# International Monetary Fund discussion note on a Capital Market Union for Europe. October 2019.

**The IMF** (International Monetary Fund) **has published a discussion note on a Capital Markets Union** (CMU) **in Europe**. This document, based on an analysis of the situation in Europe and the quantification of some of the costs of the fragmentation of capital markets as well as on the results of a survey among supervisors, market participants and associations, weighs the benefits that a CMU would have for Europe, identifies the main obstacles or problems that exist to achieve the mentioned Union and recommends a set of initiatives aimed at overcoming these obstacles.

The discussion note, developed by the technical staff of the IMF, is intended to elicit comments and **encourage debate** without the opinions expressed in it necessarily representing this body.

**I. INITIAL APPROACH**

THE EUROPEAN LANDSCAPE

Capital markets are **relatively small in size** in the European Union (EU) with a strong dependence on bank financing. European households have traditionally preferred bank deposits over securities investment which, alongside with public pension systems, have left a narrow margin for the development of private securities portfolio management. The largest sector of the capital market in the EU is investment funds, in particular Collective Investment Schemes in Transferable Securities (hedge funds and private equity funds have less relevance), followed by life insurance and private pension funds. In addition, European capital markets are **fragmented** between different Member States and savers and investors focused mainly on domestic markets.

**Brexit** will have an impact on the structure of European capital markets: the migration of activity from London to the EU will require upgrading the financial infrastructure and the inevitable reduction in the size of the European market may affect the liquidity and the functioning of the markets and increase the costs.

COSTS OF MARKET FRAGMENTATION

The fragmentation of the capital market has significant and quantifiable economic costs. **The cost** (interest on debt or loans) **and the possibility of financing companies depend largely on their country of incorporation**, which leaves companies in some countries at a serious disadvantage compared to others. Bank dependence prevents the financing of dynamic companies that, in some cases, **cannot provide guarantees on tangible assets** (real estate or other assets) to obtain a loan, with the consequent damage to innovation and growth. **Limited investment in cross-border securities portfolios** causes the local investor to be very sensitive to local economic conditions.

The **integration** would bring the **possibility of powerful macroeconomic benefits**: more funding options under competitive conditions and equating costs in the EU, greater access to venture capital and greater opportunities for diversification of investments.

BARRIERS TO CAPITAL MARKET INTEGRATION

The IMF technical staff conducted a **survey of 21 regulators and some of the most relevant market participants** whose responses allowed the identification of three main obstacles for the CMU whose elimination would bring measurable economic benefits: **insufficient transparency** of listed and unlisted issuers, **deficient and unequal regulatory quality** in the different Member States and poor insolvency regimes in some of them. **Other weaknesses** identified in the survey are: **poor quality of audits**, **excessive complexity of the procedures to recover tax withholdings** and **excessively high tax rates on interest and capital gains**. As for **the best way to update supervision**, the option of centralised supervision (perhaps influenced by the precedent in the banking field) had a lot of support, as was the establishment of a single consumer protection agency for the euro area.

Prior to this note, an **empirical analysis** was carried out **to quantify the impact of reducing the barriers identified** in the survey. One of the findings of the analysis is that better recovery rates (both for debt and capital) stimulate cross-border claims.

**II. POLICY ISSUES AND THE EUROPEAN UNION ACTION PLAN**

For the creation of a CMU, the IMF considers that an **improvement in the regulation of the sector is a key,** especially insolvency proceedings **based on the principle of proportionality**. Among the key ideas included in the discussion note the following are mentioned:

.- **The regulatory approach** on the CMU **should not focus on prudential supervision**, unlike the banking sector where this is a priority, **but in monitoring the conduct and regulatory compliance** (market discipline) to ensure investor protection. However, some entities are systemic and require strict prudential supervision, such as central counterparties (CCPs). Likewise, the regulations also guarantee some prudential supervision on the main institutional investors.

.- **Efficient insolvency procedures are important** in maximising the recovery value and efficient reorganisation of companies and the ability of creditors to execute their guarantees and establish a clear priority of credits. Early intervention is preferable before equity runs out.

.- **A solid general legal framework for conducting business activities is also relevant**: adequate protection of property rights, solid contractual and corporate law, minority shareholders protection, sound accounting and auditing standards, transparent tax rules and robust enforcement of private contracts.

Regarding the specific situation in the EU, the IMF highlights the following:

.- **The supervision** of the capital market in the EU **is mainly the task of the national competent authorities** (NCAs) while the European Securities and Markets Authority (ESMA) has the tasks of promoting supervisory convergence between them and exercising direct supervision of certain entities (credit rating agencies and transaction records). Not all NCAs have the same capacity or the same powers to carry out supervision. In this regard, self-placement (sale by banks of their own securities) and passive administration of collective funds are both two recent cases in which the lack of supervisory action by some NCAs has been detected.

.- T**he single rule book is how the unified set of UE capital markets rules is called, comprising level 1** (directives and regulations), **level 2** (delegated acts) **and level 3** (non-binding guidelines issued by the European Supervisory Authorities – or ESAs – to ensure a consistent national application of level 1 and 2 measures) measures applicable in the field of EU capital markets. **However, the significant regulatory differences between the Member States persist** because of the options and elements of legislative discretion that the directives allow, as well as their silence on some issues. In addition, only half of the EU Member States have transposed all the relevant directives.

.- **Relations with third countries are based on an equivalence process** under which the European Commission (EC) evaluates whether the regulation, supervision and application of this by third countries comply with EU standards.

.- The **EU Action Plan** (2015) for the development of the CMU, revised in mid-2017, **has meant some progress**. The most notable developments are the following: 1) the **Prospectus Regulation**, which aims to facilitate market access for small issuers by granting a passport to the prospectus for distribution throughout the EU; 2) the **Regulation on simple, transparent and standardised securitisation**, which facilitates obtaining non-bank financing by SMEs; 3) the **Venture Capital Regulation**, which covers managers whose assets under management exceed the previous cap of €500 million and considers unlisted entities with up to 500 employees as a "qualifying investment"; and 4) the **Directive on preventive restructuring and insolvency**, which regulates execution suspensions to preserve the business and the adoption of restructuring plans although, according to the IMF note, it is silent on a critical issue such as the hierarchy of claims.

.- Other ongoing Action Plan projects pending publication are: 1) the **Directive and Regulation concerning the prudential supervision of investment firms** (IF), which requires that those with assets of more than €30 billion (including subsidiaries) must obtain a bank license and, if located in the euro area, would come under the supervision of the Single Supervisory Mechanism (SSM); 2) the **Regulation on a pan-European individual pension product** (PEPP), which provides more options for saving on retirement and facilitates labour mobility within the EU; 3) the modification of the **Regulations concerning the creation of the European Supervisory Authorities** (ESAs) that strengthens supervisory convergence tools (among them, the definition up to two supervisory priorities of importance for the whole EU) and expands the areas in which ESMA has direct supervision (coordination in relation to suspicious orders, operations and activities with cross-border effects and authorisation and supervision of critical EU index administrators and third-country index administrators and of data supply service providers that operate cross borders). Some key aspects of the original EC proposals have not been maintained in the final version of the ESA review, in particular, the independence of the members of the Boards of Directors or the approval of certain prospectuses from EU and third-party countries; and 4) the modification of the **EMIR Regulation on the authorisation procedures of the CCPs (EMIR 2.2)** to strengthen ESMA's powers over both EU and third-countries CCPs. (On the issue date of this Bulletin, all these regulatory initiatives have been approved pending their official publication).

## III. FURTHER STEPS TO INTEGRATION

The IMF sets out from the fact that tax harmonisation is, for the moment, outside the scope of the EU Treaties, so the issue is not raised in the short term. However, to maximise the impact of the study, this body considers t**hree specific sets of initiatives focused on the main obstacles identified in the survey and empirical analysis**. These are the following:

### *1) Proposals to improve transparency and information disclosure*

.- **Require centralised, standardised and mandatory on going reporting for all issuers, regardless of size**, in three steps: 1) ESMA would save the information collected from the national registries in a central platform, 2) ESMA would receive the financial statements directly from the issuers and 3) ESMA would review the information submitted in accordance with comparable accounting standards. This increase in transparency would have a direct impact on price formation and market efficiency.

.- **Increase the transparency of unlisted companies**. For this, the Business Registers Interconnection System is a good joint effort of which 25 national corporate registers -that have been linked since 2016 through the European electronic justice portal- are part. At this point, the prohibition of MIFID II against bundling research costs into execution fees should be reviewed to assess whether such prohibition is inadvertely discouraging market research on small issuers and SMEs.

.- **Simplify the procedures for returning cross-border tax withholdings through digital technologies**. A single electronic processing portal and greater standardisation of reclaim forms might simplify tax refunds.

***2) Proposals to improve regulation and supervision based on the principle of proportionality***

.- **Establish a mixed supervision between the national and an European centralised system: a kind of SSM for systemic entities such as the CCPs and the larger IFs**. In the case of the CCPs, ESMA and the ECB should share supervisory powers together with the relevant NCAs to ensure the rigorous application of EMIR and the containment of systemic risk. On the other hand, the CCPs, whether they have bank authorisation or not, should enjoy access to Central Banks services to place deposits and obtain liquidity. Additionally, in the case of systemic IFs in the euro area, the ECB should also have supervisory powers and ESMA might have a coordinating function.

.- **Upgrade ESMA supervisory convergence tools to improve protection for investors across the EU** and the option of an independent Board of Directors for decision-making regarding regulatory and supervisory convergence should be explored.

.- Introduce changes to **improve the portability and profitability of the new pan-European PEPP**.

.- **Maintain close cooperation with other countries**, especially with the United Kingdom after Brexit, given the global nature of capital markets.

***3) Proposals to improve insolvency proceedings***

.- **Ensure, as a first step, that the possible reforms are based on the collection and analysis of reliable data** using the information available, under the Directive on restructuring and insolvency, on debt executions and corporate insolvency cases.

.- **Develop minimum standards for corporate insolvency and debt execution processes**, in which a unified ranking of credit claims for the entire EU or better real guarantee enforcement mechanisms were established.

.- **Systematic EC monitoring of compliance with these standards** in order to ascertain the progress of each MS (name and shame).

**IV. CONCLUSIONS**

In the opinion of the IMF, progress towards the CMU will require political will to overcome the difference between the Member States' political rhetoric of support and their irregular willingness to act. The CMU needs to complement (without displacing) the Banking Union and both to achieve the Financial Union in the EU.

In addition, it proposes that financial integration be accompanied by fiscal responsibility and structural reforms that allow progress in the convergence of productivity and per capita income throughout the EU, with fiscal adjustments and reforms in the labour market and financial products being necessary in some Member States to improve their attractiveness as investment destinations.

Finally, it concludes that although the CMU offers the promise of facilitating capital flows, it is the risk/return ratio of the investment that will determine investors' decisions.

**Link of interest:**

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