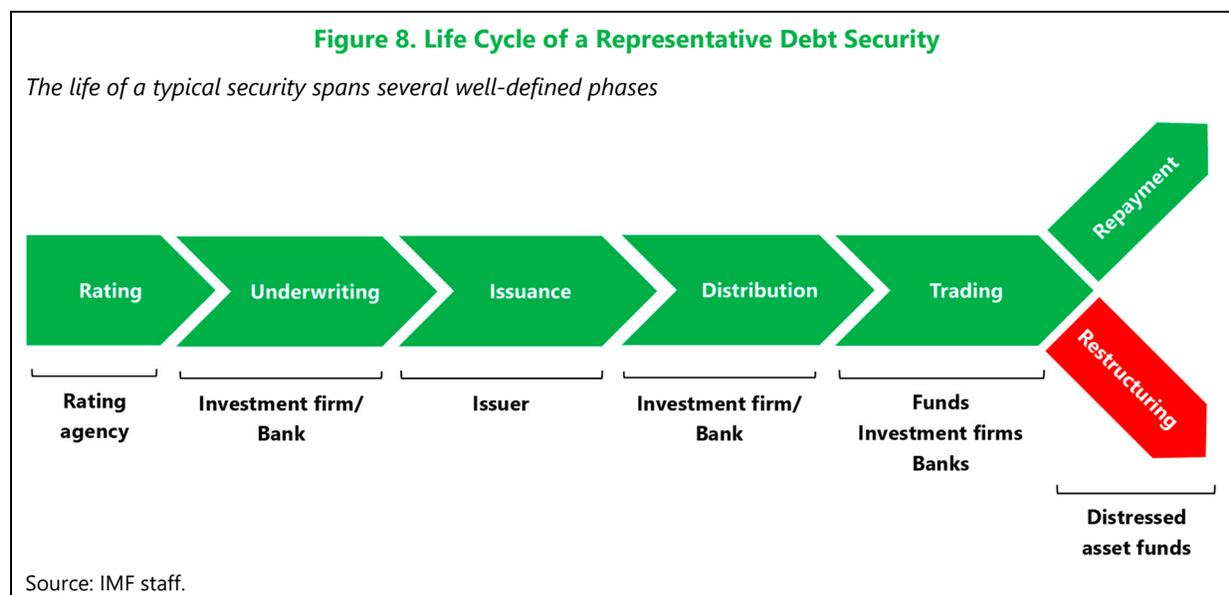
36. The survey posed a series of questions framed around the life cycle of a representative capital market instrument (Figure 8). The life of a security often begins with a credit rating, followed by an underwriting agreement with an investment bank. This is followed by issuance. Once the security is trading, investors transact with the help of brokers, which may also provide financing, while dealers support market liquidity. If at some point the issuer becomes insolvent, the security may pass to a distressed-asset investor, and reorganization or restructuring kicks in.

37. The IMF staff's survey sought to identify issues along this life cycle:

- **In underwriting, issuance, and distribution, potential issues include national differences in listing requirements, restrictions on cross-border offerings, and administrative burdens.** Competition among underwriters helps ensure reasonable terms for the issuer, and market liquidity supports efficient distribution, thereby limiting undue risks to the underwriter.
- **In secondary market trading, up-to-date information on the issuer is critical.** Investors look for company information backed by reliable audits and comparable accounting standards, and weigh the tax treatment of the investment. The level of withholding tax rates matters, but so too does the ease of obtaining withholding tax relief or refunds. Regulatory quality also matters, especially from an investor protection standpoint, including controls over corporate governance

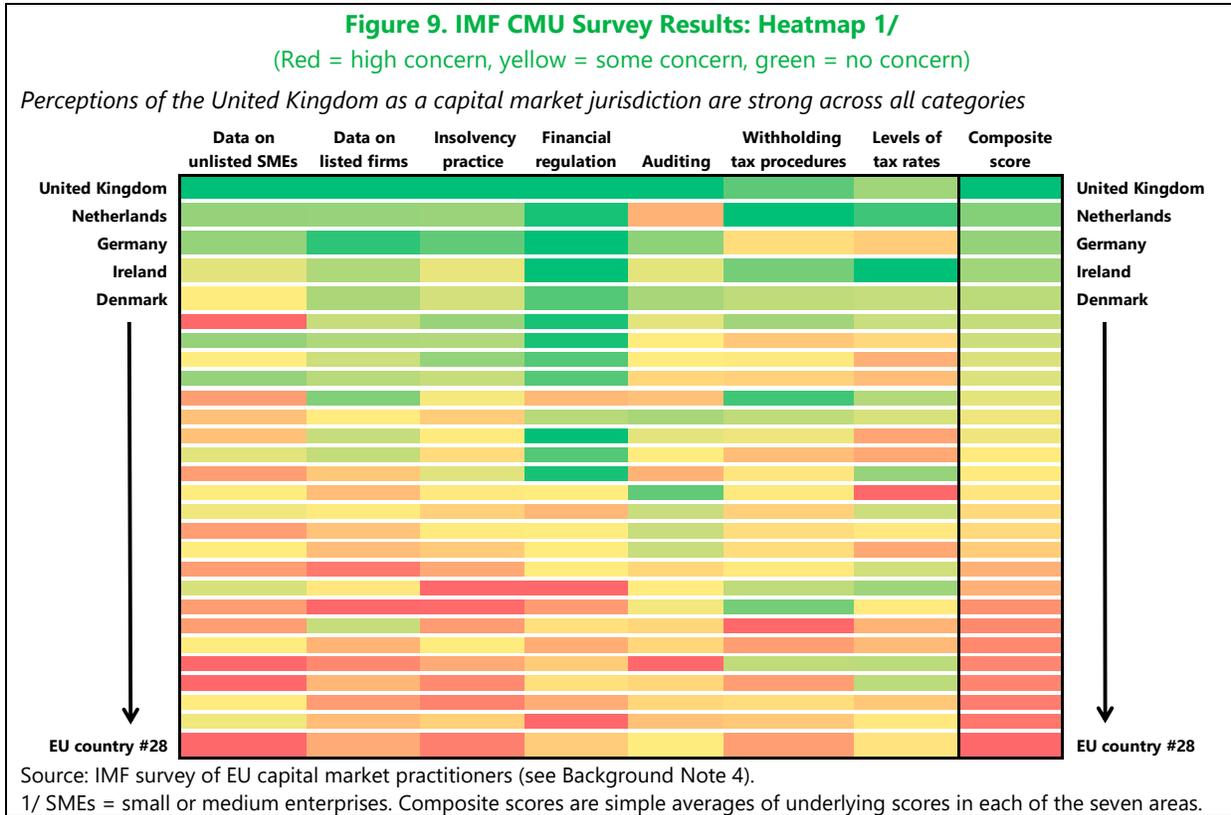
and information provision. Investors will also typically scrutinize the legal framework, including for provisions governing the ownership and transfer of securities and the quality of minority investor protection, the latter being an area of particular focus for equity investors.

- **In default or bankruptcy, the efficiency of insolvency and debt enforcement frameworks becomes a central consideration.** Elements of interest to investors include the effectiveness of court systems as well as administrative costs and the speed of decision-making, all of which fundamentally affect recovery values on impaired claims. Provisions governing debt enforcement are especially important for secured-debt investors.

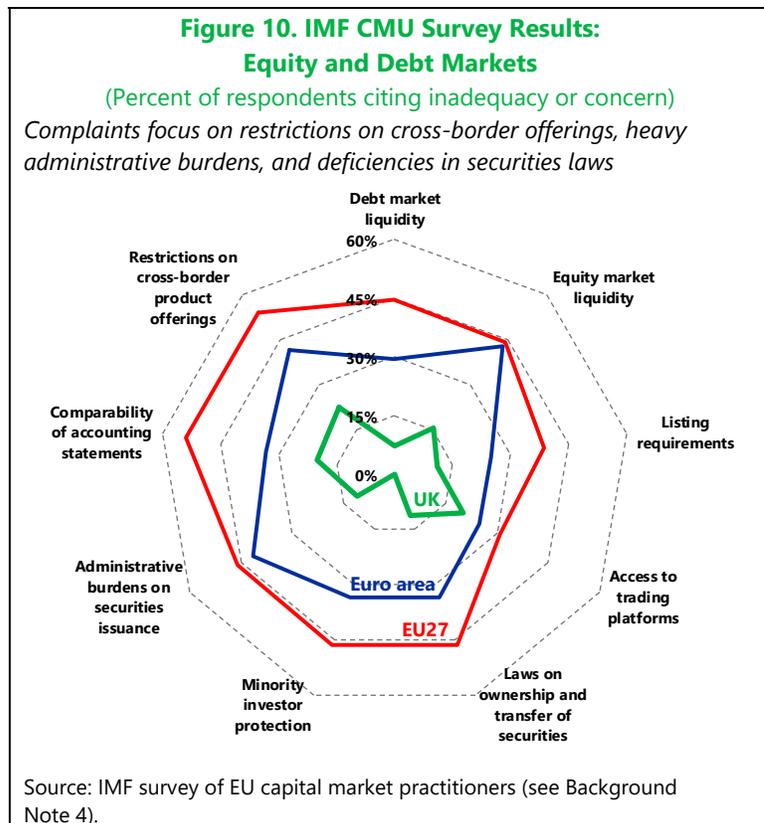


38. The survey listed country-specific questions as well as more-general questions, including on progress relative to CMU milestones. Questions were later clustered into areas relating to disclosure for listed and unlisted firms, efficiency of insolvency procedures, regulatory quality, reliability of audits, delays and difficulties in reclaiming withholding taxes, and tax rates on interest and capital gains as well as corporate profits. Respondents were asked for their views on the impact of Brexit and the desired evolution of capital market regulation. They were also asked to comment on how they view progress to date on various ongoing CMU initiatives.

39. Responses shed light on the relative severity of various obstacles and flagged the leading position of the United Kingdom as a capital market jurisdiction. 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 were flagged as areas of concern for many countries (Figure 9). Some countries were also seen to have weak audit quality, overly complex withholding tax procedures, and unduly high tax rates. The United Kingdom topped the rankings in almost all areas and was thus widely viewed as Europe's leading capital market jurisdiction.



40. Restrictions on cross-border offerings, administrative burdens, minority investor rights, and legal deficiencies were seen as key barriers to capital flows. At the EU level, more than half of respondents flagged home and host restrictions on cross-border product offerings and the comparability of accounting standards as important deterrents to integration, although the latter was seen as less of an issue within the euro area (Figure 10). More than 40 percent cited administrative burdens, minority investor rights, securities laws, and limited liquidity in both debt and equity markets. Access to trading platforms came in as an area of lower concern, as did listing requirements.

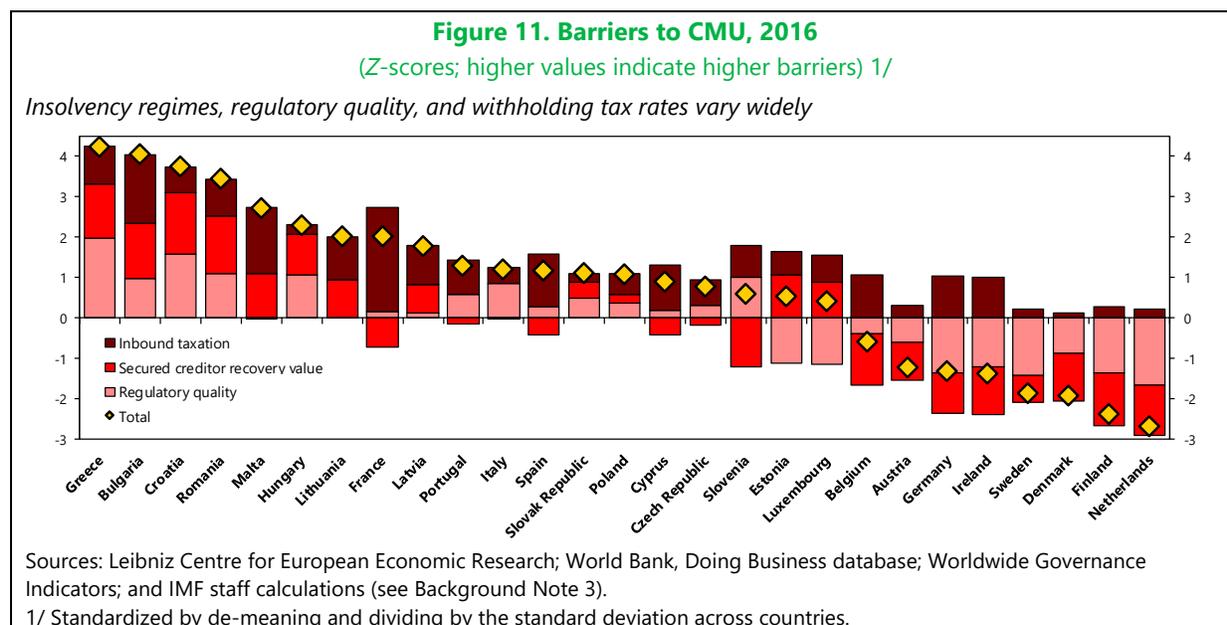


41. Most respondents sought more-efficient withholding tax refund procedures. Survey participants noted that many investors may be subject to capital market taxes in both their country of residence and the country where the investment is realized, and that this double taxation limits appetite for such investments. Reducing delays and uncertainties in establishing eligibility for withholding tax exemptions was strongly favored across the board.

B. Quantified Gains from Specific Actions

42. Empirical analysis conducted for this note quantifies the impact of reducing the various barriers identified in the survey. First, nonfinancial firms’ funding costs were regressed against firm size, profitability, leverage, and tangibility, as well as against bank lending rates and capital market depth in the home jurisdiction, identifying the policy variables that most affect the cross-country dispersion of funding costs. Second, panel regressions assessed the impact of lowering those barriers. Third, bilateral portfolio claims were regressed on the policy variables in source and destination countries to assess the impact of policies on the size of cross-border flows.

43. The analysis uses time-series data on regulation, taxation, and insolvency—areas that were flagged in the survey. The usual caveats on the use of third-party indicators apply and, in this case, sampling issues may be important. Such concerns are weighed against accessibility. Metrics on regulatory quality are from the Worldwide Governance Indicators, which gauge the implementation of policies aimed at promoting private-sector-led growth (Kaufmann, Kraay, and Mastruzzi 2010). Panel data on effective average tax rates (EATRs) on capital market investments, taking into account bilateral tax treaties, are from the Leibniz Centre for European Economic Research. Data on secured corporate recovery rates are from the World Bank’s Doing Business database.

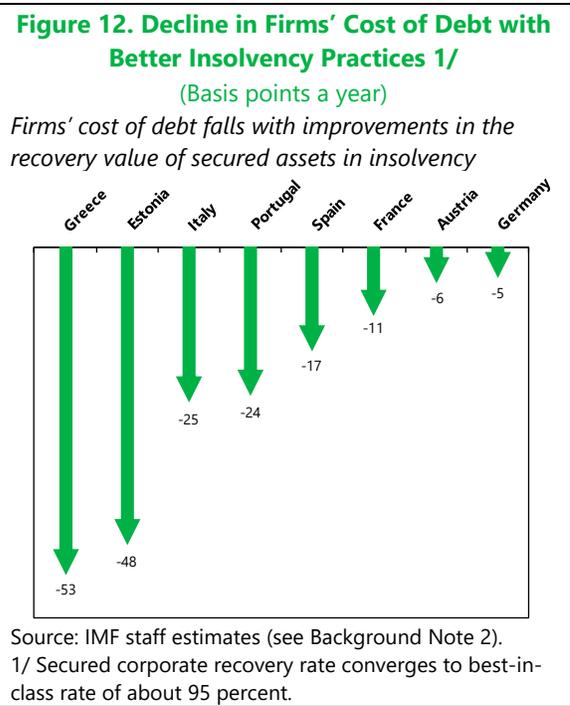


44. The third-party data matched the survey findings well (Figure 11). The 2017 capital market EATRs for Austria, for instance, ranged from 25 percent for German investors to 21 percent

for Portuguese investors, with EATRs also varying by destination country (Leibniz Centre for European Economic Research 2017). The recovery rate on secured claims—taken as a proxy for the quality of insolvency regimes—ranged from more than 90 percent in some countries to 35 percent in others. Data were standardized by dividing the cross-country mean by the standard deviation to compute so-called z-scores. These z-scores exhibit a correlation coefficient of more than 0.5 with the point-in-time scores from the survey.

45. Insolvency and debt enforcement procedures emerged as the main explanatory factors behind the wide dispersion of debt funding costs for unlisted firms.

If the national insolvency regimes with the lowest secured creditor recovery rates in the euro area were to converge to those with the highest rates, countries such as Portugal and Italy could see interest cost reductions of some 25 basis points; in Greece and Estonia the decline could be closer to 50 basis points (Figure 12).

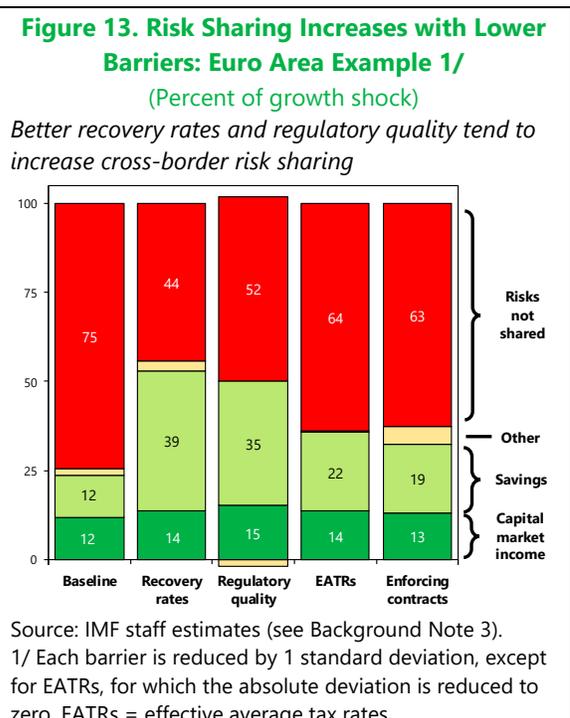


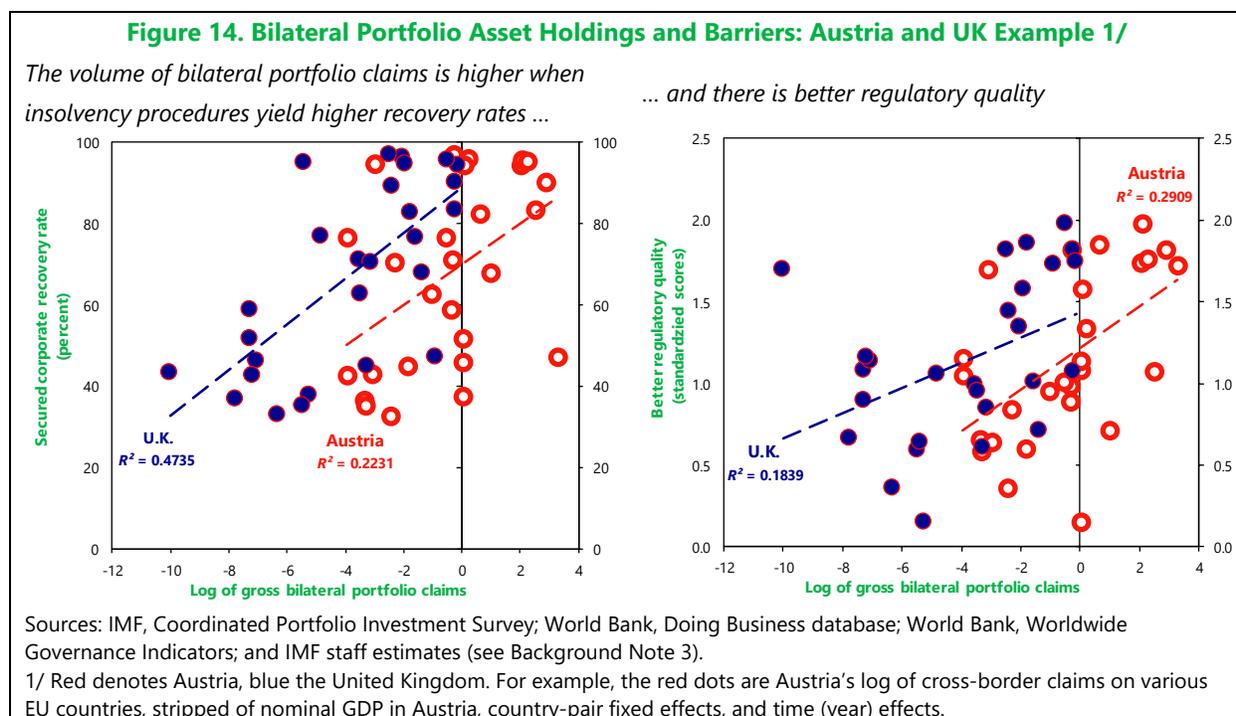
46. Insolvency regimes and regulatory quality, together with tax rates and contract law, also significantly influence consumption smoothing.

For countries where the secured recovery rate and index of regulatory quality both exceed the average by 1 standard deviation, smoothing is some 25 percentage points stronger (Figure 13; Background Note 3). Risk sharing is also higher by 11 percentage points in countries with capital market EATRs at the mean. Recent IMF work offers a summary of the current state of the debate on corporate tax harmonization (IMF 2019).

47. Further analysis shows that improving capital market regulation and insolvency regimes makes countries more attractive as investment destinations.

The finding that bilateral portfolio liabilities tend to increase as such actions are taken controls for static characteristics of country pairs such as language, contiguosness, and relative tax rates. Setting aside tax competition, which falls outside the scope of this note, private sector investors respond to higher recovery rates and value the reassurance provided by robust capital market regulation (Figure 14).





48. Whereas better regulatory quality tends to attract both debt and equity investments, better recovery rates specifically catalyze cross-border debt claims. This finding is intuitive given the ranking of creditors versus shareholders in insolvency. On average, each 1 standard deviation improvement in the secured recovery rate—equivalent to Portugal raising its rate of 69 percent to the United Kingdom's 95 percent—would multiply cross-border credit by a factor of 1.5.

49. More cross-border private risk sharing would benefit both suppliers and users of funds. A smaller euro area country such as Estonia, for instance, could see its average corporate debt funding cost fall by some 48 basis points if it could lift its secured creditor recovery rate to best-in-class levels. In so doing, Estonia would attract more cross-border bond flows from, say, German savers—and they, in turn, would earn higher returns than on German bank deposits. By connecting to more-developed markets, Estonian start-ups would see higher value-added growth, potentially lifting Estonia's overall growth potential. In a virtuous circle, private consumption in both Germany and Estonia would become less sensitive to domestic economic outcomes.

POLICY ISSUES AND THE EU ACTION PLAN

50. As the EU seeks to build an integrated capital market, how best to regulate the sector and improve insolvency processes become key questions. Public policy should be guided by a principle of proportionality, focusing on transparency, windup, investor protection, and other prerequisites for market discipline while subjecting systemic actors to intrusive prudential oversight. The EU's official CMU action plan is coherent, but mixed progress in implementation betrays a gap between member states' supportive political rhetoric and their willingness to act.

A. Regulatory and Insolvency Principles

51. The complexity of the capital market space calls for a regulatory approach that facilitates market discipline as the main restraint on risk taking. Given the diversity of legal entities involved, oversight cannot, as a practical matter, subject all nonbank financial intermediaries to intrusive prudential supervision. Instead, the main emphasis of public involvement should be on conduct-of-business oversight to protect investors, ex post enforcement to deter misconduct, and insolvency procedures to preserve value and facilitate exit (Background Notes 5–6).

52. This approach, prioritizing ability-to-fail over prudential controls, differs from that applied to banks. In banking, oversight seeks to undo the moral hazard effects of state-backed deposit insurance and liquidity privileges and control the systemic risk that arises from leverage and maturity mismatch. The prudential mandate is safety and soundness—to lower the probability of failure of the regulated entity. The more systemic the bank, the more intensive the oversight.

53. Nonetheless, some nonbank financial institutions are highly systemic, calling for strict prudential oversight. CCPs are a case in point: their enhanced role since the global financial crisis increases safety and efficiency, yet concentrates tail risk in a few key nodes (BIS 2017). Oversight of CCPs—focused on their margining practices, default funds, and capital—must seek to reduce the probability of failure to near zero, which argues for a deeply intrusive approach. Large complex leveraged investment firms involved in securities dealing can be similarly systemic.

54. Some prudential oversight is also warranted for major institutional investors, including from a systemic-risk perspective. At pension funds, allowing savers to take large losses can be politically fraught. At pension and investment funds alike, redemption risk leads to run risk for depository banks, and asset fire sales can dry up market liquidity (Cecchetti 1999). Oversight centers on the fitness and propriety of fund managers; licensing, governance, auditing, and disclosure; as well as client-asset segregation, concentration, and liquidity-risk management.

55. Efficient insolvency procedures are important. Maximizing recovery value after insolvency requires both efficient reorganization of troubled firms in bankruptcy and the ability of secured creditors to effectively realize collateral in liquidation. A clear hierarchy of claims is vital. Smooth exit for investment firms calls for early intervention, before capital is exhausted, much as for banks.

56. Smooth market functioning also requires a sound framework for doing business. Important elements include the sanctity of property rights, strong contract and corporate law, proper protection of minority shareholders, robust accounting and auditing standards, transparent tax rules, and robust enforcement of private contracts (LaPorta, Lopez-de-Silanes, and Shleifer 2008). Effective corporate law and corporate governance are especially important for equity markets.

B. Specific EU Arrangements

57. The many specificities of the EU and the euro area have necessitated a multilayered system of capital market oversight. The EU brings together 28 sovereign states, each with its own

legal framework, tax system, and capacity, which means complexity is unavoidable. National approaches to debt enforcement, corporate insolvency, and crime and punishment differ widely.

58. EU market oversight is primarily the task of national competent authorities (NCAs), with the European supervisory authorities (ESAs) playing mostly a harmonizing role. The NCAs—national securities, insurance, pension, and banking regulators, in some cases within national central banks—handle most supervision and enforcement. The ESAs—the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority, and the European Banking Authority—foster harmonized practices. Unlike in the United States, which has separate federal regulators for securities and derivatives, ESMA covers both.

59. As the survey for this note confirms, the variable quality of NCAs is problematic. Many NCAs lack adequate legal powers and capacity. Prominent cases of misconduct have gone initially undetected. One example is banks' sales of their own shares, hybrid securities, or debt to their depositors, a practice known as "self-placement"—in some countries, many small savers were told such products were as safe as bank deposits. Another example is funds claiming to be actively managed, and charging high fees, when they are merely tracking an index—ESMA estimates that as many as 5–15 percent of UCITS equity funds may be "closet indexers" (ESMA 2016).

60. The ESAs are guided by a unified set of EU capital market rules, the so-called single rulebook. Level 1 measures comprise EU directives and regulations adopted by the European Parliament and the Council of the EU ("Council"): regulations are directly applicable; directives must be transposed into national law. Level 2 measures take the form of implementing regulations or directives issued by the European Commission under delegated authority, or regulatory or implementing technical standards drafted by the ESAs. Level 3 measures are nonbinding guidelines issued by the ESAs to ensure consistent national application of the Level 1 and Level 2 measures.

61. Various directives focus on issuer information. The Transparency Directive requires issuers of securities traded on regulated markets in the EU to publish annual and semiannual financial statements. It also mandates that each EU country establish an "officially appointed mechanism" to store and disseminate such information. Usability is complicated, however, by the multitude of national databases and the noncomparability of their data. The Accounting Directive, in turn, sets minimum requirements on the content of issuers' annual financial statements.

62. The Markets in Financial Instruments Directive (MiFID-II) and Regulation are key texts. Applicable to virtually all aspects of financial market activity and all financial professionals within the EU, they seek to promote a single market for investment services and strong investor protection. Among many other features, MiFID-II proscribes bundling market research costs into execution fees on conflict-of-interest grounds and strengthens safeguards against the mis-selling of securities to retail investors, buttressing the enforcement powers of the ESAs and NCAs.

63. The UCITS Directive and Regulation lay down uniform rules to facilitate cross-border investment fund offerings to retail investors. The UCITS-V Directive lays down rules on investor information, mandating a standardized summary product-information document; on the supervision

of UCITS funds and the companies that manage them; and on UCITS depositaries. The UCITS regime has become a global brand signifying safety and quality control.

64. AIFMD establishes a harmonized framework for the managers of so-called alternative investment funds. Among others, these include real estate funds, infrastructure funds, hedge funds, and private equity funds. AIFMD focuses on managers' compliance and operational frameworks and lays out regulatory and investor reporting obligations, including on leverage, that are generally more stringent than those mandated under the Dodd-Frank Act in the United States.

65. Capital market relationships between the EU and the rest of the world come under detailed "third-country" arrangements. These center on an "equivalence," or similar, process under which the European Commission assesses whether non-EU countries' regulatory, supervisory, and enforcement regimes meet EU standards (European Parliament 2019). Subject to such assessments, EU counterparties may clear financial transactions through third-country CCPs; EU entities may access third-country trading venues; and—although never permitted thus far—third-country investment funds may be marketed to professional investors in the EU.

66. Despite the single rulebook, significant regulatory differences persist across member states. First, the transposition of directives allows an element of legislative discretion, and there are areas on which the directives are silent. Second, some directives vest NCAs with specific regulatory options and discretions. Oversight of liquidity management by investment funds is one example of countries adopting divergent approaches in both legislation and its application (ESRB 2018). Moreover, only about half of EU member states have fully transposed all the relevant directives.

67. ESMA is tasked with promoting supervisory convergence across NCAs and oversees certain entities directly. To this end, ESMA may issue Level 3 guidelines, participate in supervisory colleges, and peer-review the work of NCAs. As it does so, however, it relies to a significant extent on NCA resources; the UK contribution has been especially important in this area. ESMA also directly supervises authorized credit rating agencies as well as entities that centrally collect and maintain records of over-the-counter derivatives transactions, known as "trade repositories."

68. ESMA's supervisory convergence and enforcement powers are limited, however. ESMA cannot mandate that NCAs observe its Level 3 guidelines, nor that they implement its recommendations from peer reviews. Although ESMA's powers to fine the entities it supervises directly are stronger than those of some NCAs, they are tightly defined, resulting in fines well below those comparably applied by, say, the US Securities and Exchange Commission (Howell 2017).

C. The CMU Action Plan

69. In 2015, the EU adopted a CMU action plan focused on six main areas. These are: (1) financing for innovation; (2) raising capital in public markets; (3) facilitating long-term investment, especially in infrastructure; (4) fostering more choice for retail and institutional investors; (5) supporting securitization; and (6) reducing barriers to a unified EU capital market (European Commission 2015). A midterm review in June 2017 took stock and added new priorities, including changes to the oversight framework in view of Brexit (European Commission 2017).

70. Notable progress has already been made on several flagship items:

- **The Prospectus Regulation, in effect since mid-2019, seeks to facilitate market access for smaller firms.** It introduces exemptions to the prospectus requirements as previously laid out in the Prospectus Directive; introduces the concept of a streamlined “growth prospectus” for certain issues by SMEs; and tasks ESMA with storing all qualifying prospectuses and making them available online. The result is a standardized, simple-to-produce, and easy-to-approve disclosure vehicle for smaller issuers, bestowing a passport for distribution across the EU.
- **The Securitization Regulation, in effect since January 2019, seeks to encourage simple, transparent, and standardized (STS) securitization.** IMF staff members have previously argued that greater use of securitization in Europe could help raise nonbank funding for SMEs (Aiyar and others 2015). The STS Regulation sets out eligibility criteria for applying the STS label, which allows banks and investment firms to benefit from reduced capital charges on such holdings, with such instruments also enjoying lower haircuts in the ECB’s collateral schedule.
- **The Venture Capital Regulation, amended in 2018, seeks to encourage participation by larger asset managers.** It widens the range of fund managers eligible to manage EU venture capital funds to include those whose assets under management exceed the previous cap of €500 million. The regulation also broadens the definition of a qualifying investment to include unlisted entities with up to 500 employees, up from 250 previously, among other changes. Qualifying funds are exempt from some AIFMD requirements.

71. Among the many ongoing items, one key initiative will introduce a risk-based approach to the prudential oversight of investment firms. The proposal, which earned political agreement from the Council and European Parliament in February 2019, would require investment firms with assets of more than €30 billion, including affiliates, to obtain a banking license; if located in the euro area, such firms would automatically come under the Single Supervisory Mechanism (SSM). Smaller investment firms would fall under a new and less-exacting prudential regime.

72. Another important initiative will introduce a pan-European personal pension (PEPP) to help diversify household savings and facilitate intra-EU labor mobility. This voluntary defined-contribution product was originally envisaged to be offered in all EU member states. Each PEPP was to embed 28 “national compartments” to comply with each country’s specific tax rules. Portability was to be assured by allowing subscribers who redomiciled to transfer accumulated rights to another national compartment within the same PEPP without needing to liquidate assets. The draft regulation agreed by the Council and European Parliament in February 2019, however, allows as few as two national subaccounts, which greatly reduces portability.

73. A review of the regulations governing the three ESAs proposes to strengthen ESMA’s supervisory convergence tools. Political agreement on core elements was reached in March 2019, to be followed by technical work. Under the proposals, ESMA would define up to two supervisory topics for all NCAs to focus on in their work programs. Peer reviews would follow, headed by ESMA staff working together with NCA counterparts. NCAs would be subject to a comply-or-explain regime with regard to any resulting ESMA guidelines or recommendations.

74. The ESA review also envisages extending ESMA's mandate for direct oversight to new areas. These include cases of market abuse, where ESMA would have a greater coordinating role, issuing opinions on desired corrective actions. Pursuant to MiFID-II, ESMA would also directly supervise and authorize administrators of critical EU price benchmarks—currently defined by the European Commission to include only the euro interbank offered rate and the euro overnight index average—as well as large data reporting service providers (European Commission 2019).

75. Separately, a new European Market Infrastructure Regulation (EMIR-II) aims to strengthen ESMA's powers over both EU and third-country CCPs. Political agreement on this initiative was reached in March 2019, with EMIR-II now awaiting Council approval. For EU-based CCPs, ESMA will be given a stronger role in supervisory colleges, authority to adopt decisions addressed directly to specific CCPs, and permission to participate in onsite inspections. For third-country CCPs, those deemed of systemic importance to the EU by the European Commission under new, more-stringent equivalence procedures would be subject to new ESMA powers to demand information, conduct onsite inspections, take supervisory measures, and impose penalties.

76. Some key aspects of the original proposals were lost in the final version of the ESA review, however. In particular, the Commission had advocated for each ESA to be given a new, independent executive board with full-time members to support effective, impartial, EU-oriented decision-making. In the revised proposals, however, governance changes are limited to strengthening the powers of the chair, who will be able to propose decisions to the board of supervisors on some issues, including breaches of EU law, and set the board agenda. Another area of dilution was on prospectuses: ESMA was initially envisaged as approver for certain EU issuers and all third-country issuers, but this responsibility will now remain with the NCAs.

77. Finally, the Commission is seeking to introduce minimum EU standards for corporate insolvency and debt enforcement. The Directive on Restructuring and Insolvency, in effect since mid-2019, lays out principles on debtor-in-possession, stays of enforcement actions to preserve business, adoption of restructuring plans, and protection of new financing, as well as minimum expectations for insolvency practitioners and the judiciary (Background Note 6). An accompanying draft Directive on Credit Servicers, Credit Purchasers, and the Recovery of Collateral moots out-of-court settlement procedures for secured creditors and related measures (European Commission 2018a). The two texts are, however, silent on several critical issues, including the hierarchy of claims.

78. The survey conducted for this note gathered useful views on how best to upgrade oversight. While, as noted, a strong majority of respondents singled-out insolvency reform, there was also significant support for moving to more-unified capital market supervision in the euro area (Figure 15). Plausibly, the preference for centralized supervision, as distinct from centralized regulation, may be influenced by precedents set in the banking union, where the explicit decision was to create a *supervisory* mechanism—the ECB has no authority to engage in Pillar 1 rulemaking. Notably, some respondents also favored establishing a single consumer protection body for the euro area, perhaps loosely modeled on the US Consumer Financial Protection Bureau.

FURTHER STEPS TO INTEGRATION

79. Building on the CMU action plan, this note argues for a few targeted and actionable initiatives. By focusing where possible on steps at the EU or euro area level, it accepts that in the many areas outside the reach of the EU treaties—taxes, for instance—progress will take time. To maximize the impact, the advice is distilled into a small number of proposals focused on the main obstacles identified in the survey and empirical work: transparency, regulation, and insolvency.

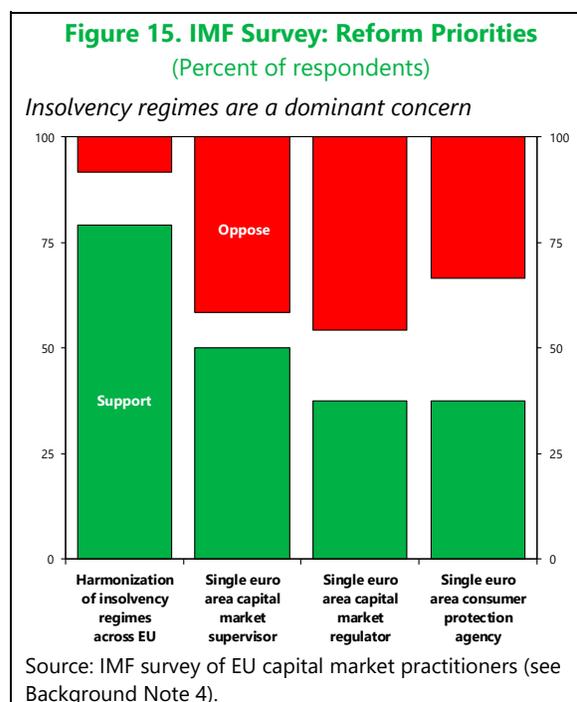
A. Enhancing Transparency

80. Given the centrality of information to the smooth functioning of capital markets, the Prospectus Regulation is a good step forward. The survey for this note found data gaps for listed and unlisted firms alike to be a major barrier to integration. The introduction of simplified prospectus rules for smaller issuers should allow more SMEs to issue securities with an EU passport, while ESMA's free and searchable online prospectus database will boost transparency.

81. Building on such progress, this note urges the major additional step of requiring centralized, standardized, and ongoing reporting by all issuers. In the United States, the Securities and Exchange Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) database provides free public access not only to prospectuses, but also to the standardized annual and quarterly "10K" and "10Q" financial statements. US issuers must submit their filings directly to the Securities and Exchange Commission. Canada has a similar mechanism.

82. Instituting centralized reporting would constitute a major change to the reporting framework in Europe and would be a process, not an event. At present, reporting is fragmented along national lines and not standardized. A first step would be to task ESMA with putting the information collected in national registries on a central platform. A second step would mandate that issuers transmit their financial statements directly to ESMA. A third and final step would be to ensure comparable accounting standards and task ESMA with reviewing the information received. Given that market-based finance revolves around publicly available information, the direct impact of this proposal on price formation and market efficiency should not be underestimated.

83. Another step could explore mechanisms to increase transparency around smaller firms. Greater investor awareness could, over time, encourage listings and issuance. Helpfully, the Business Registers Interconnection System, a joint effort by member states and the European Commission, is



promoting transparency on unlisted firms: 25 national corporate registers have been linked since 2016 through the European e-Justice portal. Supporting this, one potentially fruitful action might be to revisit the still-new MiFID-II prohibition against bundling research costs into execution fees to assess whether it is inadvertently discouraging market research on small issuers and SMEs.

84. In addition, digital technologies should be exploited to improve withholding tax refund procedures. A significant step would be to allow exemption or offsetting at source for withholding taxes on a broad set of securities on which tax information has already been exchanged (IMF 2018a). A single electronic processing portal could simplify tax reclaims, as could greater standardization of reclaim forms, ideally with an English language option. The European Commission's Code of Conduct on Withholding Tax is a useful, if nonbinding, starting point.

B. Sharpening Regulation and Supervision

85. Given the importance of both investor protection and prudential oversight of systemic entities, regulatory reforms should be pursued, guided by a principle of proportionality. IMF staff work for this note has stressed the role of capital market regulation in catalyzing cross-border investment. As noted, the approach should focus on ensuring market discipline for most entities—including through strong ex post enforcement—blended with tough oversight of systemic actors.

86. This note does not call for an SSM for the capital markets. An approach modeled on the banking union, with ESMA or some new agency taking on a role akin to the ECB's bank supervision function, is considered neither desirable nor practicable given the diversity of the capital markets and the core role of national law enforcement. Instead, this note favors a middle path where ESMA's powers and duties would be selectively enhanced, backed by new resources and legal reforms.

87. In the particular case of CCPs, however, this note urges centralized safety-and-soundness oversight. Vesting ESMA and the ECB with supervisory powers over CCPs, jointly with the relevant NCAs, would ensure rigorous application of EMIR and contain systemic risk (IMF 2018a). Given their market-clearing role, all CCPs—whether or not they hold a banking license—should enjoy access to central bank facilities to place deposits and draw liquidity. The ECB, in cooperation with non-euro-area EU central banks, should take the lead in developing a policy to ensure such access and should engage intensively in the prudential supervision of CCPs.

88. Another area calling for ECB involvement is supervision of systemic euro area investment firms. Investment firms in Europe are a mixed bag. National supervisory practices vary. It is known, however, that the preferred way for some of the largest global banks to migrate business out of London is by establishing or expanding investment firm subsidiaries in the euro area. Bringing systemic euro area investment firms under the SSM, as already agreed, will curb such opportunities for arbitrage (IMF 2018a). ESMA could be given a coordinating role.

89. Options should be explored to upgrade ESMA's supervisory convergence tools to ensure strong and uniform investor protection across the EU. ESMA's governance could be strengthened by introducing an independent executive board with full-time members, as originally

proposed, for making decisions related to regulatory and supervisory convergence. This is more important in the shadow of Brexit, which will likely lead to a multi-node EU27 capital market—in which competition among national jurisdictions must not be based on regulatory arbitrage.

90. Another area that should be revisited is the structure of the new PEPP product. The initial proposal to require each PEPP to maintain a significant number of national compartments should be revived to achieve meaningful portability. Moderating the PEPP Regulation’s consumer protection safeguards—which span disclosure, compliance, and advisory service requirements—could also be considered, with a view to easing their heavy administrative burden. Over time, the PEPP’s regulatory ceiling on administrative costs could be lowered by some 5 basis points, to levels comparable with, say, those in the United States, to improve returns to savers (Background Note 1). Greater ease in withholding tax refunds would also support portability.

91. Finally and importantly, the EU must maintain close regulatory cooperation with non-EU countries on all capital market issues, again guided by proportionality. This would apply in particular to a post-Brexit United Kingdom, given its tight financial links with the EU27, which argues for deep and ongoing engagement with UK regulators. As a general principle, diversification outside the EU should be encouraged, and maximum regulatory cooperation sought, with all leading third-country jurisdictions, given the increasingly global nature of capital markets.

C. Improving Insolvency Procedures

92. Despite formidable challenges, the EU should persist in its efforts to improve insolvency procedures where they are deficient. Both the survey and the empirical work for this note identified weak insolvency and debt enforcement regimes as a major obstacle to integration. As noted, this is not just about recovery values—although these matter deeply to investors—it is also about the ease of market exit and is therefore central to making market discipline work.

93. One modest step would be to ensure that reform efforts are informed by careful data gathering and analysis. Data on insolvency tend to be scattered and unreliable. Both the EU Justice Scoreboard and reporting requirements under the new Directive on Restructuring and Insolvency should be used to collect information on debt enforcement and corporate insolvency cases to more systematically assess effectiveness and identify gaps (European Commission 2018b; Garrido and others 2019). Member states are already working in this direction (for example, IMF 2018b).

94. Further steps could include setting EU minimum standards for corporate insolvency and debt enforcement processes. Here, one key challenge is to agree on common standards for the ranking of claims across the union. The absence of such standards not only affects payout expectations for creditors in liquidation, it also complicates the negotiating and voting environment in rehabilitation proceedings. In debt enforcement, arguably the chief measure would be better mechanisms for the enforcement of immovable collateral; current enforcement processes are ineffective and prone to delays in some member states (Council 2017b).

95. Finally, systematic monitoring of member states' progress in observing such standards could be instituted at the EU level. Again, the Commission could take the lead, modeling its efforts on the IMF and World Bank's *Reports on the Observance of Standards and Codes* (Council 2017a). Although this would be a "soft" approach, it should be noted that the Basel Core Principles for Effective Banking Supervision, for instance, have created real incentives for betterment, with national banking regulators often viewing their scores as part of a global "beauty contest."

CONCLUSION

96. This note has sought to methodically lay out the benefits of greater capital market integration in Europe, identify barriers, and chart a practical way forward. It urges a set of targeted policy steps—led by the EU institutions, with complementary actions at the member state level—cutting directly to the core issues of enhancing information, upgrading prudential oversight of systemic actors, strengthening investor protection, and improving insolvency procedures.

97. Achieving CMU will require political will to overcome resistance from vested interests. One source of resistance will be incumbents that fear losing rents, potentially including local bank lobbies; local banks will need to be persuaded that the solution to structurally weak profitability lies partly in venturing carefully into capital market business (Rajan and Zingales 2003). Another could be national authorities, some of whom may tacitly condone home bias; here the challenge will be to argue the case for CMU as a way to encourage a two-way flow of capital for the benefit of all.

98. The vision of a truly integrated European financial union requires a well-functioning banking union and a vibrant CMU, in healthy competition. The CMU must complement, not displace, banking, allowing the whole to be more than the sum of the parts. Harnessing the economic benefits of both market- and relationship-based finance will require proportionate public oversight. In the capital markets, the regulatory approach must center on facilitating effective market discipline, with intrusive prudential oversight of systemic actors.

99. Ultimately, however, progress toward financial integration must be matched by fiscal responsibility and structural reforms. Efforts to complete the banking union and CMU must be part of a broader push to close productivity gaps and advance per capita income convergence across Europe, with countries pursuing fiscal adjustment as well as product and labor market reforms to improve their attractiveness as investment destinations. CMU offers the promise of easier capital flows—but it is the trade-off between risk and return that will determine their direction.

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