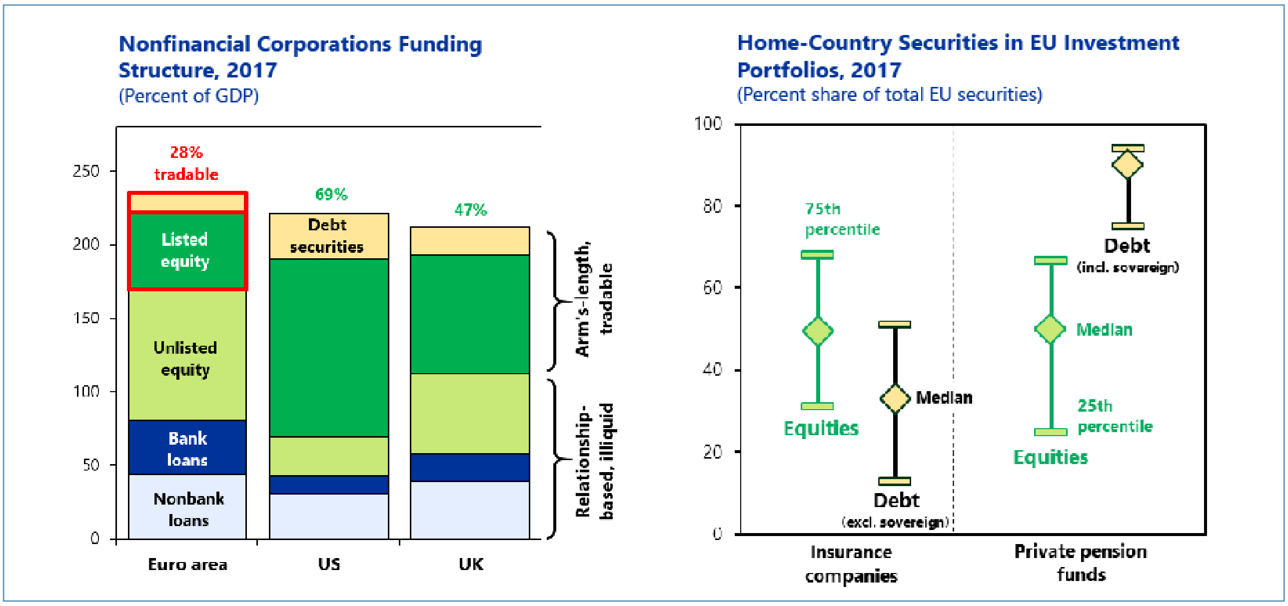
CMU way forward : IMF proposal for a new action plan

The Chair introduced the objective of the session which was to discuss the staff discussion note recently published by the IMF on the CMU: *A Capital Market Union for Europe*[1]. This paper focuses on recommendations to move the CMU forward, now that a large part of the Commission's CMU Action Plan has been adopted. The IMF has been involved in the work on CMU in Europe for a while, including on topics such as high-quality securitisation.
An IMF representative presented the key findings and recommendations of the paper.

Assessment of EU capital markets

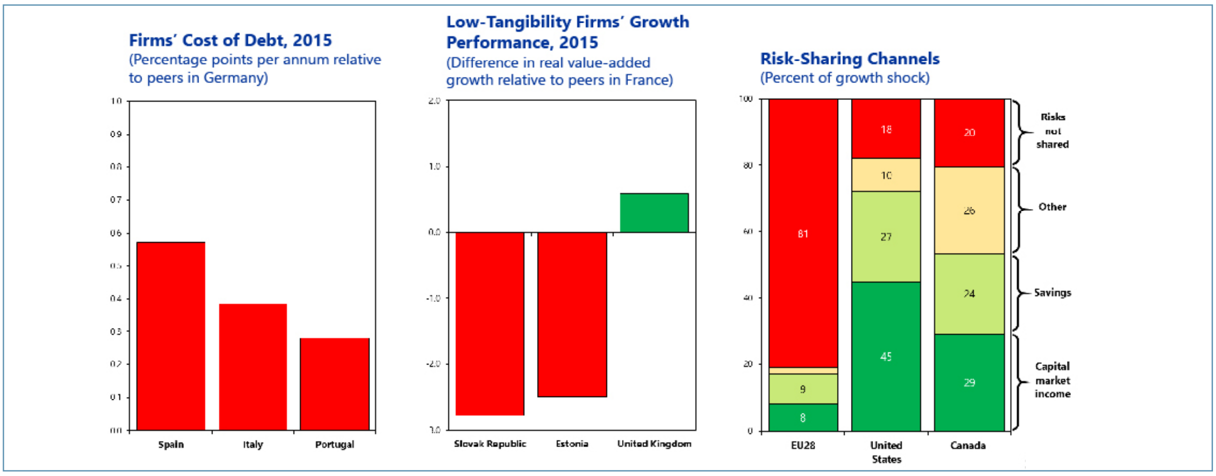
The first piece of analysis relates to the level of development of capital markets with a snapshot of how non-financial corporations fund themselves in the euro-area compared to the US and the UK. Arm's-length tradable financing – bonds and listed equity – was separated out from relationship-based financing – unlisted equity and loans. This shows that the euro-area's share of traded finance - at 28% - is much smaller than in the US or in the UK. Although relationship-based financing has its advocates who speak of its stability benefits, arm's-length financing is characterised by its efficiencies. Given this starting point in Europe, there is plenty of room for Europe to develop its tradable financing. In terms of EU market integration, insurance companies and private pension funds in Europe are heavily concentrated in their home-country securities, on both the equity and debt side.

Low reliance on traded instruments; Pervasive home bias



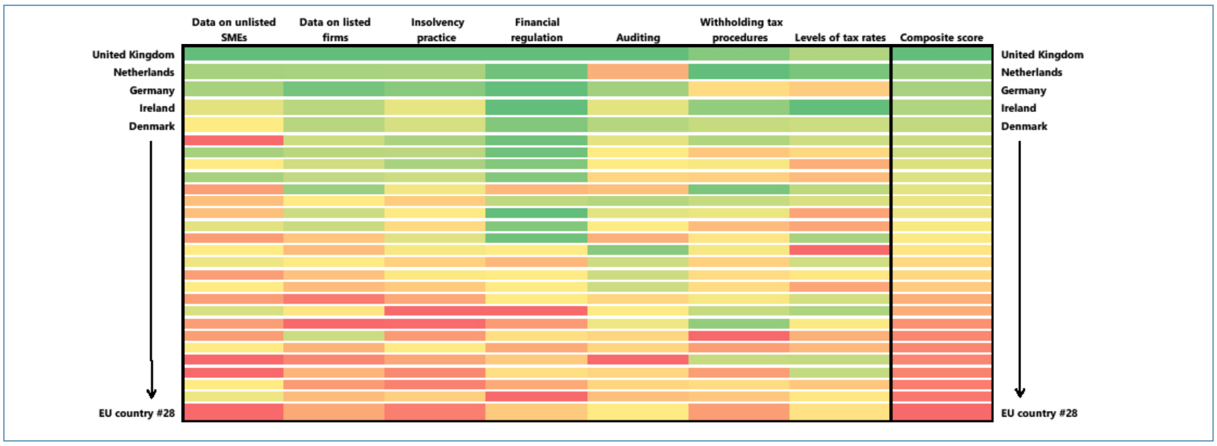
The second area of assessment of the paper relates to the costs of European fragmentation. In order to assess these costs, firm-specific data was analysed to weed out factors such as firm size and profitability and to try to distil the effect of where a firm is incorporated. The results show that fragmentation makes a material difference. A typical non-financial corporate in Spain for example will pay 60 basis points more on debt funding than its peer in Germany and in Italy 40 basis points more, which is quite significant in an era of zero interest rates.
The growth performance of low-tangibility firms in different Member States relative to their peers in France was also considered. These can be thought of as typical IT start-ups. The basic notion is that a firm of this type in a jurisdiction where capital markets are less developed will have a harder time reaching out to venture capital (VC), so will go to banks. This means that it may be rationed out of funding because these firms, by their nature, do not have much by way of plant and machinery to post as collateral. This risk – in certain European countries – of holding back innovation is a second cost of capital-market fragmentation.
Thirdly, risk-sharing channels were also assessed, comparing the EU with the US and Canada. The idea behind private cross-border risk-sharing applied to equity markets is the following: if a firm based in Country X has equity owned by investors in Country Y, when Country X is hit by a local shock and the share price falls, the valuation hit is taken in Country Y. This will contribute to reducing the impact of local shocks on Country X's consumption. Data shows that the macroeconomic smoothing of a local shock is four-times lower in the EU than in the US, meaning less resilience to shocks.
The evidence therefore shows that capital-market fragmentation has different impacts on funding costs, growth potential and resilience.

Uneven corporate funding costs, restraints on innovation, limited risk sharing



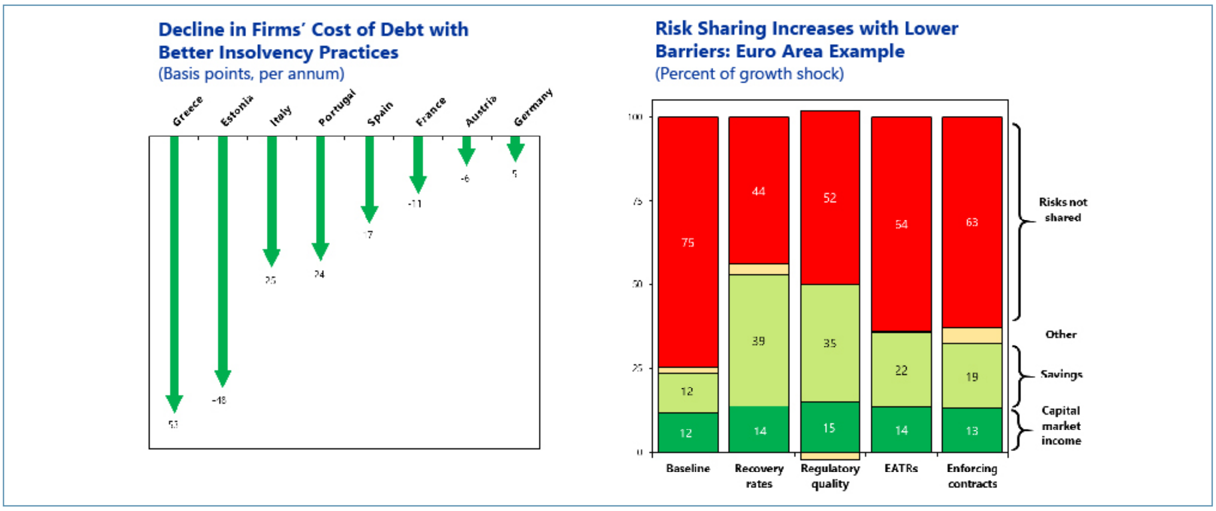
The next stage of the analysis was based on a survey of the potential areas of concern regarding capital markets in each Member State. Respondents to the survey included European and national capital market regulators and also some of the largest institutional investors in Europe. Although the survey results revealed significant differences across countries, common areas of concern appeared relating to data availability on both listed and unlisted firms, insolvency practices and capital market regulation. The UK is generally viewed as the best performing capital market jurisdiction in Europe by survey respondents.

Survey responses flag data gaps, insolvency, regulation



The results of this survey were then corroborated with empirical work. To assess the funding cost savings that firms could gain if their countries were able to improve their insolvency regimes to best-in-class standards, the quality of a country's insolvency regime was proxied by the recovery rate of a secured creditor using so-called third-party time-series data. This analysis showed that if Italy for example could improve its insolvency regime to be closer to the UK's standard, its firms would save around 25 basis points on funding, which is a significant amount. The analysis also showed that risk-sharing channels in the euro-area can improve with better recovery rates and better regulatory quality in particular.

Better insolvency regimes and regulatory oversight can lower firms' cost of debt and increase macroeconomic smoothing



Recommendations for moving the CMU forward

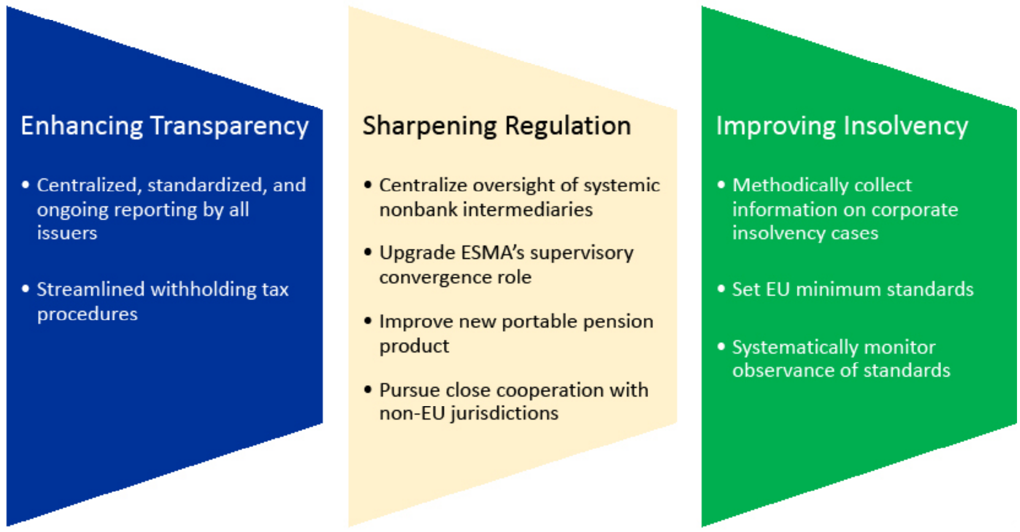
Based on this evidence, recommendations were put forward in three main areas: transparency, regulation and insolvency. Although the assessment shows that the EU's CMU Action Plan is generally well thought-out and covers most, if not all, of the basic elements necessary to develop capital markets further, there is a need to 'reboot the project' in order to achieve significant progress.

The foremost recommendation is possibly on transparency because arm's-length tradeable finance hinges on publicly available information. The first proposal in this area is for the EU to introduce standardised, centralised electronic reporting for all issuers on an ongoing basis. This would be a major change to the current reporting framework in Europe and would replicate what already exists in the US and Canada. In the US for example, anyone can access the Securities and Exchange Commission's Electronic Data Gathering, Analysis and Retrieval (EDGAR) database via its website and retrieve, for free, prospectuses and the 10-K and 10-Q annual and quarterly financial statements, standardised for all issuers, irrespective of size. Yet this cannot be replicated in Europe by decree; it is a multi-stage process, ultimately involving work on accounting standards. Digital technology could also be harnessed to improve transparency in cross-border withholding-tax procedures.

Secondly, a more tailored approach is required on regulation. Empirical work indeed shows that improvements in individual jurisdictions tend to attract more capital. The full energies of hands-on, day-to-day prudential supervision must be focussed on a few systemic entities; namely, large investment firms and central clearing counterparties (CCPs). On investment firms, this is in train; for euro-area CCPs, a direct role is needed for the European Securities and Markets Authority (ESMA), jointly with the European Central Bank (ECB), going beyond what has been adopted so far. The paper also supports stronger supervisory-convergence powers for ESMA to ensure uniform investor protection across the EU.

Finally, insolvency is a difficult area that cuts to the heart of national sovereignty, but an essential one. A soft and pragmatic approach is proposed, based on best-practice standards and a monitoring of how countries progress toward observing them. This sort of 'name and shame' approach has been effective in other areas such as the Basel Core Principles for Effective Banking Supervision.

Three obstacles, three policy priorities



Comments and reactions

The Chair then asked the other members of the panel to react to these conclusions and proposals.

An official agreed that it is necessary to think about how to move the CMU forward now that the initial CMU action plan is essentially completed. This reflection started at the Eurofi meeting and at a special session of the ECOFIN in Bucharest in April 2019 and will be a key priority of the forthcoming Commission. All the "non-revolutionary" proposals to develop capital markets have been included in the existing CMU action plan. This is a good starting point, but the more far-reaching areas of transparency, insolvency and market infrastructure must now be further reviewed. The CMU action plan must also take more account of the current dominance of banks in Europe, which is different from the US. Capital markets in the US represent three-quarters of a total amount of financing of € 62 trillion compared to one-third in Europe of a total of € 51 trillion[2]. This shows that there is a high potential for improvement.

The official however considered that one may have expected the IMF, given its relative freedom on the subject, to go further and make proposals also in more controversial areas like the area of supervision at the EU level, which is obviously a crucial issue. In Paragraph 86 the note states that it 'does not call for a Single Supervisory Mechanism (SSM) for the capital market' because, 'it is considered neither desirable nor practicable, given the diversity of the capital markets and the core role of national law enforcement'. This justification does not seem relevant because the EU is precisely about changing national law.

The second point that one may have expected to see more strongly emphasized relates to the comparison with the US in terms of exposure. One of the strengths of the US is that exposure to the dollar and to the US is easy to obtain, via a bond or another instrument. Exposure to Europe is less easy, for many different reasons. A third point is about the strong position that Europe has in sustainable finance. How sustainable finance could contribute to a rebooting of the CMU should be further assessed.

Another official broadly agreed with the conclusions and recommendations of the IMF report that strike a good balance between ambition and prudence.

The critical point tackled by the IMF paper is the question of what else needs to be done to move the CMU forward. The official agreed with the proposal on transparency and information dissemination, which is particularly relevant for equity markets. Insolvency procedures are also of crucial importance and it is worth going for “the long haul” that is probably required in this area. It is a difficult area where a step-by-step approach is needed. This approach should focus on areas where agreement is possible and use research and indicators of the differential performance of Europe on insolvency procedures as a basis. The emphasis on harmonising the ranking of claims on the liabilities side is right, to which should be added improving reorganisation proceedings, creditor participation, SME procedures and early warnings. Some countries have made progress with SME procedures and are examples that more progress can be achieved. The possibility of a 28th insolvency regime is not mentioned in the IMF paper, but would be an interesting option to further assess also.

Seriously developing equity markets in Europe would normally require a holistic approach, cutting across different areas including funding science, financial education and ensuring competitive product markets. One specific and important improvement in this regard that is not captured in the paper and needs to be further emphasized, the official suggested, is the role of financial literacy, for example because demographic developments make individual pension savings increasingly relevant. Evidence shows that there is quite a diverse level of financial literacy across euro-area countries and if literacy was increased to the level of the best performing countries this would be conducive to a higher level of equity holdings. A particularly effective way of of improving financial literacy is through the secondary schooling system. The G20 together with the OECD had a priority on financial education under the German presidency, which needs pursuing. Many countries have some form of strategy towards improving their level of financial literacy and this needs revisiting to identify where further progress is most needed in Europe.

In addition there is one conclusion of the paper on which the official had some doubts, which is the recommendation to consider re-bundling research costs and execution fees under MiFID II. Before doing so, the official would like to see evidence that this will not discourage investment and that the access to finance of SMEs would improve as a result of re-bundling.

Reacting to the previous speakers’ remarks and suggestions, the IMF representative responded that the project had focused on picking those proposals that appeared to be the most actionable, and on avoiding roadblocks that may be very challenging to tackle. Not pushing for an SSM was deliberate also because the supervision of major banks is very different from that of market activities and the diverse entities that operate in the capital markets, which range from pension funds to mutual funds and CCPs, and where there is often a heavy focus on ex post enforcement through the justice system.

Regarding MiFID II, the IMF paper is not suggesting a re-bundling of research and trade execution service fees, the speaker clarified, but simply that a study should be conducted in order to decide objectively what should be the next course of action. There are many market anecdotes on the implications of unbundling for SME markets in particular, so it is essential to objectively assess these potential impacts. Financial literacy is an important issue also, the IMF official agreed, but other actions also need considering, such as the further development of private pension schemes. ■

[1] IMF staff discussion note «A Capital Market Union for Europe» - September 2019. Authors: Ashok Vir Bhatia, Srobona Mitra, Anke Weber et al. This working paper has been seen by the IMF Board, but is not an IMF board-endorsed policy.

[2] See Figure 4 page 6 of the IMF paper.