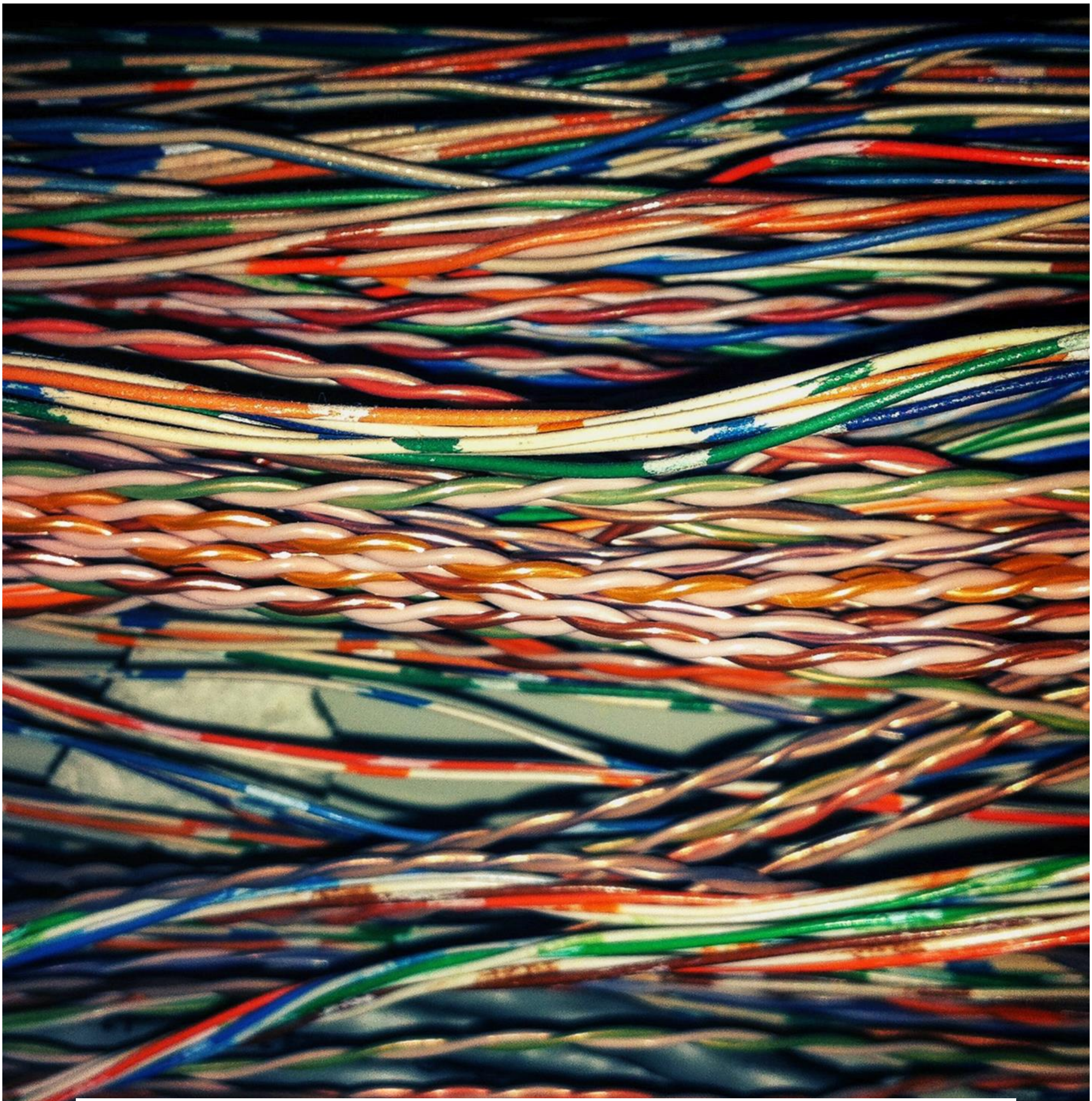

Financial market integration in the EU: A practical inventory of benefits and hurdles in the Single Market

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Contents

1 Abstract

It is 25 years since the European Union (EU) agreed to complete the European Single Market (SM) in goods, services, people, and capital. While many barriers to the free movement of capital across borders have been removed, some important practical hurdles are still in place. The euro crisis has shown that the European financial sector in particular remains vulnerable and fragmented and this poses serious risks to the stability of both national economies and the euro area as a whole. In 2015, the European Commission therefore set out a list of measures to establish an integrated capital market in the EU by 2019.

The first part of this policy paper analyzes the channels through which financial integration affects growth, stability, and convergence in the EU, including capital allocation, production specialization, diversification of risk, and access to investment opportunities. The second part takes stock of persisting administrative and legal hurdles that impede full market integration. In particular, this paper distinguishes between a firm-level perspective, investors, and banks in its analysis. The final part provides some specific recommendations to improve the internal market for capital in the EU.

2 Introduction

Twenty-five years after the European Single Market (SM) came into being, its overall success in contributing to economic growth is undisputed. Nevertheless, there still exist considerable hurdles to full market integration, particularly in the area of capital markets and financial services. Reaping this potential is not only important for creating a level playing field across the SM as a whole. Financial market integration also plays a vital part in stabilizing the Economic and Monetary Union (EMU). In fact, the European Central Bank (ECB) has repeatedly highlighted the significant potential inherent in international diversification and risk sharing within the EMU. Especially in times of crisis, such mechanisms could help mitigate financial distress and lead to overall risk reduction (Draghi 2018). Moreover, economic theory provides a variety of explanations and channels through which a truly integrated financial market could contribute to economic growth and convergence in the European Union (EU).

In the past few years, major steps have been taken to bolster financial market integration in a variety of ways. This includes establishing the European banking union as well initiating the Capital Markets Union (CMU). While the banking union encompasses a central banking supervision and resolution mechanism to ensure a level playing field and financial stability, the CMU aims at deepening capital markets so as to improve funding and international investment. These milestones, if and when fully implemented, could undoubtedly provide significant gains. As of now, however, impediments to capital and financial flows still exist. This raises questions: Where do we stand in terms of financial markets integration? What are the remaining obstacles and what needs to be done to tackle them?

In this paper, we take stock of progress and identify some of the hurdles that need to be overcome to facilitate cross-border financial flows in the SM. We take a bottom-up case study approach to identify the experiences that different market participants face when involved in cross-border financial transactions. Our aim is to derive concrete proposals to strengthen the SM in practical terms. While Europe's economic and financial framework has been upgraded considerably in the wake of the euro crisis, we point out blind spots and potential improvements that can cater to financial stability and growth. The paper does not claim to provide a complete list of all extant barriers and hurdles, but intends to initiate a discussion on which additional measures should be taken and thus contribute to a broader debate on how to complete the SM in capital and finance.

The remainder of the paper is structured as follows. Chapter 3 defines the term financial integration and briefly describes its historical background. We then review the literature on the benefits and potential problems of financial integration. Chapter 4 points at concrete hurdles that still exist for different financial market players. Chapter 5 sets out potential solutions and policy recommendations.

3 On the benefits of a single market for capital and finance in Europe: A review of effects and channels

This section outlines the potential benefits from European financial integration and the channels through which they materialize. In general, a well-functioning common financial market is a precondition for growth and convergence in the EU. Standard economic theory predicts that capital flows from relatively rich to relatively poor countries can especially increase productivity and thus foster catch-up by lower-income countries. Larger financial flows, for instance through better integrated equity markets, can increase labor productivity through capital-deepening and – by facilitating technology transmissions – impact positively upon total factor productivity (TFP), a crucial measure of innovation and efficiency (ECB 2018). However, there are many additional effects generated by the free movement of capital and financial services across European borders that will be outlined below. Before doing so, it is worth illustrating the characteristics of a financially integrated market, and describing how and to what extent this has been achieved so far.

3.1 Definition and history of financial integration in Europe

In general, financial integration can be seen in light of two overarching classes of definitions: one is based on the idea of positive integration (i.e., establishing a sound common regulatory framework), while the other focuses on negative integration (i.e., removing barriers that impede financial integration). Ehigiamusoe and Lean (2018) provide a comprehensive definition based on removing the abovementioned impediments. Specifically, financial market integration is seen as interlinking formerly separated financial markets in a way that involves the exchange of information, cross-border capital flows and investments, trading in financial products, and attracting foreign financial resources. “In essence, financial integration entails eradication of restrictions on cross-border financial operations so that financial institutions can freely operate, firms can directly borrow or raise funds, and equity and bonds investors can directly invest across countries without restrictions” (Ehigiamusoe and Lean 2018).

A somewhat shorter and often employed definition of a “financially integrated market” is provided by Baele et al. (2004) and relates to positive integration. The authors state that “the market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics (1) face a single set of rules when they decide to deal with those financial instruments and/or services; (2) have equal access to the above-mentioned set of financial instruments and/or services; and (3) are treated equally when they are active in the market.”

The road to such a full-fledged financial market has been very long in the EU (see Valiante 2016 for a detailed overview). The foundations of (relatively) free capital movement were laid down with the 1957 Treaty of Rome that established the common market. The Maastricht Treaty of 1993 stipulated the goal of achieving fully free movement of goods, services, people, and capital in the SM. Since then, further steps such as the Financial Services Action Plan and the establishment of the EMU have led to an ever more integrated financial single market. In response to the financial crisis and the subsequent euro crisis, a single regulatory financial framework containing a whole range of common rules governing the financial sector was put in place to ensure a level playing field and develop a more resilient financial system. These include – but are not confined to – microprudential and macroprudential bodies (e.g., the European Banking Authority and the European Systemic Risk Board) as well as the (incomplete) banking union.

The two most far-reaching recent initiatives to integrate financial markets in Europe are the banking union and the CMU (see e.g., ECB 2017). The banking union was designed to relax the vicious circle of bank and sovereign (in)solvency ('doom loop') within the euro area and stabilize financial markets in at least two more important dimensions. First, the Single Supervisory Mechanism (SSM) was set up to centralize monitoring and supervision of large European banks under the auspices of the ECB. Second, the Single Resolution Mechanism (and Fund) (SRM/SRF) came into force so as to restructure or even liquidate troubled banks in an orderly fashion that would reduce market disruption and contagion. In addition to the harmonization of national rules, the European Commission proposed a third pillar of the banking union in 2015: a European deposit insurance scheme (EDIS). It intends to create uniform legislation that insures private deposits against bank default, independently of the location and jurisdiction in which a bank operates (see e.g., ECB 2016). Finally, the most recent proposal to advance SM is that of the CMU, to deepen capital market integration and facilitate credit access by creating a pan-European market-based loans system. It would therefore constitute more of a negative integration process: unlike the banking union, not necessarily creating new and urgently needed institutions and mechanisms, but primarily seeking to strengthen the current institutional framework and remove obstacles in the common financial market (Valiante 2016).

3.2 Theoretical benefits and channels of financial integration

A large body of academic work has emerged that investigates the progress and effects of financial market integration, as well as the channels through which it exerts its influence in Europe and beyond. While there are many different measures of financial integration (e.g., Adam et al. 2002; Bekaert et al. 2013; ECB 2016), the benefits can be consistently categorized as enhancing growth, facilitating macroeconomic and financial stability, and supporting the smooth conduct of monetary policy.

Integrating financial markets across borders primarily has the potential to boost overall economic growth in the EU. Theoretically, this can happen through various potentially interlinked channels, ranging from improved capital allocation, investment opportunities and specialized production, over increased total factor productivity (Gehringer 2013; Gehringer 2015), to more competition and better developed financial sectors (Levine 2001) in the Member States (Edison et al. 2002; Baele et al. 2004; Stavarek et al. 2011; Ehigiamusoe and Lean 2018). A truly integrated capital market can also foster innovation, as funding of risky, but promising, ventures becomes easier (Valiante 2016).

Furthermore, financial integration is likely to improve international diversification and risk sharing behavior of private agents (see Obstfeld 1994; Acemoglu and Zilibotti 1997 as early contributions among a vast and growing literature). If financial integration enhances the decoupling of private spending from the disposable income of the local economy, then consumption can be smoothed over time. Moreover, within financially integrated markets, banks operating at EU-wide level will also be able to continue lending money even when their home economies enter a recession. In this context, the establishment of the European banking union should increase risk sharing across member states by creating a common regulatory framework, promoting cross-border retail banking, and thus reducing the bank's dependency on the local economy (ECB 2016). Hence, by limiting the home bias, risks are not only shared, but in fact also reduced (Draghi 2018). This, in turn, may imply a higher degree of financial and macroeconomic stability with benefits for all (ECB 2018).

Finally, monetary policy itself has a vital interest in highly integrated financial markets. As the ECB transmits its policy through financial markets, market efficiency is of course decisive. When, at the same time, financial integration contributes to less volatile and more synchronized business cycles in terms of consumption and possibly production (Imbs 2006; Kose et al. 2003; Kose et al. 2009; ECB 2016), the ECB should find it easier to conduct a "one-size-fits-all" monetary policy for the euro area. In this context, it has been shown that cross-border bank linkages in the United States, for instance, not only decrease business cycle fluctuations across states, but also increase cyclical convergence among them (Morgan et al. 2004).

3.3 Potential caveats of financial integration

Financial integration can also feature downsides that need to be monitored and addressed carefully when pursuing further integration. For instance, creating the conditions for retail banks to operate across borders may lead to market consolidation. This in turn could lead in the extreme case to monopolistic tendencies that hamper competition and market efficiency (Baele et al. 2004). Furthermore, if banks become disproportionately big this can induce more systemic risk. Another drawback could be the risk of even increasing financial instability in times of crisis because capital flows could be reversed more quickly, thereby weakening the insurance function of financial markets (De Grauwe 2018). Withdrawing capital from poorly performing countries, for instance, would also be much easier if banks were not simply tied to just one member state's economy.

Moreover, deepening integration can also promote production specialization in line with comparative advantages. This could make asymmetric shocks more likely and lead to decreasing international synchronization of output growth. In that case, the ECB's ability to pursue a "one-size-fits-all" monetary policy would be undermined. Economic theory, however, provides no clear guidance as to whether increasing financial integration will lead to a more specialized production pattern. Abolishing barriers to trade and financial flows could also promote intra-industry trade that would eventually increase international co-movement of production cycles. Empirical evidence on the effects of financial integration on trade and output synchronization is inconclusive so far (Imbs 2006; Kose et al. 2003).

Overall, whether the theoretical benefits from integration can be realized in practice depends very much on the financial markets' resilience in times of economic and financial distress. According to the ECB (2016), a (single) European financial market may "be regarded as resilient when abnormal arbitrage opportunities do not arise in cross-border asset markets under financial stress, or when the ability to issue and purchase financial instruments in these markets does not change abruptly." The resilience of the financial system is in turn mainly determined by the composition and direction of financial asset flows. Whether such flows consist of debt or foreign direct investment, short-term or long-term maturities, inter-bank or cross-border bank lending, or run bidirectionally or unidirectionally, can only indirectly be influenced by policies. A tendency to short-term debt financing, for instance, is regarded as riskier and more volatile than longer-term equity financing, especially when capital flows one way to vulnerable economies (ECB 2016; Valiante 2016).

However, over the past years, much has been done at the European level to improve resilience, to facilitate cross-border finance, and to create a level playing field for capital and financial services. In other words, many low-hanging fruits of financial market integration have already been plucked. To achieve a fully integrated single market that unlocks further benefits from financial integration, the focus now needs to be on specific impediments to financial transactions. This is especially true for areas such as cross-border banking, where fragmentation has increased since the financial crisis. By removing such practical obstacles (see next chapter), risk and fragmentation could be even further reduced, with benefits not only for the SM, but also for euro area stability.

4 When theory meets reality: What practical hurdles do we have?

In this chapter, we compile a broad, but certainly incomplete, list of concrete barriers to European financial integration. For this purpose, we conducted interviews with leading experts from academia, policy, and industry to ask them for examples that they observe and judge to be standing in the way of deeper financial and economic integration in Europe. The examples come from the three areas of banks, firms, and investors.

4.1 Banks

4.1.1 Ring fencing of liquidity of banks and bank subsidiaries by national regulators

This is an example of a barrier that inhibits cross-border activities by banks, especially by those with a broader European customer base. Intragroup lending for bank subsidiaries with parents in other European countries may be severely restricted by national regulators (one prominent, often cited example is Unicredit with its German subsidiary *Hypovereinsbank*). National regulators enjoy wide latitude in determining the magnitude of intragroup exposures and have a number of tools to "make life miserable [for the bank]" (according to an interviewed expert) if it does not conform to regulatory expectations with respect to cross-border exposures. Reportedly, German regulators are stricter in this regard than their counterparts in, for example, France, the Netherlands, and Italy. This may thwart a level playing field and create hurdles to intra-European capital flows. A solution to this and comparable issues is to delegate more regulatory powers to the European level; that is, the SSM. As part of a more general reform that also includes removing regulatory privileges for sovereign debt, restrictions on intragroup cross-border exposure for SSM-supervised banks could be abolished altogether.

4.1.2 Inconsistent application of resolution rules

Resolution and state aid rules are not applied in a consistent manner. In particular, the bail-in rules following the introduction of the Bank Recovery and Resolution Directive (BRRD) have so far only been applied in the case of the Spanish bank Banco Popular. In other cases and most notably in that of several Italian banks, these rules were circumvented by reclassifying these banks on short notice as being non-systemically important, enabling the use of so-called 'liquidation aid'. The European Commission needs to ensure that state aid law is reformed in a way that it is synchronized with the requirements of the banking union. This way it can ensure that bail-in rules are more credibly implemented in practice. As a consequence, this should enhance the credibility of European resolution rules and help to resolve unviable banking businesses.

4.1.3 Lack of opportunities for bank loan securitization

Market participants report that they face steep discounts when they attempt to securitize their loans. This is likely to be the case as investors distrust the composition of the mortgage pools offered by banks (a classic 'lemon market problem'). In contrast, this appears to be less of an issue in the US, as government-sponsored enterprises guarantee certain mortgage-backed securities vis-à-vis investors and thereby certify the quality of the underlying mortgage pool. This ensures a liquid market. The financial crisis highlighted the risks of blanket government guarantees for mortgage pools (in particular, subprime mortgages). As a compromise, it may be helpful to have an independent and trusted institution, for example, the European Investment Bank, certifying and rating mortgage pools to facilitate securitization (and potentially also setting standards with respect to junior-tranche retention rules).

4.1.4 Lack of cross-border mergers and home advantage by national regulators for local banks

As part of the response to the financial crisis, Basel III instituted higher capital requirements for Globally Systemically Important Institutions (G-SIIs). While justified from a financial stability perspective, this can be seen as discouraging cross-border mergers of European banks. In fact, the identification methodology for G-SIIs includes the category of cross-border activity of a banking group – one that embraces cross-border activity between member states. At the same time, national regulators are often criticized for treating local banks in a more lenient fashion, although their failure may also endanger financial stability (see savings and loans crisis or collapse of Spanish Cajas during the recent crisis). This imbalance may be remedied by expanding SSM coverage to have an impartial supervisor creating a level playing field. In addition, national governments ought publicly to declare their political support for the creation of truly European banks.

4.1.5 Covered bonds remain an opaque asset class due to diverging regulation

Covered bonds are a popular method of European bank refinancing. However, divergent national regulations prevent a transparent, easy-to-value European asset class. National fragmentation in two areas has prevented harmonization so far. First, insolvency as well as mortgage/collateral law remains strongly fragmented across euro area member states, which is a barrier not just for harmonized covered bond issuance, but also for cross-border lending more generally. Second, are disharmonious cash flow features of the covered bonds. For example, asset encumbrance due to varying overcollateralization rates poses additional barriers to a deeper banking union. Recent proposals by the European Commission seek to address the second issue, but do so only incompletely while not addressing the central topic of mortgage law at all. To remove remaining barriers, further standardization as well as advancing proposals for mortgage law harmonization (e.g., Eurohypothek) would be helpful.

4.2 Firms

4.2.1 IPO prospectus regime causes bureaucracy and legal uncertainty

Currently, the European Commission is in the process of reforming the IPO prospectus regime. This move is welcome. However, there is a risk that the current reform proposals might increase bureaucracy. In particular, the obligation to present a categorization of risk factors (and to limit these factors to exactly fifteen) burdens firms with legal uncertainty, as ex-post realization of risks that were previously missed out could be interpreted by courts as a deliberate intention to mislead. Generally, the prospectus requirements should be designed as useful information for potential investors, not as a comprehensive listing of all factors affecting business outlooks in all imaginable circumstances. This principle should be kept in mind when designing new prospectus rules.

4.2.2 Excessive reporting requirements responsible for firms avoiding public listing

There are ongoing debates and proposals on Corporate Social Responsibility (CSR) and/or Environmental, Social and Governance (ESG) reporting requirements. These might even include country-by-country reporting, which would significantly increase administrative burdens on listed firms. As in the previous point, before introducing new reporting requirements, the administrative burden of these requirements on listed firms should be critically evaluated. Likewise, inconsistent and overlapping reporting requirements should be abolished.

4.2.3 Sale of insurance products requires large legal and bureaucratic efforts

Despite the introduction of the Insurance Distribution Directive (IDD), selling insurance products across EU member states still requires significant legal and bureaucratic efforts. This is because the IDD, the main goal of which is consumer protection, is a minimum harmonization directive and therefore rules and regulations can (and do) still vary across member states, sometimes requiring different/higher standards. As in the banking sector, the goal should be to introduce EU-wide standards that allow insurance products to be sold under common rules (i.e., ‘passporting’). This could be achieved, for example, by increasing the power of the European insurance regulator (EIOPA).

4.2.4 Debt bias in corporate taxation distorts financing and harms cross-border risk sharing

Most corporate tax systems of EU member states (notable and exceptional examples of reforms in this matter include Belgium and Italy) feature deductibility of interest payments on debt while no such measure exists for equity funding of firms. This distorts firms’ financing decisions towards debt over equity, creating incentives for excessive leverage – for both banks and non-financial corporations – and allowing for easier profit shifting into low-tax jurisdictions. Furthermore, research has indicated that the most effective way to promote cross-border risk sharing and consumption smoothing is cross-border equity holdings. Removing the debt bias in corporate tax systems could thus significantly contribute to the development of equity markets in Europe.

4.2.5 Fragmented bankruptcy regimes create uncertainty and impede cross-border lending

Insolvency procedures differ strongly across member states, with several adverse consequences. To begin with, inefficient bankruptcy proceedings in some states are a major barrier to investment and their economic recovery. Furthermore, fragmented bankruptcy regimes provide cross-border creditors with a major source of uncertainty about both the duration of the proceedings and the amount that can be recovered in court, making the loss-given-default – an important variable for creditors – difficult to price. It also thwarts securitization, that is, the pooling of loans to borrowers across member states for selling to investors. For these reasons, disintegrated insolvency laws represent a major impediment to cross-border lending. While complete harmonization of national insolvency laws may be unrealistic in the short- or medium-term, it may be feasible to introduce a European insolvency law to which firms may voluntarily opt in (in agreement with their creditors). As a consequence, listed companies could be required to transition to the European law. In addition, special bankruptcy courts that apply European insolvency law ensure an efficient and fair treatment of creditors and debtors, independent of their nationality.

4.3 Investors

4.3.1 European countries suffer from inadequate stock market participation

Many European countries have low stock market participation rates compared with other developed countries. This poses a significant challenge, as stock returns are significantly higher than most other asset classes over longer investment horizons. In particular, as many European societies are ageing, pension systems might come increasingly under stress. Higher stock market participation rates may be helpful in alleviating these strains and could increase cross-border risk sharing. While the exact causes of low stock market participation may not be easily identifiable or even amendable (e.g., culture or financial literacy), one possible reason is regulation and associated bureaucracy for retail investor advisors. Therefore, as part of the effort to harmonize retail investor advisory rules across the Union, it is worthwhile establishing an opt out rule, under which informed customers can invest in a large class of financial products, including individual stocks and mutual funds, without repeated bureaucratic requirements.

4.3.2 Employee share ownership is heavily bureaucratized.

Employee share ownership may be one option to give employees a larger stake in their firm's economic outcome, thereby better aligning interests of owners and employees. In addition, employee share ownership may contribute to mitigating wealth inequality, reducing aversion to investing in stock markets and motivating employees, for example, by offering stock options. However, complex rules apply to companies looking to set up employee share programs or executive stock option schemes, for example, transparency rules, which often create legal uncertainty for firms and vary across member states. This is particularly relevant for cross-border implementation of employee share-ownership schemes, which further add administrative burdens, for example, differences in minimum vesting periods and other compliance standards. To resolve this issue, one could establish mutual recognition of employee share ownership plans (i.e., ‘passporting’), for example, by applying the administrative rules of the member state in which the parent company is established. A further measure could be to establish the principle of taxing and administering employee share plans according to the place of residence at the end of the vesting period for employees moving within Europe.

4.3.3 Differences in the application of accounting rules lead to information asymmetries across European countries

Information gathered from firms' balance sheets and income statements is among the most fundamental sources of knowledge for investors. Useful interpretation across firms relies heavily on trust in the accuracy and consistency of the numbers reported. However, attempts at harmonizing accounting standards across the EU remain incomplete, as International Financial Reporting Standards (IFRS) are interpreted and applied inconsistently, resulting in significant deviations. This inconsistency means investors have to pay heavily for information on national accounting standards and introduces uncertainty, harming the level and efficiency of cross-border investments. To reduce these information asymmetries, a central regulator could take over the powers of national authorities so as to enforce the consistent application of accounting rules across the EU.

5 A call to further European integration: Practical ideas to improve the Single Market on capital

There is strong consensus on the welfare-enhancing effects of integrated European capital markets. In particular, capital markets can significantly contribute to risk sharing among euro area member states. This is particularly relevant in the European context. As there is only limited political appetite for risk sharing at fiscal level (e.g., Eurobonds, extensive euro area budget), the share of risk through capital markets should play an even more important role rather than continue as a missing element of a properly functioning currency union. In this sense, stronger capital market integration may contribute to solving underlying fundamental challenges in the euro area. Here is a broad, albeit incomplete, list of possible steps towards achieving financial market integration in Europe.[1]

1. Increase SSM coverage.

2. Consistently apply resolution rules and close banks with unviable business models.

3. Enable the European Investment Bank to certify mortgage-backed securities.

4. Further harmonize covered bond regulations, and advance proposals on creating a Eurohypothek.

5. Streamline IPO prospectus regimes and reduce reporting requirements.

6. Remove the debt bias in corporate tax systems.

7. Introduce an opt in European insolvency law, including bankruptcy courts.

8. Create common distribution rules for European insurance products.

9. Harmonize retail investor advisory rules; include an opt out for informed investors.

10. Simplify and harmonize employee share ownership regulation.

11. Set up an agency to enforce consistent application of accounting principles.

As stressed throughout this paper, these proposals are neither comprehensive nor final. They are meant to invite and stimulate a discussion around these important issues. Feedback on all points raised in this study is highly appreciated. We would explicitly wish to encourage experts from academia, policy, and industry to add further proposals for a comprehensive political agenda in advancing market integration in Europe.

[1] For a detailed list of further proposals, see Valiante (2016).

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