Company finance in the EU, and the Capital Markets Union

There is no automatic connection between domestic stock market capitalisation and availability of market-based finance for companies. The EU's largest stock markets finance firms that operate internationally.

Capital mobility and cross-border investment already take place between Member States. Pension funds in Estonia, Luxembourg and Portugal hold over 50 percent of their portfolio in foreign investments. Holdings of overseas equities in UK pension funds are higher than holdings in domestic equities.

Between 35 and 50 per cent of SMEs in some Member States employ fewer than ten staff. European SMEs are substantially smaller than their US counterparts, thus lacking the critical size to tap the capital markets.

Post-crisis financial regulation of banks and new regulations being developed for insurance companies have likely contributed to the dearth of financing for EU companies.

Recommendation: The Commission must consider the adverse impact that regulatory measures, both at Union and Member State levels, have had on business finance. Reducing the regulatory burden will go a long way in furthering the goals of the CMU, without the negative systemic consequences of centralisation.

The European Commission has made increasing the availability of finance to European businesses one of its priorities for the next five years. Its key initiative in this regard is the Capital Markets Union, which aims to enable EU companies to raise funds on capital markets more easily through debt securities and equity issuance. The objectives are threefold:

- to unlock investment for European businesses, especially SMEs;
- to make the EU more attractive to international investors;
- to make the financial system more stable by reducing businesses' vulnerability to a bank credit squeeze.

The Green Paper released by the Commission on 18th February[i] argues that increased standardisation and the development of pan-European financial instruments could help to direct finance from the capital markets to a growing number of businesses across all Member States, particularly those where bank lending is prevalent. However, the need for, and thus the success of, the CMU as proposed by the Commission will be contingent on three questions:

1) whether the stark differences in the development of capital markets between Member States are a barrier to company finance, and therefore whether eliminating those differences would improve the status quo;
2) whether there are economies of scale from having similar standards and legal requirements across all Member States, particularly when there is already free movement of capital and freedom of establishment across the Union;
3) whether there are potential unintended consequences from top-down integration of regulation for the availability of finance and systemic risk, in light of the experience of recent regulations such as Solvency II and the AIFMD.

The problem

The February Green Paper outlines some of the perceived challenges to integrated capital markets in Europe. In particular, comparisons are made with supposed greater availability of securities-market-based finance in the United States. It is argued that, if capital markets were as deeply integrated in the EU, billions of euros in extra finance could flow to business.

There is no automatic connection between the level of development of capital markets, as measured by domestic stock market capitalisation, and the availability of market-based finance to domestic businesses, contrary to what the Green Paper implies. For example, London hosts the most dynamic stock market in the EU, yet 70 percent of FTSE 100 profits come from outside the UK.[ii] The same is true for other international financial centres like the Netherlands, Luxembourg – and the US. Companies in these countries tend to be more reliant on capital markets than their counterparts in other Member States, but this is likely because their economies are more integrated with global financial markets.

Moreover, there is little reason to believe that capital mobility is hindered by a lack of standardisation. Any EU insurance company, pension fund, bank and hedge fund is able to operate across all Member States and move its capital freely. Pension funds across the Union hold substantial investments in foreign securities, with Estonia, Luxembourg and Portugal investing over 50 percent of their portfolio abroad.[iii] Another example is the UK, where pension funds hold more money in international than in domestic equities.

Stock markets in any one country can provide finance to companies operating on an international basis. The problem would appear not to be the absence of a unified EU capital market, but the fact that many countries do not have the liberal environment necessary for their capital markets to be connected to international markets, including those in other EU countries. This explains why some economies with comparably small domestic markets, such as Switzerland, Singapore and Hong Kong, have evolved into financial powerhouses. It is unclear how further integration as outlined in the Green Paper would help businesses in other Member States in the absence of cultural, institutional and domestic-policy changes.

Market- vs. bank-based finance for European SMEs

Why are EU SMEs, particularly those in some Member States, so reliant on bank finance? This will determine whether, and how, the CMU can enable them to obtain finance from the capital markets. As the Commission has acknowledged, some of the factors at work are historical and cultural and therefore unlikely to be substantially affected by the policy changes envisaged in the CMU. Yet a look at the profile of SMEs across Member States, and in comparison to their US counterparts, shows how differences in SME size have shaped the status quo.

Micro enterprises with fewer than ten staff (which account for nine out of ten SMEs[iv]) are particularly prevalent in southern and eastern Europe, accounting for between 35 and 50 percent of non-financial business employment compared with less than 25 percent in France, Germany and the UK.[v] The picture for small and medium-sized businesses is somewhat less heterogeneous, although even there employment shares range from the high twenties (percentage points) in the Baltic states to the lower teens in Greece and Poland. The differences with the United States are also vast. The US employment ceiling for qualifying as an SME is 500, compared to 250 in the EU. Even so, small businesses account for just under half of US private-sector employment,[vi] against more than two-thirds in Europe.[vii]

The prevalence of micro and small enterprises in the EU suggests that many companies lack the critical size required to tap capital markets, especially when compared with their much larger American counterparts. The large variation in average SME size helps to explain at least part of the divergence in bank- vs. market-based finance, and it may also be why a significant proportion of European SMEs lack any sort of credit scoring. Yet, without a radical reduction in the transaction costs associated with securing capital markets finance, many EU SMEs are unlikely to turn to these. Financial innovation in the form of peer-to-peer and peer-to-business lending may lead to such a positive supply shock, but a review of the Prospectus Directive by itself (while it should be welcomed for other reasons) is unlikely to do so.

Regulation and its impact on capital markets finance

The 2008 financial crisis spurred a raft of regulatory reforms which have had, and will continue to have, fundamental implications for the EU financial sector.

Solvency II, the Directive regulating insurance companies from 2016, aims to ensure adequate provision for risk by introducing minimum capital requirements (MCRs) and solvency capital requirements (SCRs) that insurers must target.[viii] Yet the capital charges associated with different (and differently graded) types of debt encourage purchases of sovereign bonds and covered bonds issued by banks, at the expense of other forms of debt. This not only undermines the goals of the CMU by making corporate debt less attractive to insurers, but it could also increase systemic risk by promoting purchases of risky sovereign bonds. Adding infrastructure debt to the list of favoured bonds, as suggested in the Green Paper, might again induce concentration in this particular segment, making the financial system more vulnerable to shocks. At any rate, while the need for complex statutory capital requirements demanded by Solvency II is disputable, capital charges for infrastructure bonds should be determined on their own merits and not by the promotion of an unrelated agenda.

The Alternative Investment Fund Managers Directive (AIFMD) is also highly relevant to company finance, as it applies to hedge funds, venture capital funds and other providers of risk capital not subject to the UCITS Directive. While it introduced an ‘EU passport’ for AIFMs to be able to market all across the Union, additional disclosure and marketing requirements have increased compliance costs (particularly for private equity and venture capital firms), reducing the attractiveness of the EU as an investment destination for risk capital.[ix] There is a real possibility that the AIFMD will lead some non-EU providers to leave Europe altogether, with negative implications for investor choice and business finance, especially considering that only 5 per cent of global hedge funds were domiciled in the EU as of 2009.

Additionally, new and stricter bank regulations, most significantly Basel III but also the Financial Transactions Tax (FTT) currently being negotiated by eleven Member States, will also have an ongoing and measurable impact on financial markets, not just in the EU-11 but across the wider European financial sector.[x]

How to improve company finance in the EU

- Review Solvency II and the AIFMD for their impact on investment by insurers, pension funds and risk capital providers. Consider the likelihood of post-crisis regulation increasing systemic risk in financial markets by creating artificial incentives for particular types of investment.
- Relax the Prospectus Directive to make it easier for SMEs and start-ups to raise funds on capital markets.
- Give up plans for a Financial Transactions Tax in the EU-11. Most impact assessments point to negative effects on GDP, and the FTT also raises administrative and legal problems.
- Promote the take-up of capital-based pension plans, to complement and gradually replace pay-as-you-go state pensions. Savings from these plans will infuse much-needed funds into capital markets.
- Increase equity as opposed to debt financing, encourage the introduction of an Allowance for Corporate Equity (ACE) by Member States, which would reduce the tax advantage of debt for companies.[xi]
- Promote liberalisation and tackle the impediments to the flow of capital arising from national regulations, rather than trying to unify regulation at the EU level.

[i] European Commission, “Green Paper: Building a Capital Markets Union” (Brussels, 2015).
[ii] Jim Levi, “The changing face of the FTSE 100”, *Moneywise*, 25th Aug 2011. http://www.moneywise.co.uk/markets/corporate-news/the-changing-face-the-ftse-100.
[iii] Organisation for Economic Cooperation and Development (OECD), “Pension markets in focus” (Paris: OECD, 2013), 23. Indeed, according to the OECD, “foreign investment [by pension funds] tends to be greater in [Eurozone] countries.”
[iv] European Commission, “Facts and figures about the EU’s small and medium enterprise”, http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/.
[v] Manfred Schmiemann, “Enterprises by size class – overview of SMEs in the EU” (Brussels: Eurostat, 2008), 5. The figures are from 2005.
[vi] Office of Advocacy, Small Business Administration, “Frequently asked questions” (SBA, 2012), 1.
[vii] Press release, “Do SMEs create more and better jobs?” (European Commission, 2012).
[viii] Amarendra Swarup, “A well-intentioned folly: the macroeconomic implications of Solvency II”, *Economic Affairs* 32.3 (October 2012), 19.
[ix] Laurence Copeland, “The EU proposals for the regulation of alternative investments”, *Economic Affairs* 32.3, 33-34.
[x] PriceWaterhouse Coopers, “Financial transaction tax: the impacts and arguments – a literature review”, 8-11.
[xi] Cf. Serena Fatica, et al. “The debt-equity tax bias: consequences and solutions”, Working Paper 33 (Brussels: European Commission, 2012), and Ruud A. de Mooij and Michael P. Devereux, “An applied analysis of ACE and CBIT reforms in the EU” (Springer, 2010), for a review of the impact of ACE reforms.

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