DEUTSCHE BUNDESBANK
EUROSYSTEM

# Deutsche Bundesbank's reply to the European Commission's Green Paper "Building a Capital Markets Union"

## Background

The free movement of capital constitutes a cornerstone of the European Single Market. Several initiatives have been launched with a view to achieving this goal. For example, the removal of capital controls was initiated in 1988[1]; the Financial Services Action Plan (FSAP) was adopted in 1999 and implemented in the 2000s.[2]

However, despite the progress that has been made, there is a strong sense that **capital market development and integration in Europe remain incomplete**. The financial crisis has contributed to a fragmentation of financial markets. External corporate finance and cross-border capital flows tend to be dominated by bank debt. Dealing with the debt overhang in some Member States has been cumbersome. Key policy areas that affect financial structures remain under the discretion of national legislators and constitute a source of market fragmentation.

With the **Banking Union**, important gaps in the supervision of banks have been closed. Detecting risks in banking earlier and dealing with those risks that have materialised are the key goals of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), respectively. Through the bail-in tool, private sector risk sharing should become the rule rather than the exception. The **Capital Markets Union** (CMU) project aims at complementing the Banking Union and deepening the Single Market for capital. The CMU project should thus **encompass all 28 Member States** and should not be restricted to the Euro area.

As regards corporate financial structures, **bank credit – and thus debt finance – remains a key source of external corporate finance**. In several Member States, the volume of stock market capitalisation falls short of the volume of bank credit granted to the private sector.[3] Flow-of-funds data show that European non-financial firms rely much more on bank loans than on corporate bonds. For U.S. firms, in contrast, bonds are more important than bank loans. More developed and more

[1] Council Directive 88/361/EEC of 24 June 1988.
[2] The "Markets in Financial Instruments Directive" (MiFID) aims at developing and integrating European equity and debt markets. For an initial review of all elements of the FSAP see CRA (2009): "Evaluation of the economic impacts of the Financial Services Action Plan", *Report prepared for the European Commission*.
[3] Langfield, S., M. Pagano (2014): "Is Europe Overbanked?", *ESRB Report of the Advisory Scientific Committee, No. 4.*

integrated markets for debt and equity, however, could have provided valuable funding alternatives to the real economy when banks reduced their lending during the global financial crisis.[4] Furthermore, banks have a stronger tendency than capital market investors to roll-over debt and to postpone balance sheet restructurings in times of financial crisis, which hampers growth-enhancing post-crisis deleveraging processes.[5] Consequently, the strong concentration of corporate finance in Europe on bank debt may have magnified the negative effects of the global financial crisis of 2007-09 on economic growth.

As regards the **structure of cross-border capital flows**, capital market integration in the Euro area had progressed rapidly as of the late 1990s, but it partially reversed since the financial crisis. The integration of capital markets was driven primarily by debt instruments. During the crisis, however, wholesale bank lending flows showed a sudden reversal towards domestic markets, which might have contributed to an aggravation of the economic crisis. Likewise, cross-border investments into bond markets within the Euro area increased until 2007/08, but receded in the aftermath of the crisis. In contrast, cross-border equity investments in public stock markets within the Euro area grew steadily over the past 15 years and remained stable even during the financial crisis. Cross-border bond and equity investments by non-Euro area EU residents are at the same time relatively weak.[6] Overall, the home bias of both stock and bond holdings in the Euro area is substantially below OECD average.[7] In contrast to the well-integrated public markets for bonds and stock, there are other market segments in the EU, such as the market for venture capital, that remain highly fragmented, and cross-border investments, such as mergers and acquisitions (M&A), are impeded by institutional barriers.[8]

Moreover, a debt overhang appears evident in some Member States as **high stocks of non-performing loans remain on banks' balance sheets**. This hampers the efficient reallocation of capital in the real economy, which would facilitate a return to economic growth.[9] This contrasts developments in Europe with those in the U.S., where the post-crisis deleveraging process has been much more pronounced.

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4 Adrian, T., P. Colla, H. S. Shin (2012): "Which Financial Frictions? Parsing the Evidence From the Financial Crisis of 2007-9", *NBER Macro Annual Conference, 20-21 April 2012*. Becker, S., V. Ivashina (2014): "Cyclicality of Credit Supply", *Journal of Monetary Economics, 62*, pp. 76-93.

5 Gambacorta, L., Yang, J., Tsatsaronis, K. (2014): "Financial Structure and Growth", *BIS Quarterly Review March 2014*, pp. 21-35.

6 ECB (2015): "Financial Integration in Europe 2015", April 2015.

7 De Santis, R. A., B. Gérard (2009): "International Portfolio Reallocation: Diversification Benefits and European Monetary Union", *European Economic Review, 53 (8)*, pp. 1010-1027. In Germany, for example, almost 60% of the public stock market capitalisation is in foreign ownership. Bundesbank (2014): "Ownership Structure in the German Equity Market: General Trends and Changes in the Financial Crisis", *Bundesbank Monthly Report, September 2014*, pp. 19-32.

8 Hopt, K. (2014) "Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis", *Columbia Journal of European Law, 20 (2)*, pp. 249-282. Jones, A., J. Davies (2014): "Merger Control and the Public Interest: Balancing EU and National Law in the Protectionist Debate", *King's College London Dickson Poon School of Law Legal Studies Research Paper No. 2015-12*.

9 Liu, Y., C. B. Rosenberg (2013): "Dealing with Private Debt Distress in the Wake of the European Financial Crisis", *IMF Working Paper No. 13/44*.

In sum, these stylised facts suggest that there is potential for the CMU project to further develop and integrate European capital markets. In particular, a **higher share of equity in external finance and in cross-border capital flows has the potential to generate a "double dividend"** by making the European financial system both more conducive to growth and more resilient to shocks. Growth and financial stability could be promoted through the following channels:

First, equity capital is conducive to **innovation and investment**.[10] Firms' demand for external equity increases in parallel with their need to finance investment opportunities from research and development (R&D).[11] In the U.S. supply of external equity financing contributed substantially to the rise in R&D activities in the 1990s[12] and private equity has stimulated R&D activities by European firms.[13] The CMU project should pay particular attention to the positive impact of private equity investments in young firms on their innovation activities[14] and on the positive spillover effects that venture capital investments in individual firms have on innovation activities of other firms.[15]

Second, equity (and other forms of capital with state-contingent pay-out streams) provides a **buffer against losses for financial and non-financial firms**. Whenever risks materialise and a firm experiences a negative shock, the value of equity adjusts and dividend payments can be suspended. Equity investors bear upside and downside risks immediately, and larger equity buffers ensure that viable businesses can experience larger shocks without going out of business or cutting investment. Equity thus provides an **ex ante insurance mechanism**. In contrast, standard debt contracts are insensitive to the borrower's situation. If risks materialise, the amount of outstanding debt remains the same. Creditors' claims are protected from losses, and risks are not shared unless the debtor enters insolvency proceedings and risk sharing occurs through haircuts. Insolvency proceedings, however, are often ineffective, create distortions – such as the postponement of investments – and may lead to the liquidation of viable parts of businesses. These factors are particularly prevalent for small and medium-sized enterprises (SMEs)[16], so that more equity finance would be particularly effective for those firms. Firms' optimal capital structure, however,

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[10] Kortum, S., J. Lerner (2000): "Assessing the Contribution of Venture Capital to Innovation", *RAND Journal of Economics, 31 (4)*, pp. 674-692.

[11] Aghion, P., A. Klemm, S. Bond, I. Marinescu (2004): "Technology and Financial Structure: Are Innovative Firms Different?", *Journal of the European Economic Association, 2 (2-3)*, pp. 277-288.

[12] Brown, J. R., S. M. Fazzari, B. C. Petersen (2009): "Financing Innovation and Growth: Cash Flow, External Equity, and the 1990s R&D Boom", *Journal of Finance, 64 (1)*, pp. 151-185.

[13] Popov, A. A., P. Roosenboom (2009): "Does Private Equity Investment Spur Innovation? Evidence from Europe", *ECB Working Paper No. 1063.*

[14] Lerner, J., M. Sorensen, P. Strömberg (2011): "Private Equity and Long-Run Investment: The Case of Innovation", *Journal of Finance, 66 (2)*, pp. 445-477.

[15] Watzinger, M., M. Schnitzer (2014): "Measuring Spillovers of Venture Capital", *Beiträge zur Jahrestagung des Vereins für Socialpolitik 2014.*

[16] Bergthaler et al. (2015): "Tackling Small and Medium Sized Enterprise Problem Loans in Europe", *IMF Staff Discussion Note No. SDN/15/04.*

depends only indirectly on the degree of capital market development and integration so that capital structures are likely to change only slowly in response to the CMU project.

Third, and in a similar vein, higher cross-border equity holdings could contribute to improved **risk sharing across Member States**, provided risks are widely spread and held by those investors that are best suited to manage them. If a certain country is hit by a local macroeconomic shock, cross-border equity holdings would induce an immediate sharing of losses among investors from different countries, thus smoothing the impact of the local shock on income and consumption. In contrast, cross-border debt contracts do not allow an equally effective risk sharing. Before the financial crisis, however, cross-border capital flows in Europe occurred to a large extent through bank credit and cross-border portfolio investments were dominated by debt instruments. Risks that materialised were thus mainly borne by local borrowers. More private sector risk sharing through cross-border equity investments would reduce the necessity for additional channels of fiscal risk sharing, which feature prominently in recent policy debates. The potential benefits of better risk sharing through cross-border equity investment go beyond the Euro area. Non-Euro area Member States are also impaired by insufficient risk sharing. Currently, for example, exchange rate risks in foreign currency denominated loans are mainly borne by local debtors. More cross-border equity investments could thus benefit all 28 Member States.

## Priorities for Reform

Against this background, we see three main **priorities for reforms**:

- As regards the **stock of financial assets** in Europe, the restructuring of private sector debt is currently constrained by a lack of effective insolvency legislation in some Member States. In order to facilitate dealing with legacy assets, a reform of deficient national **insolvency laws** should be envisaged. Insolvency proceedings should ideally allow for a quick recovery of viable businesses and liquidation of unviable ones in a predictable and transparent manner. This would facilitate debt restructurings, allow dealing with legacy assets on banks' balance sheets, and stimulate the reallocation of funds to productive use, thereby aiding economic recovery. More generally, harmonisation of relevant aspects of national insolvency laws would increase legal certainty for investors, in particular equity investors.

- As regards the **flow of new funds into firms**, the CMU should aim at removing existing barriers to the development and integration of European capital markets. In order to reduce frictions for market-based financing in the EU, greater harmonisation of frameworks for securitisations and loan funds could be envisaged. Yet, an ambitious and effective **reform agenda needs to go beyond short-term priorities**. In order to foster the development and integration of European equity markets in the form of equity crowdinvesting, venture capital, private placements, public stock markets, or M&A, the CMU should address – within the competencies of the EU – further-reaching national policies, which affect the structure and integration of financial markets. These include company laws, takeover rules, and aspects of insolvency laws and tax systems. **Corporate governance structures and takeover rules**, for instance, can be impediments to (cross-border) investments and M&A transactions. National **tax systems** usually allow for the tax deductibility of interest expenses, hence providing incentives to finance investments via debt rather than equity. More generally, investors face the risk of sudden changes in key national legislation. This “political risk” leads to risk premia on equity and debt investments that weaken capital market integration and private sector risk sharing. Therefore, the Commission should encourage Member States – for instance through the structured dialogue on the CMU – to ensure legal certainty for capital market investors.
- Finally, to support growth and financial stability, the CMU should **avoid creating additional distortions**. Steering investments into particular asset classes may lead to a misallocation of resources and set incentives to engage in excessive risk taking. For instance, changing risk weights underlying bank and insurance capital regulation in order to encourage the development of specific market segments or asset classes may set the wrong incentives. Furthermore, it should be taken into account that increased market-based financing can result in a shift of activities towards the less regulated shadow banking sector. In order to avoid that such developments pose new risks to financial stability, the effectiveness of the current regulatory and supervisory frameworks should be continuously assessed and the frameworks should be amended if necessary.

## General principles for reforms

In general, **full harmonisation of national regulations may not be needed or possible**. Regulations that shape financial markets are imbedded in a set of institutional frameworks, cultural norms, and deep-rooted preferences. These change only slowly and are not easily affected by regulations and policies. However, harmonisation may not be needed as, for example, very different corporate governance structures can lead to similar economic outcomes.[17] Harmonisation may also not be possible since the principle of subsidiarity has to be respected. At the same time, national policy can have a significant impact on financing decisions, market development, and incentives for cross-border investments. The EU can play an important role by **enhancing transparency about national regulations** that constitute explicit or implicit barriers to the contestability of financial markets[18] and the free flow of capital.

Furthermore, promoting SMEs should not be a policy goal per se but a way of creating a competitive landscape for firms to contest markets and promote innovations. Thereby, it needs to be considered that, **according to the pecking order of finance, different forms of finance suit different types of firms at different stages of development**. Especially SMEs constitute a very heterogeneous group of firms with differing financing needs. Start-ups, which are typically opaque and do not have a track record of repaid debt, usually receive capital from informal sources, such as family, friends, or own employees. When firms leave the seed-stage, they start using bank finance or venture capital to finance growth and investments. Public debt and equity instruments, which come with substantial fixed costs, are used primarily by large, more transparent companies that raise large amounts of capital. Information asymmetries also add a geographical dimension to investors' decision making and firms' financing structures. Local bias is particularly relevant for SMEs and can only to a limited extent be alleviated by the CMU. Which type of barrier to capital market development and integration matters most for which type of firm is ultimately an empirical issue.

Finally, **low levels of investment in some Member States are not necessarily caused by a lack of funding opportunities**. Weak investment and expansion into new domestic and foreign markets can also be driven by low productivity, too little innovation, the absence of profitable investment opportunities, or an insufficient post-crisis deleveraging process in the European private sector that limits firms' borrowing

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[17] Schmidt, R. H., G. Spindler (2000): "Path Dependence, Corporate Governance and Complementarity", *Working Paper Series: Finance & Accounting, Johann Wolfgang Goethe-Universität Frankfurt a. M., No. 27.* Heinrich, R. P. (2002): "Complementarities in Corporate Governance", *Kiel Studies. Springer Science & Business Media*.

[18] Baumol, W. J., J. C. Panzar, R. D. Willig (1982): "Contestable Markets and the Theory of Industry Structure", *Harcourt Brace Jovanovich, Inc.*.

capacities. These issues cannot be resolved entirely by the measures discussed in the CMU project; they require additional, structural reforms. Any initiative targeted at relaxing financial constraints for a particular subset of firms should therefore only be started following a thorough **analysis of the need for action** and should be accompanied by a thorough **impact assessment** meeting the requirements of objective policy evaluation. Before delving into new initiatives, it would be useful to set up a structured process of **policy evaluation** that would allow gaining better knowledge of the causal effects of policy reforms and possible, unintended consequences.