EDITORIAL

EUROPEAN UNION: CAPITAL MARKET FRAGMENTATION AND THE COST OF NON-CMU

In a recent speech, ECB President Christine Lagarde said that when the financing needs of an economic transformation exceed the capacities of fragmented financial markets, developing a capital markets union becomes crucial. This is the point at which the EU has arrived. According to European Commission estimates, financing the energy and digital transition will require more than EUR 700 billion annually. One way of reducing capital market fragmentation is by lowering the cost of information gathering for investors, e.g. through the harmonisation and, where possible, simplification of standards and regulations. This would increase the risk bearing capacity of investors and lower the cost of financing for issuers. This would represent an important step on the road to a much-needed capital markets union.

In a recent, important speech, ECB President Christine Lagarde made a strong call for action to establish a capital markets union. Faced with "*an immense financing challenge, the moment for action is now. So I encourage all of us to be bold and not to let this moment pass*[1]." The financing challenge concerns the huge investment needs in terms of the energy and digital transition. According to the European Commission, "*additional investments of over EUR 620 billion annually will be needed to meet the objectives of the Green Deal and RepowerEU*" whereas the digital transition -bridging the EU's investment gap in this area- is expected to cost at least EUR 125 billion annually[2]. Interestingly, C. Lagarde made a comparison with the US where the development of railroads in the 19th century and the associated financing needs led to the development of capital markets to tap the domestic and foreign investor base. This was necessary considering that the banking system was too fragmented to be able to meet the investment needs throughout the country. According to the ECB President, history teaches us "*that a capital markets union emerges when there is a need to finance an economic transformation that exceeds the capacities of fragmented financial markets.*"

Capital market fragmentation can have many causes. Investors may prefer domestic assets -preferred habitat- because they have a better understanding and an easier access to information. Investors may be less familiar with foreign assets and may consider that the cost of information gathering is too high. International differences in terms of regulations -e.g. insolvency laws- increase this cost and may act as a barrier to international investments. International differences in terms of listing rules may reduce the willingness of companies to tap international capital markets[3].

Due to capital market fragmentation, the investor base is narrower, the capacity to invest in risky assets -equities, corporate bonds, infrastructure, etc.- is lower and the cost of financing through capital markets is more expensive. Breaking down the walls separating markets would broaden the investor base and increase the risk bearing capacity due to diversification effects. As a consequence, financing costs would be lower. An example illustrates this point. Imagine a French investor with a portfolio invested in cash and a domestic risky asset with a risk of 15%. We call this asset A. Then the investor decides to invest in a risky asset -asset B- of another Eurozone country, e.g. Germany. For the ease of the argument, it is supposed that the German risky asset has the same risk and expected return as the French asset but is imperfectly correlated with the latter. Chart 1 shows the risk of the portfolio -excluding cash- invested in two assets with the same risk and expected return. It illustrates the well-known result that the lower the correlation between the two assets, the bigger the diversification effect and the lower the portfolio risk[4].

PORTFOLIO RISK FOR DIFFERENT CORRELATION ASSUMPTIONS

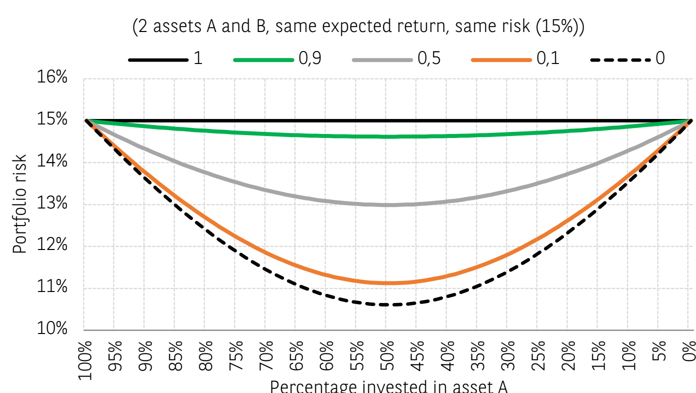

CHART 1

SOURCE: BNP PARIBAS

1 *A Kantian shift for the capital markets union*, Speech by Christine Lagarde, President of the ECB, at the European Banking Congress, Frankfurt am Main, 17 November 2023.
2 European Commission, *Strategic Foresight Report 2023*.
3 For this reason, the European Commission's 2022 capital markets union package consists of legislative proposals regarding "the harmonisation of certain aspects of insolvency laws within the EU in order to increase the efficiency and predictability of frameworks, in particular for cross-border investments" as well as "the listing rules for companies, particularly small and medium-sized enterprises (SMEs), with a view to reducing administrative burdens and red tape and making it easier for EU companies to go public." Source: Capital markets union - Consilium (europa.eu).
4 Expected portfolio risk corresponds to the standard deviation of expected portfolio returns. This depends on the risk of the individual assets of the portfolio, the weights of the assets in the portfolio and the correlation between the various assets.

> Measures aimed at lowering the cost of information gathering for investors would reduce market fragmentation, increase the risk bearing capacity of investors and lower the cost of financing for issuers. This would represent an important step on the road to a much-needed capital markets union.

This risk reduction enables the French return-maximising investor to reduce his exposure to cash and to invest more in risky assets, whilst still respecting his risk limit. International diversification thus increases his risk bearing capacity. This is illustrated in chart 2. For a correlation of 0.8, the investor can raise his exposure to the domestic and foreign risky asset with 5.4%[5]. Despite its simplicity, this theoretical example provides important insights. Firstly, international diversification allows an increase of the exposure to risky assets, thereby increasing long-term portfolio returns. Secondly, this increase benefits both the domestic and foreign firms and ventures that are raising money through capital markets and lowers their financing costs. Thirdly, it enhances two-way cross-border flows: much like French investors, German investors have an interest in tapping the diversification opportunities provided by international diversification.

The importance of these issues is illustrated by a recent European Commission analysis of cross-border venture capital flows in Europe[6]. Venture capital plays an important economic role through the creation of new businesses and jobs thereby fostering innovation and stimulating economic growth. However, compared with more traditional investments, information is even more crucial for this asset class, "*where funds invest into small firms (e.g. start-ups) which are not required to comply with international accounting standards or with disclosure requirements, on top of being systematically affected by high risk. Language barriers as well as regulatory and institutional dissimilarities further exacerbate information asymmetry*[7]." As a consequence, there is a scarcity of cross-border capital flows within Europe -they account for only 23.1% of venture capital investments (average for the period 2007-2020)-, leading to the conclusion that "*most of the investments of European private equity intermediaries remain within national borders*." Clearly, lowering the information barriers and hence the cost of information gathering -e.g. through the harmonisation and, where possible, simplification of standards and regulations in the EU- would be an important step on the road to a much-needed capital markets union.

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RISK BEARING CAPACITY AND CORRELATION

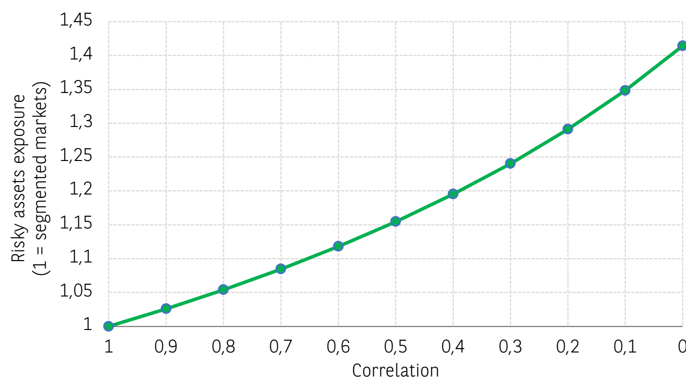

CHART 2

SOURCE: BNP PARIBAS

5 To illustrate this point, suppose an investor has a portfolio of 20% invested in cash and 80% in a risky asset A. Cash is riskless and has zero correlation with the risky asset, which has a risk of 15%. This implies a portfolio risk of 12%. By investing in a second risky asset (B) with a risk of 15% -financed through a reduction of his exposure to A-, this risk declines due to a diversification effect. This allows the investor to increase his overall exposure to risky assets and to reduce his cash exposure. For a correlation between A and B of 0.8, the risky part of the portfolio becomes 84.3% -an increase of 5.4%- and the cash weight declines to 15.7%. Portfolio risk remains at 12%.

6 Pierfederico Asdrubali, *Patterns of Cross-Border Venture Capital Flows in Europe,* European Commission, discussion paper 195, November 2023. A venture capital fund is a pool of dedicated financial capital provided by investors to start-up firms and small businesses with perceived long-term growth potential.

7 Source: see footnote 6.