Ashok Vir Bhatia / Srobona Mitra / Anke Weber

Barriers to Capital Market Integration in Europe: Evidence from an IMF Staff Survey

European finance is still sharply split along national lines: savers buy domestic assets, and investors fund themselves through domestic banking systems. About 40 percent of EU households' savings are held as bank deposits, compared with 10 percent in the United States. Less than 30 percent of euro area nonfinancial firms' liabilities are tradable securities. And – speaking more directly about integration – more than half of EU long-term investors' assets are domestic claims (Figures 1 and 2).

The results are threefold: an uneven playing field in terms of corporate funding costs; 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, based purely on domicile. Certain types of firms – notably start-ups with few assets to post as collateral – may be denied financing, limiting innovation and growth. And consumption is four times more sensitive to local shocks in EU countries than in the 50 US states, reducing resilience.

What prevents more capital market integration (CMI) in Europe? This article presents the methodology and results from a survey of national market regulators and market participants as conducted for the recent International Monetary Fund staff discussion note on "A Capital Market Union for Europe."

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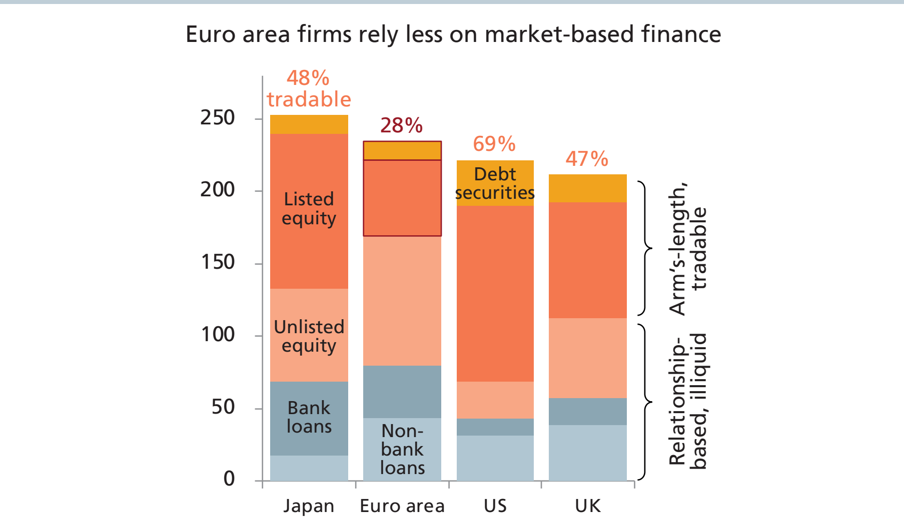
Survey on Obstacles to CMI

The survey posed a series of questions framed around the life cycle of a representative capital market instrument (Figure 3):

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,

Figure 1: Nonfinancial Corporations' Funding Structure, 2017 (Percent of GDP)



Sources: Haver Analytics; and IMF staff calculations 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 corporate 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 on debt enforcement are especially important for secured-debt investors.

Country-Specific and General Questions

The survey listed country-specific questions as well as general questions, including on progress relative to the European Commission's capital markets union (CMU) action plan 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.

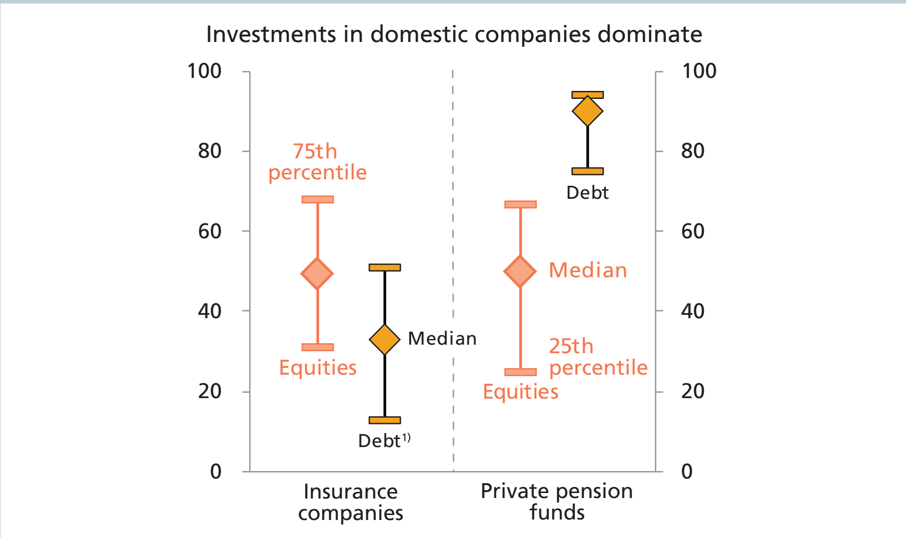
The survey was sent to 249 investors, including many of the largest asset managers, pension funds, venture capital funds, and insurance companies in Europe. It was also sent to all national capital market regulators in the European Union. The survey was completed by 10 financial institutions and 21 national regulators, with private equity investors responding as a group.

Survey Findings: Obstacles to Capital Flows are Higher in Some Countries

Survey responses shed light on the relative severity of various obstacles and flagged the leading position of the United Kingdom as a capital market jurisdiction (Figure 4).

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. Some countries were also seen to have weak audit

Figure 2: Home-Country Securities in EU Investment Portfolios, 2017 (Percent share of total EU securities)



1) Excludes sovereign paper. Sources: European Insurance and Occupational Pensions Authority; Mercer European Asset Allocation Survey; and IMF staff calculations


Ashok Vir Bhatia

Senior Resident Representative
to the European Union, IMF, Brussels


Srobona Mitra

Senior Economist, IMF,
Washington DC

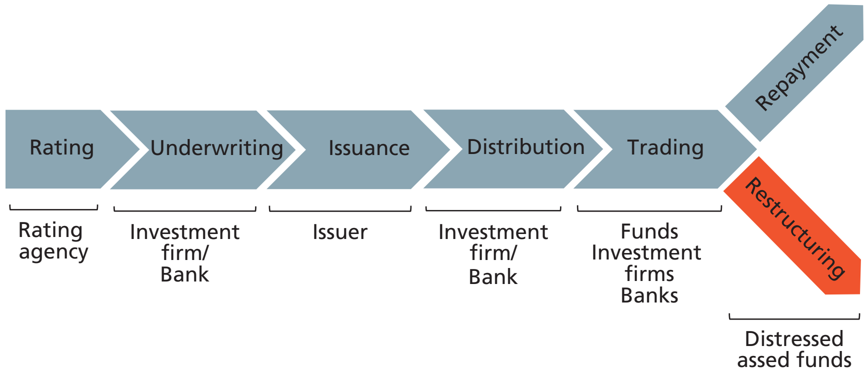

Anke Weber

Senior Economist, IMF,
Washington DC

Dieser Artikel basiert auf einer Studie, die von den hier genannten und weiteren Autoren für den Internationalen Währungsfonds (IWF) zur Kapitalmarktunion durchgeführt wurde. Der Europäische Finanzmarkt ist demnach immer noch entlang der nationalen Grenzen streng abgegrenzt. Sparer kaufen immer noch heimische Anlagen und Investoren finanzieren sich immer noch überwiegend über das heimische Bankensystem. Basierend auf den Ergebnissen geben die Autoren der Politik die Empfehlung, die Transparenz mit einem zentralen und standardisierten sowie durchgehenden Reporting für alle Emittenten von Anleihen und Aktien zu erhöhen. Darüber hinaus wird geraten, die Regulierung basierend auf Proportionalitätsprinzipien zu verschärfen, um die Investoren besser zu schützen. Als dritte Schlussfolgerung wird empfohlen, das Insolvenz-Regime in Europa aufzuwerten. Wenn es gelänge, den Kapitalfluss innerhalb Europas zu verbessern, könnte die EU nach Meinung der Autoren ihr volles ökonomisches Potenzial ausschöpfen. (Red.)

Figure 3: Life Cycle of a Representative Debt Security

The life of a typical security spans several well-defined phases



Source: IMF staff

quality, overly complex withholding tax procedures, and unduly high tax rates. The United Kingdom topped the rankings in almost all areas.

Restrictions on cross-border securities offerings, administrative burdens, minority investor rights, and legal deficiencies were seen as key barriers to capital flows (Figure 5). At the European Union 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. More than 40 percent of respondents 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.

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 cross-border investments. Reducing delays and uncertainties in establishing eligibility for withholding tax exemptions was favored across the board.

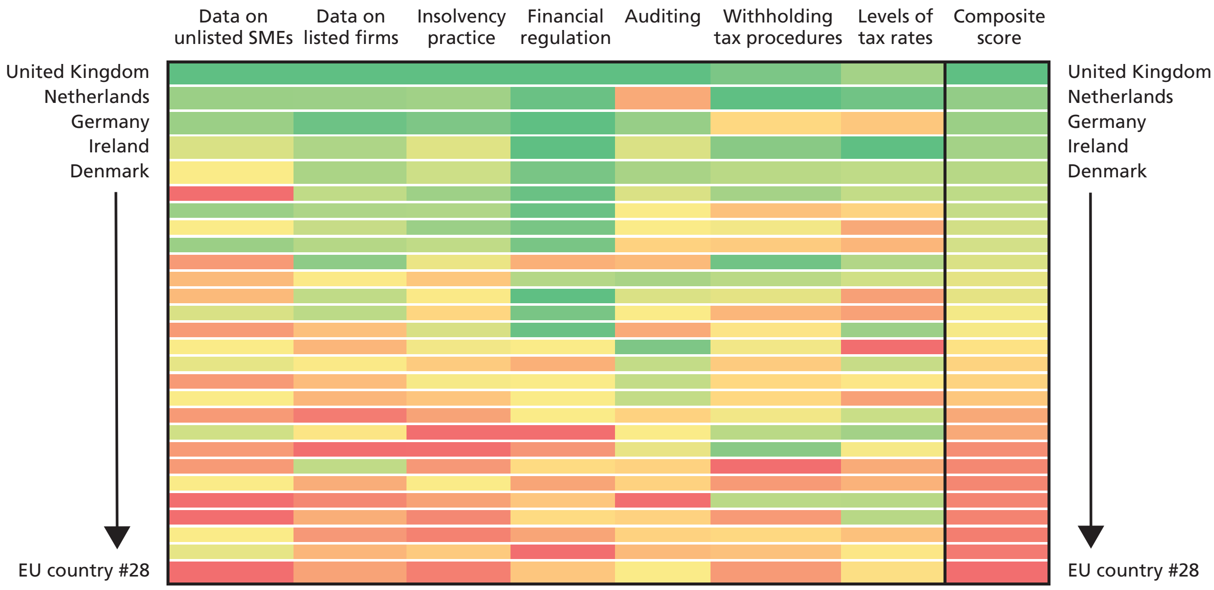
The survey also gathered useful views on how best to upgrade oversight (Figure 6). While, as noted, a strong majority of respondents singled out insolvency reform, there was also significant support for moving to more-unified capital market supervision in the euro area. Notably, some respondents also favored establishing a single consumer protection body for the euro area, perhaps loosely modeled on the US Consumer Financial Protection Bureau.

Policies to Reduce Obstacles

Based on these findings – and building on the achievements of the EU's CMU

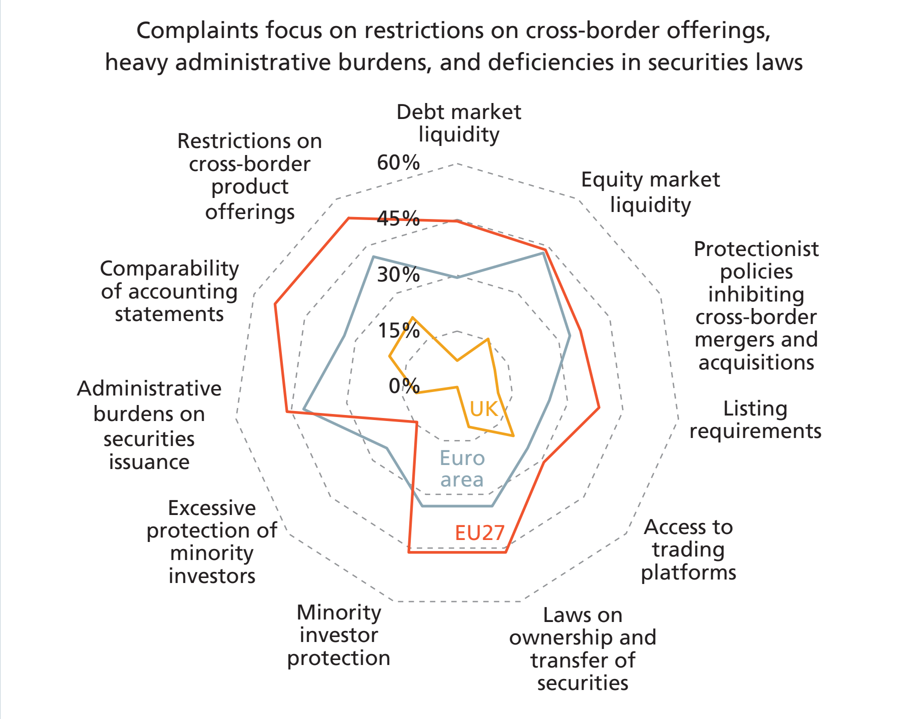
Figure 4: IMF CMU Survey Results: Heatmap[1)] (red = high concern, yellow = some concern, green = no concern)

Perceptions of the United Kingdom as a capital market jurisdiction are strong across all categories



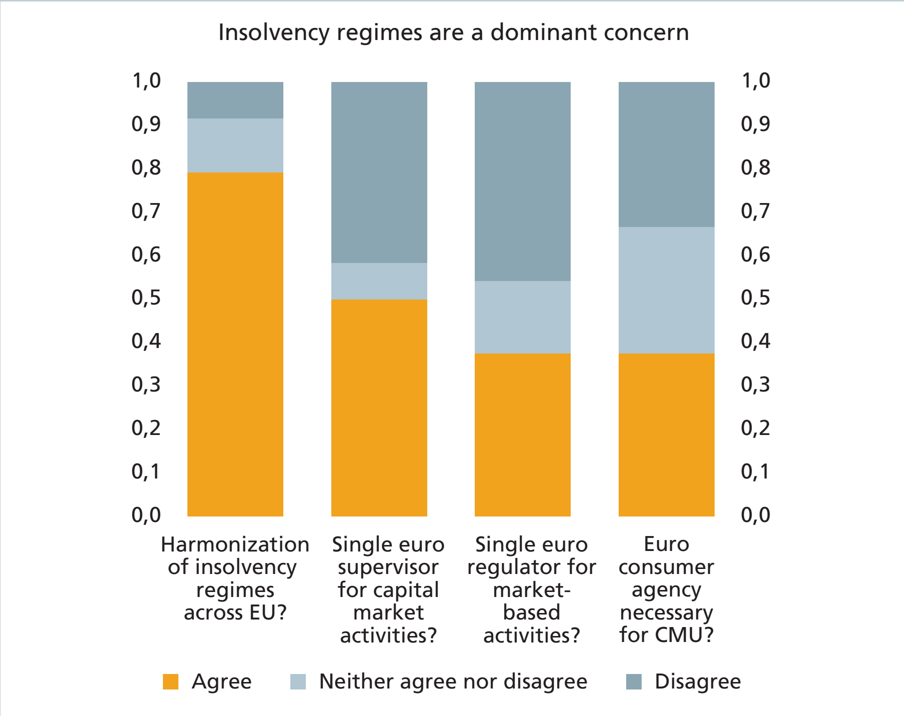
1) SMEs = small or medium enterprises. Composite scores are averages of underlying scores in each of the seven areas.
Source: IMF survey of EU capital market practitioners

Figure 5: IMF CMU Survey Results – Equity and Debt Markets (Percent of respondents citing inadequacy or concern)



Source: IMF survey of EU capital market practitioners

Figure 6: IMF Survey – Reform Priorities (Percent of respondents)



Source: IMF survey of EU capital market practitioners

Action Plan – we would encourage European policymakers to consider three targeted sets of initiatives in pursuit of greater capital market integration.

Conclusions for Policymakers

First, transparency can be enhanced by requiring centralized, standardized, and ongoing reporting by all issuers of bonds and equities, irrespective of size, on an ongoing basis. This would be a major change to the European reporting framework. And digital technologies can be used to streamline cross-border withholding tax procedures.

Second, regulation can be sharpened, guided by a principle of proportionality, to contain systemic risk and improve investor protection where it lags. Systemic entities such as central clearinghouses and large investment firms should be brought under centralized oversight. The European Securities and Markets Authority can and should be strengthened by introducing independent board members. The new pan-European pension product could be pepped-up with design changes to enhance portability and cost-efficiency. And, recognizing the global nature of capital markets, the EU should aim for maximum regulatory cooperation with non-EU countries, again guided by proportionality.

Third, insolvency regimes should be upgraded. The European Commission should carefully collect data in an area where the existing information is unreliable; develop a code of good standards for corporate insolvency and debt enforcement processes; and systematically follow up on EU member states' progress toward observing such standards.

Larger intra-EU portfolio flows would help move the EU toward realizing its full economic potential. In our view, a few well-targeted and relatively technical initiatives to remove identified barriers to such flows could have a significant impact – and should be possible to pursue without new high-level political deliberations.