EUROPEAN CENTRAL BANK
EUROSYSTEM

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Developing and Integrating European Capital Markets: CMU Now and Beyond

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CEPS Presentation

Outline

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

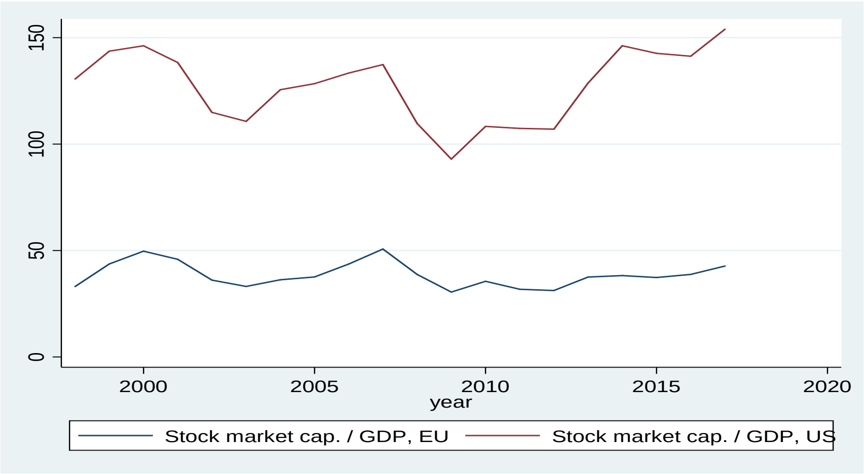
1. Introduction and objective of the presentation

Capital markets are critical for growth, private risk sharing, and stable financial integration

- **European economy less dynamic than global peers**
  - Lower rates of output growth, innovation, and new business creation
- A number of important **adjustment mechanisms are very constrained**
  - Limited public (fiscal) risk sharing
  - Limited labour mobility
  - Fixed nominal exchange rate in EA
- **Private financial markets can partially address these deficiencies**
  - Growth benefits from increased public and private equity investment
  - Risk sharing (consumption smoothing) from private cross-border asset holdings
  - Cross-border equity holdings deliver more stable financial integration than debt holdings
- ECB/Eurosystem has been a **strong supporter of the CMU project since its inception** but it has also consistently called for **more impactful initiatives**
- “Impact” here regarded as initiatives aimed at enhancing:
  - Innovation and economic growth through a financial structure with a high enough equity share (Special Feature A of the 2018 ECB Financial Integration Report) and/or
  - Private financial risk sharing, notably through capital markets (Special Feature A of 2016 ECB Financial Integration Report) and/or
  - Stability of households’ and firms’ funding (substituting between loans, bonds and equities)

Outline

Equity markets: development and integration still at low levels

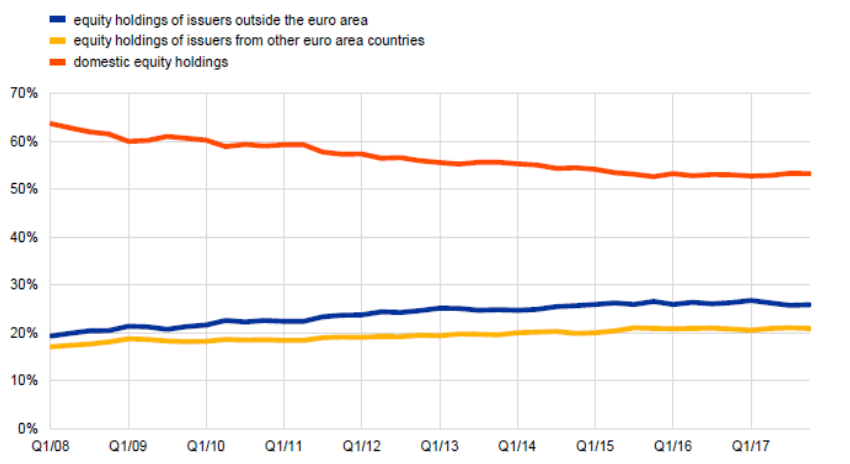


- **Public equity markets smaller** in Europe than in the US
  - Also increasing more slowly since the crisis
- **Implications for long-term growth**
  - Larger equity markets support innovation and productivity growth
  - In EU as well, especially in high-tech industries (Kremer and Popov, 2018)

- **Large home bias** in EA equity holdings
  - Decreasing in recent years
  - Other EA equity holdings increasing slowly
- **Implications for risk sharing**
  - Cross-border ownership of productive asses increase risk sharing through the capital channel (Giovannini et al., 2018)
- **Implications for financial stability**
  - Cross-border equity holdings most stable form of integration (Giovannini et al., 2016)

Euro area holdings of equity (including investment fund shares and other equity) by geographical issuer counterparty

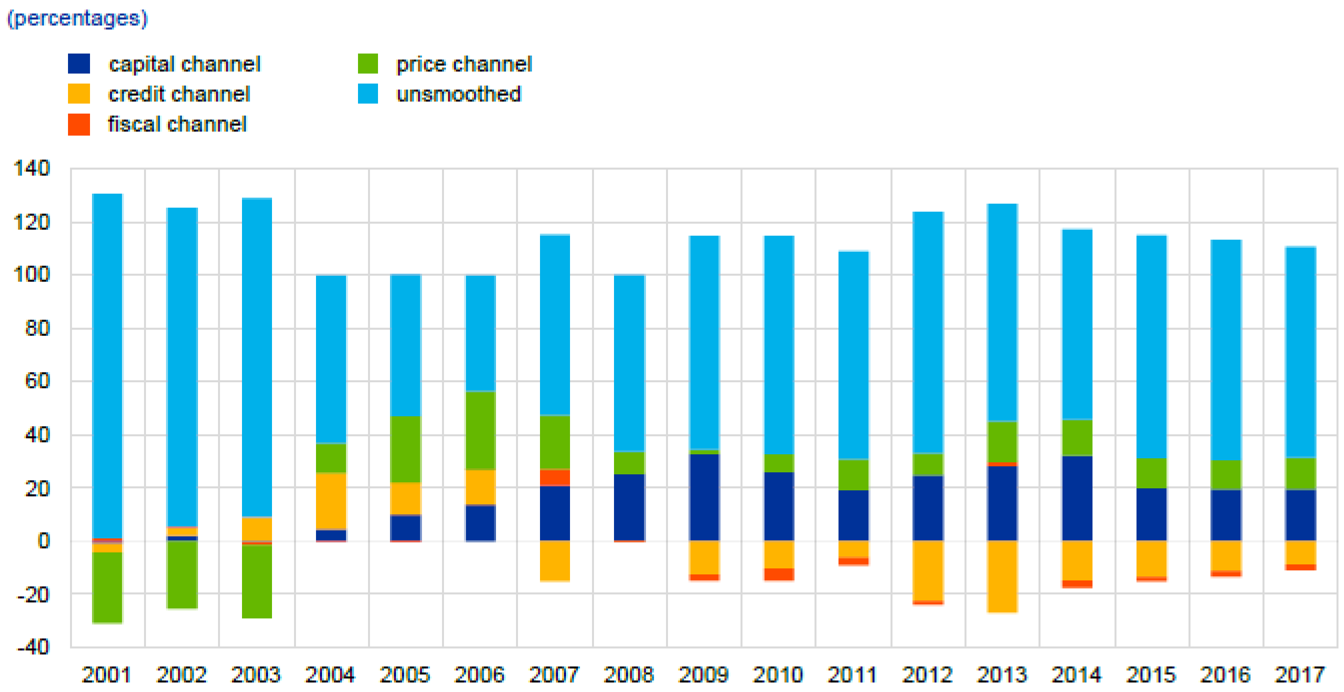
(percentages of total euro area holdings of equities, quarterly data, Q1 2008 – Q4 2017)



Source: ECB.

Risk sharing: Low contribution of private financial markets

Consumption risk sharing in the euro area and its channels



Source: ECB calculations.

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

Outline

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

Low impact

High impact

Venture capital:
EuVECA, EuSEF Regulation

Crowdfunding:
Regulation

Sustainable finance:
Action Plan

Investment fund distribution:
Directive and Regulation

Proprietary effects of transactions in securities
Communication

SME listings
Communication

Local/regional cap. markets:
Communication

Intra-EU investments:
Communication

Securitisation:
STSS Regulation

Prospectus:
Regulation

Non-bank supervision:
Regulation on investment firms

FinTech:
Action Plan

European pension products:
PEPP Regulation

Covered bonds:
Directive and Regulation

Assignment of claims:
Regulation, Communication

Recovery of collateral:
Directive

Preventive restructuring:
Directive

Insolvency

Debt-equity tax bias:
CCCTB Directive

Supervision:
ESMA review

Adopted

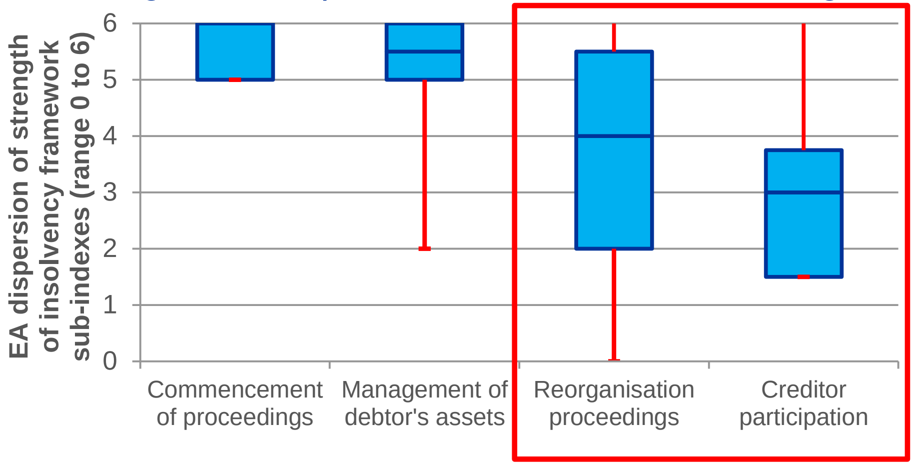
Proposed

Upcoming

Insolvency frameworks – some initiatives, but not enough

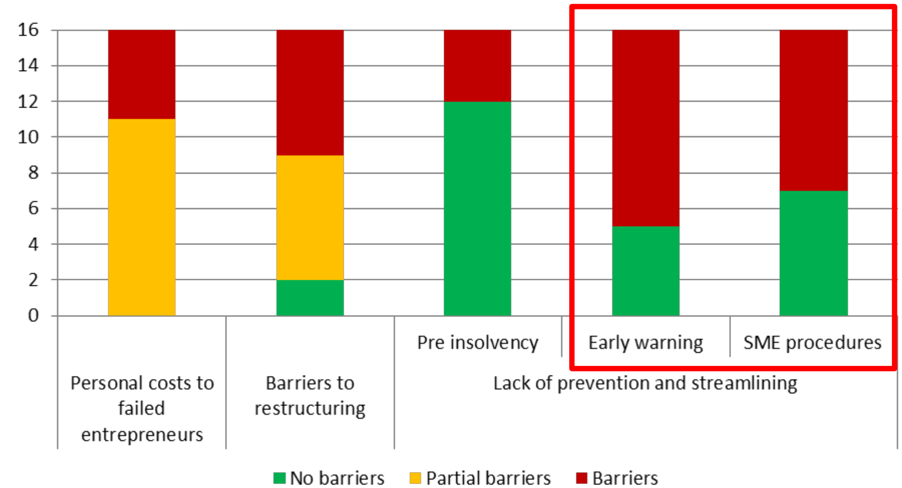
- Research supports the **high relevance of efficient insolvency frameworks**
  - ECB: promote risk sharing in the euro area (Giovannini et al. 2018)
  - OECD: improve capital reallocation, prevent firm “zombification” (McGowan et al. 2017)
- CMU Action plan contains a **welcome directive on restructuring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

Reorganisation plans and creditor roles/ranking



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

“Early warning” and special SME procedures



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

➡ Lower NPLs, higher investor certainty, more cross-border investment

Retirement savings in well-designed private pension funds boost equity markets and foster growth and risk sharing

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

Private pension investments (all pillars)

Country	Total (% of GDP)	Equity Share (%)
Australia	122	51
Japan	32	11
Switzerland	123	30
United Kingdom	97	20
United States	133	44
Finland	58	39
Ireland	56	N/A
Netherlands	178	38
France	9	N/A
Germany	6	5
Italy	9	20
Spain	14	11

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

Simulation of additional EA equity investments (in % of current equity market capitalisation)

Increased Equity Shares	Increased Savings and Equity Shares
To Euro Area median	
1.2 – 1.3	1.3 – 1.4
To Finnish level	
3.6 – 3.7	41.9 – 44.9
To US level	
6.0 – 8.4	180.1 – 198.9

Notes: Authors' calculations using the same sources as in the upper right-hand table. Increased total savings are simulated assuming that pension investments per capita reach benchmark level.

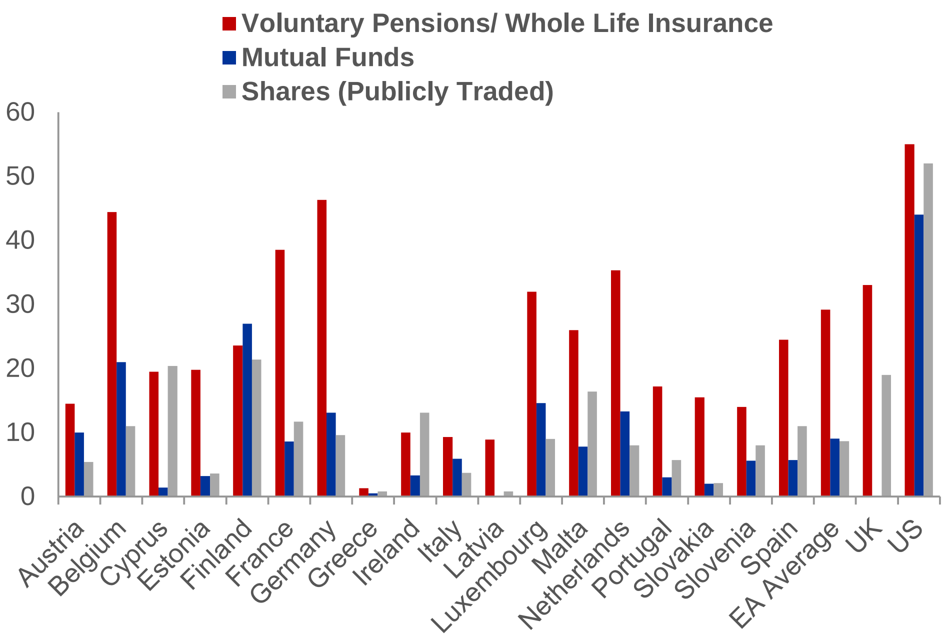
- Pension reforms would make a big difference (com-plementary to CMU PEPP)
- Complex policy direction
- But without it important supporting factor missing

3. Impactful policy initiatives in current and future CMU

Financial literacy stimulates asset ownership (part. capital market products) and fosters risk sharing

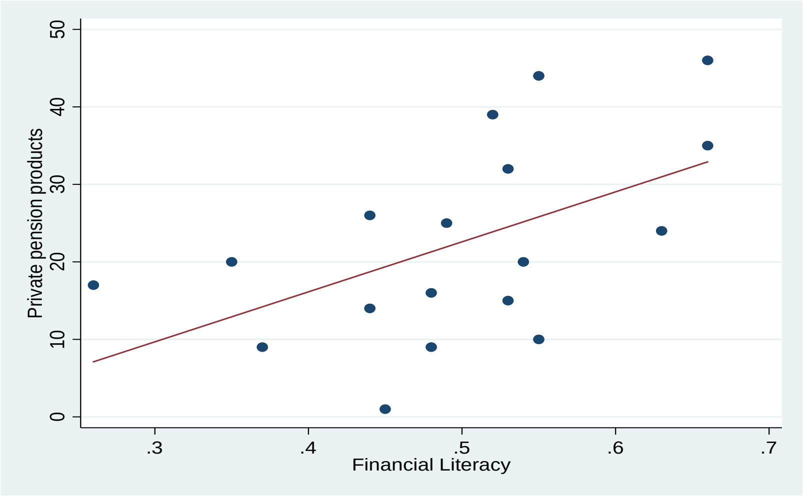
- Supported by ECB and other research for the euro area (van Rooij et al. 2011, Giovannini et al. 2018)

Share of households holding different asset classes by country (in %)



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

Relationship between financial literacy and the demand for private pension products



Notes: ECB calculations using euro area data on financial literacy from Standard and Poor's (2014) and on private pension ownership from the HFCS.

- Financial literacy in the euro area can be improved: only half of adults in median EA country "financially literate"
- Strengthening basic financial education in schools
  - Saving and borrowing; cumulative interest; risk and return; diversification; inflation

CMU has had limited success so far, needs to be considerably more ambitious going forward

- **Much room to grow further for capital markets in Europe**
  - Low current levels of capital market development and integration
  - Low degree of risk sharing through private financial markets
- ECB/Eurosystem **fully supports the CMU project**
  - Would like to see **more impactful initiatives** in the future
- **Progress on some important objectives**
  - Insolvency frameworks
  - European pension products
  - Taxation (in particular, debt-equity tax bias)
  - Supervisory/institutional architecture for capital markets (ESMA reviews)
- **Need to focus on the most impactful initiatives**
  - Harmonizing further insolvency frameworks around best practices
  - Developing public and private equity markets
    - Pension reform to increase private savings and pension funds' equity shares
    - Improve financial literacy for market investment
  - Safe asset

THANK YOU!

Annex

Key initiative with high relevance within the CMU framework

Common Consolidated Corporate Tax Base (CCCTB) - Debt-equity tax bias

Scope: mandatory for large firms, optional for small firms

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

Benefits of AGI	***Caveats of AGI***
Less leverage is **beneficial for financial stability**	Budgetary implications
Reduced cost of equity **increases investments**	Creates tax planning opportunities for multinationals

ESAs review

- The proposals aim at:
  - **Improving** the **mandates**, **governance** and **funding** of the 3 ESAs
  - Ensuring **stronger and more integrated financial supervision** across the EU
  - Strengthening the ESAs' capacity to ensure **consistent supervision** and **uniform enforcement** of the single rulebook.
- **However**, an increased non-bank financial sector should be accompanied by **an expansion of the prudential framework for non-bank financial institutions** to adequately address systemic risks
- **Therefore**, macroprudential authorities should have **adequate tools to address systemic risks in the non-bank sector** → the CMU work should strive to provide the legal basis for such macroprudential tools
- In the longer term, CMU will warrant an **appropriate supervisory architecture**, leading ultimately to a single European capital markets supervisor

Key initiatives with potential for high relevance if coupled with more ambitious reforms

European Pension Products (PEPP Regulation)

Aim: channel more savings into long-term investments

Impact: increase the depth, liquidity and efficiency of capital markets

Proposal: standardised EU-wide personal pension product (as complement to public and occupational pensions)

Benefits	*Missing elements*
Saver: simple and transparent product, portability across MS	Need geographical diversification requirement for investments
Provider: economies of scale for operating across MS	Potential further tax incentives

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

Aims: (i) effective preventive restructuring and second chance frameworks in all MS, (ii) make insolvency procedures more efficient by reducing length and costs

Impact: promote cross-border investment. Link to Banking Union (depositor preference, NPLs).

Proposal: (i) common principles for early restructuring, (ii) automatic full discharge within 3 years to give entrepreneurs a second chance

Benefits	*Missing elements*
Fewer liquidations, thus less NPLs	Improving and harmonising core aspects of insolvency laws
Creditor: higher recovery rates, faster procedures	Out of court proceedings
Debtor: liquidation is less likely, second chance	(*Both addressed in detail in section 4*)

Insolvency frameworks – some initiatives, but not enough

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  - ECB: promote risk sharing in the euro area (Giovannini et al. 2018)
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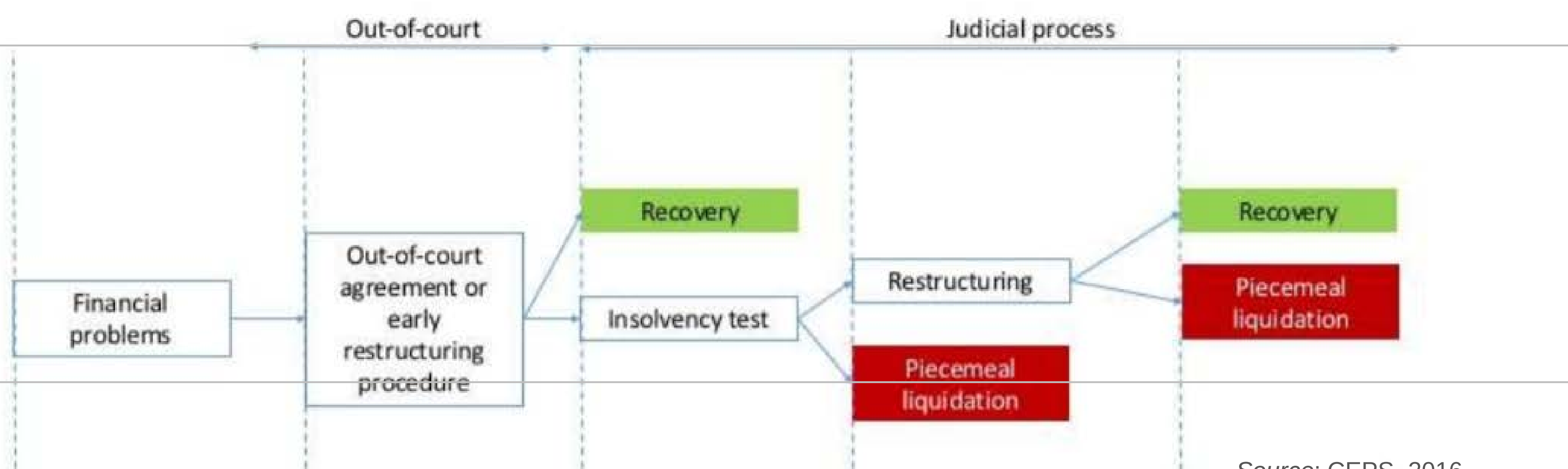
Proposals

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

Insolvency timeline



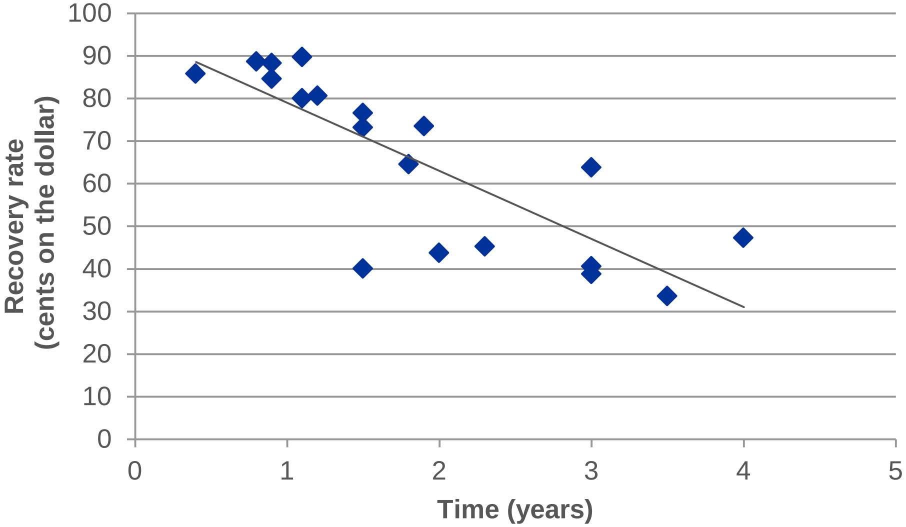
Source: CEPS, 2016

"Noise" indicator of market liquidity in selected euro area sovereign bond markets

Insolvency frameworks

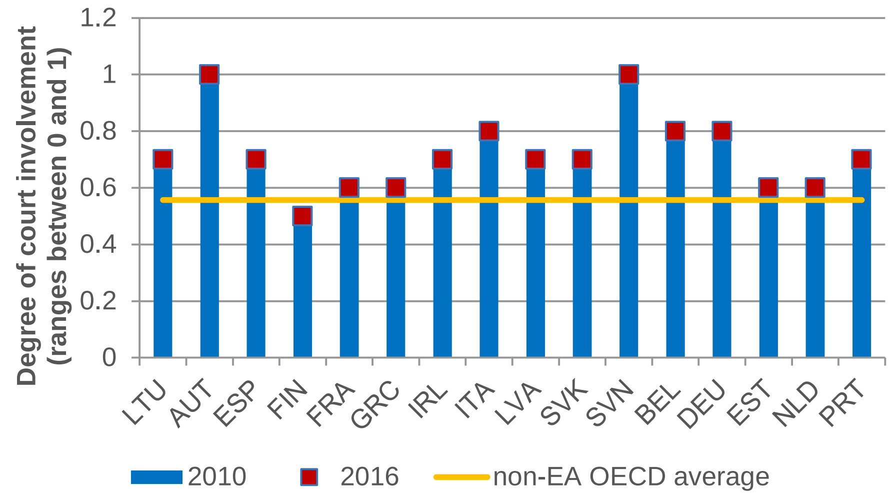
Efficient insolvency frameworks require judicial efficiency and/or out-of-court settlement alternatives

Improve efficiency of judicial systems



Source: Euro area countries using World Bank data, 2017

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



Source: OECD, 2017

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

Safe assets and capital markets union

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