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Capital Markets Union: A Work in Progress

Quick and high impact measures for the Capital Markets Union

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Capital Markets Union¹ has three objectives. The first objective is to improve access to finance for all businesses but especially SMEs; the second is to increase the share of capital markets in the funding mix of the real economy; and the third is to make capital markets more effective and integrate them more closely across borders. This paper examines the best impact measures for the Capital Markets Union to proceed successfully.

INTRODUCTION

The European Commission's Capital Markets Union (CMU) has three objectives. The first objective is to improve access to finance for all businesses but especially SMEs; the second is to increase the share of capital markets in the funding mix of the real economy and the third is to make capital markets more effective and integrate them more closely across borders.¹

The CMU initiative was launched on 18 February 2015 with the issuance of a Green Paper entitled *Building a Capital Markets Union*. The way in which the Commission is approaching the issue, by looking both to what the private sector can provide as well as what the public sector should do, and

selecting a staged approach to the project, to gather momentum for it and not to have to wait to do something until everything has been done, is a positive sign.² The European Parliament also adopted its first (and probably not the last) resolution on the CMU in July, giving a cautious welcome to the Commission's thinking³. Both industry and civil society have shown remarkable interest in the subject with 422 responses to the Commission's CMU Green Paper⁴.

This article is based on a unique exercise aimed at bringing together the end-users of the CMU to design practical solutions to the CMU: on 19 March 2015, the Konrad Adenauer Foundation UK office and Standard Chartered Bank organised a CMU simulation game to develop and test CMU solutions that can be implemented by 2019⁵. The game was hosted by KPMG and gathered private and public sector experts. There were 15 teams (trade associations, NGOs and academics) proposing specific policy solutions for the CMU. The proposals were evaluated by experts from the "end users" of the CMU (investors and companies). Alongside the evaluators, there was a high-level jury of politicians and officials. Finally, a small European Parliament and Council team tested the political feasibility of the proposals. Three policy areas were deemed by evaluators and jury members to make the biggest positive impact on Europe's economy within the

next four years. First, reviewing the structure of financial intermediation in Europe to ensure long-term equity funding for the economy; second, moving mid-sized firms and high-growth start-ups from bank lending to capital markets and facilitate access to equity funding; and third, balancing the need for transparency from investors with measures to allow for flexibility for investors.

The EU needs to have more integrated, efficient, and effective financial markets. ⁶The economic and political motivations for proposing a CMU are clearly visible. The name is more symbolic than real, as the substance falls short of achieving a fully unified capital market across the EU. Economically, CMU can help to bolster firms' access to capital beyond the traditional bank-centred focus prevalent in Europe. Even more important is the political message: the CMU, however symbolic, is a commitment to the Single Market, and to keeping the UK on board. The City of London stands to benefit from a continent-spanning market, which would facilitate transactions and promises economies of scale. It is therefore no surprise that the CMU initiative was welcomed by British business groups and politicians, including Chancellor George Osborne. Seen from this perspective, fulfilling the original objective of the Treaties of Rome on the free movement of capital chimes with British proposals for a more competitive EU. Many see it as a clever move to help overcome the various confrontations between Europe and Britain on financial services, which are not just limited to political disagreement concerning financial regulation, but increasingly courtroom battles over financial laws. ⁷

Finally, and maybe most importantly, the CMU is a step that signals a return to a more traditional EU activity of 'market building'. In the long history of EU efforts to promote a single market for capital, the EU has always been strong at playing the

role at which it is most effective: to facilitate exchange of capital flows across borders, by removing obstacles to cross-border investment.

I. THE STRUCTURE OF FINANCIAL INTERMEDIATION IN EUROPE

The funding model of a country's economy is a result of its historic development that cannot be changed quickly. It has cultural components (e.g. equity culture, risk taking or levels of trust in society) and is mutually dependent on other policy areas, like pensions, social security or taxation.

Europe's bank dependent funding structure and European citizens' preference of debt over equity products will not change for now.

Savers in Europe prefer to invest in debt products, which they consider safer (due to the high deposit guarantee levels), while savers in the US prefer and are also forced to invest more in equity, private insurance and pension products. European households have much less assets to invest on average than US households. And the wider social security nets (state pension and sickness insurance) in Europe remove some of the pressure on individuals to invest in private insurance and pension products. European pension funds provide €4.3tn in investable assets and invest 37% of their portfolio in equities, vs €14.9tn and 53% respectively in the US.

European countries are of course not uniform in their preferences and there are outliers to the average figures. The simulation game produced an important comparison of Swedish and German equity culture. About 80 % of Swedes invest directly in funds privately and 60 % of children in Sweden have savings in funds. This is much higher than even in the US, where 49% of families hold stocks. On the other hand, only 13% of Germans held shares or equity funds in 2014 and this has

declined by one-third since 2001⁸ due to perceived market failures.

These decisions are embedded in social and political preferences on both sides of the Atlantic, which are not about to change. Discussing them mostly exceeds the remit of the CMU. Promoting equity culture can help to make some improvements, but it seems unreasonable to expect radical changes in behaviour.

We must be aware of the direct impact these different saving preferences have on maturity transformation by financial intermediaries to turn savings into funding for corporates. Investments by US savers have a longer maturity than the bank deposits preferred by most EU savers – therefore it is easier for the financial system to provide for long-term investments in the US.

The post-crisis prudential reforms limited both private equity (as equity investors or as debt financing) and long term investments by banks. At the same time, Solvency 2 is limiting the ability of institutional investors to invest in equity. All these tendencies work against the availability of long-term equity funding for the economy.

II. MID-SIZED FIRMS AND HIGH-GROWTH START-UPS ARE THE “SWEET-SPOT” OF CMU

For the CMU to have an impact on investments on the short term, it should focus on moving mid-sized firms from bank lending to capital markets (direct placements, securitisation) and helping more young, high-growth firms to access equity funding. Bank balance sheets are a much scarcer commodity today due to recent regulatory changes. Firms of all sizes are competing for access to these reduced balance sheets, but they are impacted in different ways.

Large firms draw most of their funding from capital markets and are thus less bank-

reliant. They are struggling however with the reduced liquidity in bond markets as wholesale banks move out of market-making.

In its 2014 [corporate cash survey](#), the Association of Corporate Treasurers showed that the financial crisis forced companies in general to increase their cash-holdings⁹. They saw this cash pile as a buffer against the risk of reduced bank lending and political uncertainty. While 72% of treasurers are now expecting to run this pile down, almost 40% of them expect to hold more cash than they used to do.

Smaller firms are totally bank dependent and will remain reliant on bank finance. Relieving the pressure on bank balance sheets from larger firms could allow bigger access for these smaller firms to limited funds. Although a jury member was sceptical whether capital freed in banks via securitisations would be used to create more lending to SMEs.

Mid-sized firms are mostly bank dependent at the moment, but they are slowly turning towards market funding like direct placements or equity markets. Due to their larger sized loans, mid-sized firms could also profit from a more active securitisation market, provided that securitised loans are not retained and used for collateral at the ECB, but are placed on the market.

How to reduce funding costs for mid-sized listed companies?

85% of all companies quoted on EU stock exchanges are small or mid-cap companies, but EU regulation is made assuming that all quoted companies have the same resources as the Eurostoxx50 e.g. one German DAX30 company employs 9 people to do its non-financial reporting alone; in smaller companies the Finance Director or Company Secretary often acts as the Investor Relations contact as well – there is no separate department.

Reduce administrative costs of listing by 30-50%¹⁰

- Step I: Regulatory freeze on legislation affecting issuers until 2019
- Step II: Perform cumulative impact assessment of financial regulation on issuers only
- Step III: Based on the results of the impact assessment, and responses to the CMU Green Paper, draw up proposals to reduce regulatory & administrative burdens on quoted companies e.g. changes to Prospectus directive below
- Step IV: Consider new better regulation provisions for smaller issuers—new SME Test for Issuers

Revise the Prospectus Directive

- Introduce the concept of an IPO and Secondary Public Offer
- Create a Proportionate Prospectus for Secondary Public Offers on regulated markets
- Ensure that the Proportionate Prospectus for Secondary Offers applies to all types of secondary public offer
- Address the process of the national competent authority approving a prospectus
- Increase the thresholds under which a prospectus does not have to be produced
- Exempt offers carried out under the Takeover Regime from the prospectus regime
- Create a specific prospectus regime for SME Growth Markets

How to encourage institutional investors to invest in mid-sized companies:

In order to facilitate much needed investment by Europe's institutional investors into small- and mid-sized companies, the European Commission encourage a pan-European debt private placement market ("**PEPP**"). This should include both a loan-based and a note-based PEPP.

There are three national private placement markets in Europe that can have significant scale on the short term. The German loan-based schuldschein market is a long-established and well-developed market, having issued around €8 billion worth of loans in 2013¹¹. The French private placement market, which caters for both loan and note placements, remains primarily a domestic market but has experienced rapid growth from virtual non-existence a few years ago to facilitating €7 billion worth of issuance in 2013. The UK private placement market has historically been limited in scale. However, this may be set to change, in part due to a new wide exemption from withholding tax for interest on private placements.

The EU should to encourage and facilitate growth and development of Europe's existing private placement markets initially. Over time, with the assistance of more standardised documentation where possible there is scope for building wider and deeper debt PEPP.

Loan-Based (Debt) PEPP

The EU would benefit from more consistent legal documentation for loan transactions for SMEs in particular. In particular a common approach to assignment and transfer would assist and help to achieve a smooth secondary market. There are limits to the capacity of different jurisdictions to run such markets. It is likely that the larger EU member states are better placed to create them - but, in such

circumstances, the markets should be open to corporates/borrowers from all over the EU and such corporates are likely to gravitate towards those markets which best serve their own needs both financially and geographically.

Note-Based PEPP

Cost is the main impediment to SMEs issuing notes through a private placement. Increased legal costs, various agent fees and the potential requirement of a prospectus can significantly increase the cost of a issuing notes rather than granting loans. Therefore, in order to increase the number of SME note issues in Europe, reducing the borrower-side costs is a priority.

Unlike the loan market, the note market is regulated at EU-level by the Prospectus Directive and MiFID. In many cases, a note issue on the private placement markets will fall within an exemption from the need to produce a prospectus. However, due to the high costs associated with producing a prospectus, the Prospectus Directive exemptions should be immediately widened to ensure that they are invariably available to SMEs seeking to issue in the private placement market. The "qualifying investor" base should be widened to ensure that most expected PEPP market investors are included and the "minimum note denomination" threshold should be lowered.

How to boost funding to job creating start-ups?

High-growth, high-risk start-ups are a unique sub-group of smaller firms. These young firms are often too risky for bank lending. UK data show that in the early stage there is a very high risk of business failure with only 52% of new businesses surviving for 3 years and 28% surviving 7 years. Instead of bank lending, these start-ups normally draw financing from venture capital and in times of abundant funding they tend to "hoard cash", waiting for investment opportunities. Compared to the

US, these start-ups are often facing difficulty to access equity capital in the EU¹². The sources of equity funding for SMEs are underdeveloped in Europe compared to the US: US PE and VC funds had €488bn to invest in 2013, compared to €245bn in Europe¹³.

Proposals to channel venture capital investment to high-growth start-ups:

- Develop a pan-European angel investor marketplace for these start-ups - what you might call pre Capital Markets Union. "High growth businesses in particular struggle to access cross border funding, and often go to US for investment. Part of the solution must be to remove barriers to cross border business angel activity such as contradictory rules in fiscal incentives which prohibit a single market in Business Angel finance."
- Facilitate VC investing through a centrally managed initiative similar to the US Small Business Investment Company that provides financing in the critical \$250,000 - \$5m range in the form of subordinated loans or equity investment.
- Crowdfunding helps start-ups to overcome the demand of capital for early-stage (equity) financing. Existing divergent national regimes resulted in a fragmented European market. Harmonisation to overcome this could follow either of two options: A limited harmonisation option would involve investor self-certification, a cap for investors/offerings, and investment information on a pan-European basis. Full harmonisation would introduce a European passport for (equity) crowdfunding platforms. This would only require crowdfunding platforms to obtain one single authorisation/registration from any competent authority within the EEA to be able to offer their services on a cross-border basis throughout the whole EEA.

III. INVESTOR'S DILEMMA

The discussion highlighted a potential conflict between the fiduciary duty of asset managers and possible “political” requirements regarding their investments. There was clear agreement that investors should consider the interests of wider society not only those of their beneficiaries. The question was whether a conflict between these two objectives may arise and in this case which one should prevail? In practice, this has raised several sub-questions: Should investors managing the savings of EU citizens invest in EU assets, especially in equities? (As one of the participants pointed out, European pension funds invest 37% of their portfolio in equities vs 53% in the US.) Should they follow a socially responsible investment strategy against absolute returns? And most importantly should they be mandated by law to follow pre-defined investments strategies or should this be achieved on a ‘comply or explain’ basis with adequate transparency.

Participants mostly agreed about the need for transparency from investors. But there were disagreement about the administrative burden of too much transparency and about mandating inflexible investment strategies, without consideration to changing market environment and the wide variety investors on the market. Some participants warned policymakers to be conscious of the outsize financial risks this may create in the future. Practical policy answers to these questions should

- strike the right balance between obligation versus “comply or explain” (asset managers and evaluators thought the comply or explain approach worked well);
- define the right level of transparency and disclosure on investment decisions that doesn't place unnecessary burden on small and mid-sized companies (most participants thought that reporting burden of smaller companies should be further reduced instead of increasing it);

- global ESG standards (like UNPRI or Equator Principles) already exist for sustainable investment – the EU should embrace these standards rather than seeking to create new ones;
- define the level of control for beneficiaries over investment decisions (which should be linked to issues of financial literacy).

Should asset managers be mandated to pursue an ESG compliant investment strategy over absolute returns?

One of the participants argued that capital market participants and investment products should be mandated by law to consider environmental, social and corporate governance (ESG) factors: it was “disappointing that ESG has been included in the CMU Green Paper as an afterthought: the only mention is as an emerging investment category”.

Reactions to this were mostly negative. As one of the evaluators pointed out: “A pension fund's duty is to meet the needs of its pensioners by choosing assets from around the world. It is not an arm of the state, it has a fiduciary duty to its beneficiaries.” Another evaluator has argued that this would result in lower returns for beneficiaries: “*We can choose a return of x by investing on the basis of economic criteria only or we can opt for a return of 0.x if we invest in a socially responsible manner.*”

Answer from an investor emphasized that “*a company exploiting its employees, its local community, is not a good investment as it would hurt its cash flow on the long term*”. However this investor thought that “comply and explain” is sufficient for ESG objectives and investors should not be mandated by law to follow these objectives in their investment decisions.

Is more transparency the solution?

A participant quoted the Kay Review¹⁴ stating the decline in ‘relationships of trust

and confidence' in favour of a highly intermediated investment chain with misaligned incentives at every step. Institutional investors with long-term liabilities judge performance and award mandates over short-term horizons. One of the evaluators agreed that markets were indeed inefficient, *"they favoured short termism over long termism by nature"* and they did not properly recognise or reward companies who make long-term plans and investment, including on sustainability. This was contradicted by one of the investors, arguing that *"a company exploiting its employees, its local community, is not a good investment as it would hurt its cash flow on the long term"*.

Participants mostly agreed that transparency and accountability were good for a sustainable investment ecosystem: *"Investors need to know that they are under scrutiny. More accountable and transparent investors make better investment decisions."* They can help change short-termist culture and reward good behaviours. A participant argued that this should include requiring investors to publish voting records and rationales, meaningful, substantive RI and engagement policies and outcomes that they know will be scrutinised by beneficiaries, civil society and the media will encourage more responsible behaviour.

Do we need more rights for individual investors and do they have adequate financial literacy to exercise these rights?

It was proposed that the IORPs Directive, currently being reviewed, could give savers rights to be consulted about a scheme's investment policies; to access annual reports explaining how their pension fund or insurance company has implemented these policies and is managing long-term risk; to elect representatives to governing committees; and to receive responses to reasonable requests for information. The aim is not to bombard all savers with lots of information which many would not use but make the information available to those who do want it and to civil society.

An asset manager thought that lack of trust in the financial system and lack of financial literacy made it difficult to hold reasonable conversations in public. There was also concern whether smaller listed companies should be subjected to detailed ESG reporting requirements. As one evaluator argued: *"it takes a lot of time for companies to do it. It's easy for big companies, but for small companies it's very demanding. Also, it's less useful as small companies are often deeply linked into the local economy and even retail investors can get to know them much more easily."*

Skewed regulatory incentives?

Similarly to the new capital requirements discouraging banks from long term infrastructure and equity investments, Solvency 2 impedes investment by insurers into equity markets. Regulators must be aware of the impact of their policy choices, therefore more efforts would be required to produce a cumulative impact assessment of prudential rules on investment, growth and job creation.

In the light of low interest rates and anaemic growth in Europe, regulators should review Solvency 2 to allow for more flexibility to investors.

IV. A CMU THAT REMAINS OPEN TO THE WORLD

The European Commission regularly cites that 90% of economic growth is now coming from outside of Europe¹⁵. As the EU's current trade strategy argues "we need to seize the opportunity of higher levels of growth abroad, especially in East and South Asia.¹⁶" But the ability of European companies and consumers to take advantage of this growth may be limited by the current regime for assessing equivalence. Therefore the Commission should set out proposals for a new equivalence regime in its forthcoming CMU action plan. One of the objectives of the CMU should be the development and putting into practice of a new regime for assessing equivalence with

partner countries. This needs to be both pragmatic and predictable, providing a coherent approach in the equivalence determination. The regime needs to take account of the different regulatory environments and approaches in partner countries, eschewing a one-size-fits-all approach, and instead providing for flexibility on the basis of agreed principles. Elements of this new regime should include:

- A principles-based assessment, not a line by line tick-box exercise. Equivalence needs to be assessed from the perspective of the objectives the regulatory regime being assessed is designed to achieve and the success with which it does so. A line by line assessment is not only inappropriate, but also risks missing whether or not the regulation in question delivers the outcomes it is intended to. Where possible, and to make this easier and coherent, equivalence should be assessed from the standpoint of internationally agreed standards, which all parties should be working to adhere to.
- EU regulation orientated to international standards, both in Level 1 and in interpretation at Level 2. In order to take the lead in reversing the trend towards disaggregation of capital markets, the EU should make clear that it will orientate its own standards to international ones where they exist, both at level 1 and when setting out how the rules will be interpreted at level 2.
- The criteria for how equivalence will be assessed should be clearly defined at level 1, thus enabling international partners to more effectively plan ahead, and so avoid gaps in access to markets. Similarly, there should be clear guidance at level 1 on how regulation should be interpreted at level 2 to make future regimes predictable and enable partners to plan ahead.
- There should be formalised regulatory dialogue, as legislation is being devised, progressed and finalised, so that partner countries can better understand EU rules, and contribute any ideas that may avoid measures that may inadvertently

undermine the flow of capital in and out of the EU. These regulatory dialogues should be replicated by the ESAs at level 2, too, to ensure coherent supervision.

- Clear timelines should be given to the equivalence assessment process, and a process of prioritisation needs to be defined. This should be based on the dual principle of (i) working with jurisdictions that are already very close to the EU's regimes (the low hanging fruit,) and (ii) those with the most significant trading relationships (the ones likeliest to yield the most benefit to EU citizens and businesses.)
- As part of its mission to promote growth and jobs, the EU authorities should proactively identify who these jurisdictions are and engage with them, rather than waiting for them to contact the Commission. It is in Europe's consumers and businesses' interests for these equivalence assessments to be completed, and the EU authorities have it within their competence to initiate the assessment.
- The equivalence assessment has to be non-discriminatory, and, where partners are equivalent, non-discretionary. The Commission should comply with ESMA determinations of equivalence, and do so promptly.

Finally, the new equivalence regime should ensure the principle of no repeat judgements. For example, if another country's competent authority is deemed to be independent for the purposes of the equivalence assessment for one piece of EU legislation, it should be deemed to be so for them all – notwithstanding any subsequent changes in its status, of course.

V. THE PROBLEM WITH MARKET MAKING

While there is no single measurement for liquidity, there is general agreement that this has been reduced since the financial crisis. The Committee on the Global Financial System brought together 29 senior officials from 22 central banks to assess changes in

market liquidity. It's report¹⁷ shows that market liquidity is currently at a premium, and volatility shocks and market dislocations may become more common.

A participant argued that public debt and equity markets benefit fully from the essential role played by intermediaries in bringing issuers and investors, users and providers of capital together, facilitating risk management, and ensuring continuity of supply and demand by use of their own resources (i.e. balance sheet) to make markets.

Recent regulation has both significantly reduced the incentive for existing liquidity providers to 'make markets' and increased barriers to entry for any alternative players.

How to improve market liquidity?

As a first step a cumulative impact assessment should consider the barriers to the provision of liquidity through market making:

- Market transparency in MiFID 2: Reduction in market-making in less liquid instruments if firm quotes need to be made available to multiple parties (pre-trade) and large transactions require immediate disclosure (post trade). The calibration of what stocks are liquid or illiquid for the purposes of the transparency requirements must strike a careful balance to achieve transparency without putting at risk the capacity or willingness of intermediaries execution in size in thinly-traded stocks
- CSDR seeks to improve market discipline and certainty of settlement and risk mitigation in EU markets by punishing failed settlement and imposing buy-in against actors who fail to deliver. However, it is equally important that CSDR regime takes adequate account of the market characteristics of SME and illiquid securities to avoid adversely impacting the liquidity profiles of these securities to the detriment of all market participants. This could

adversely impacts illiquid securities and exposes market makers to considerable fines

- Central clearing rules in EMIR: Shift in market-making activity from non- to centrally-cleared derivatives as well as from OTC to exchange traded derivatives, reinforcing liquidity bifurcation. Decline in inventories given higher cost of hedging. Reduced market-making in derivatives in particular for non-centrally cleared instruments

- Decline in inventory as hedging costs rise due to the Short Selling Regulation: The decision to define exempt market making activities by reference only to activities on a trading venue, means market makers cannot use the exemption in relation to trading OTC derivative transactions. This is particularly significant for some sovereign debt and most sovereign CDS instruments where dealing occurs away from trading venue because these venues lack the capacity to cope with trading large bespoke and generally very illiquid instruments.

A proposed Financial Transaction Tax: the cascading effect of taxation risks depressing trading volumes in low-margin market-making transactions making them completely illiquid.

VI. SUPPORTING LONG-TERM INVESTMENT

One of the participants suggested to mandate prudential regulators to promote long-term investment and funding for SMEs as an objective on equal footing with financial stability.

Banks, insurers and pension funds are the biggest sources of funding, but bank and insurance capital rules discourage long-term, infrastructure, equity and SME financing. Banks in particular have more data than anyone else – they will still need sound underwriting practices, but if the prudential rules effectively ration banks' lending, they may cherry-pick the best creating an adverse

selection problem for other potential providers of finance.

There are valid reasons for designing prudential rules in this way, including the lessons from the financial crisis. Prudential regulators may not wish to have an objective to promote the flow of funding as they may feel unable to properly balance this against safety and soundness objectives. However, without addressing this, the CMU may only have limited success if prudential regulation will continue to create new barriers.

Another participant proposed a pan-EU real-time database of infrastructure projects built on 28 Member State infrastructure databases. This would increase the visibility of infrastructure demand through an infrastructure pipeline. The European Commission's proposal to establish a European Investment Project Pipeline is welcome and the database currently maintained by the EIB of projects which have been submitted to it for financing goes some way to address this need, but is not sufficiently visible or comprehensive. A fully pan-EU infrastructure database which standardises key metrics such as funding requirements, contractual structures and environmental requirements would enable greater investment by the private sector. Projects included on the central database could be submitted by individual companies as well be drawn from the 28 Member State databases.

VII. SMES ARE CRUCIAL FOR THE SUCCESS OF THE CMU – BUT NOT SUCH A LOW HANGING FRUIT AS MANY HAVE THOUGHT

There was wide agreement among participants that SMEs rely overwhelmingly on banks for finance. And, surprisingly to some, there is more money available to European than to US SMEs: €2.0tn vs €1.2tn in outstanding stock, but the majority of EU financing is bank lending (€1.4tn vs €0.5tn)¹⁸. Micro and small firms are too small for bond markets, thus they are

dependent on bank lending. Bank lending to SMEs often involves comparatively small amounts that no other market participant would be willing to provide (except for crowd-funding platforms). Average SME lending in the UK is around £10,000, which is very small even for retail banks.

Small, high-risk start-ups may use non-bank funding (mostly equity finance from venture capital), but they only represent 1% of the total SME population. (See discussion on the CMU “sweet-spots”)

This is unlikely to change any time soon. Some participants have called for more standardised capital market solutions for SMEs, but nobody could present a specific operational idea on how small firms could draw funding from capital markets. The CMU could make a difference by

- moving mid-sized businesses (the upper band of the SME category, depending on definition) to the bond and equity markets, thus allowing more access for small firms (the vast majority of SMEs) to bank balance sheets;
- encouraging more venture capital funding for young, high-risk firms that create an outsize proportion of new jobs (firms less than 3 years old only account for 17% of total employment but create 43% of new jobs);
- resolving informational frictions in SME markets by EU wide credit registers and harmonised accounting standards (more difficult to achieve than most participants expected);
- improving access to finance for the smallest SMEs by encouraging more cross-border lending and cross-country integration in the SME lending market;
- providing more information sources on funding options to SMEs, increasing financial education and mentoring.

Some often cited solutions that are unlikely to work

One of the most surprising conclusions concerned SME credit information: central credit registries and accounting harmonisation.

Most people who intervened stated that harmonising SME accounting standards would be an almost impossible task by 2019 (see below in VIII/5). And without such harmonised reporting standards, a simple cross-border comparison of financial information remains difficult.

Jury members voiced scepticism on the usefulness of Central Bank based credit registers in general and the often cited Banque de France register in specific as a tool for supporting investment decisions to SMEs (see below in VIII/4). It was emphasized that Central Bank credit registers have developed primarily as prudential supervision and monetary decision making support tools¹⁹ and not as sources for investor information. These registers distribute data on existing loans and even if all legal barriers could be solved, would not serve as an adequate tool for deciding on finance to new clients. The work undertaken at the ECB in establishing a Euro area credit register (AnaCredit) is also aimed at collecting information on credit exposures and credit risks to support the macro and micro-supervisory tasks²⁰. Another jury member expressed his fears that SME loan securitization can become the next sub-prime crisis. While securitisation should be encouraged, in an economic downturn securitised SME loans will be the first to default.

What could work: voluntary credit registers and SME benchmarks

Under the existing data protection rules, the only way forward for credit registries seemed to be a voluntary credit register for larger SMEs considering external market based finance. A participant also remarked

that whether comparable credit information (even if achieved against the odds) will not in itself change investors' risk appetite and will not lead to greater funding of SMEs.

One of the evaluators remarked that investors "are looking every week into moving into smaller investments but have no benchmarks for pricing or guidance on the sector. An SME benchmark would help not only flow of finance but getting pricing right."

VIII. IMPROVING THE FLOW OF FINANCE TO "TRADITIONAL" SMES

Participants made several proposals on improving the flow of finance to the bulk of SMEs. In order to correctly introduce the variety of ideas, we decided to allocate a separate chapter to these.

1. Relieving pressure on bank balance sheets

The approach welcomed by evaluators was to focus on relieving the pressure on bank balance sheets from larger firms and thus allow banks to lend more to smaller firms. However there is no guarantee that the freed up capital will be lent to smaller firms, unless there is a business case for banks to do so – which takes us back to reducing capital requirements for SME lending without endangering financial stability:

Participants agreed that improving securitisation markets, including the securitisation of SME loans, will help. Though it's linked to this, there was no discussion on the usefulness of Central Bank provision of cheap funding to banks for lending to SMEs (the Bank of England's Funding for Lending scheme²¹ or the ECB's TLTRO). The currently existing securitisation markets in Spain and Italy are characterised by high-retention rates (for use as collateral with the ECB) and low rates of placement on the market.

2. *Standardization of loan terms*

Another idea presented, but not widely discussed, was to drive a greater standardization of SME loan terms. This would allow SMEs to compare lending conditions across different banks. It remains unclear if this would be feasible at domestic level and more research may be required whether such initiatives already exist in individual Member States. Comparable loan terms cross-border seem unfeasible considering the tiny cross-border lending and the remaining huge differences in retail markets in the EU.

3. *The real lesson from the US about “interstate lending”*

Participants suggested that “EU Regulation should focus on lowering entry barriers for new lenders, including non-banks, into local and national markets, thus encouraging diversity and competition. This should also make local economies more resilient against local or national bank failures. *For CMU to work it will therefore be paramount to encourage genuine cross-country integration in the retail/SME banking sector by reducing the de facto barriers to foreign entry and by encouraging cross-border consolidation of banks.*” There are interesting lessons here from state-level banking deregulation in the US and from banking sector liberalisation of the post-socialist EU Member States. A cross-border retail banking market can reduce the price and increase availability of credit for non-financial firms.

4. *A pan-EU SME credit register – sounds good but difficult to realize*

In many European countries credit data are shared through a central credit register (CCR), owned and operated by central banks or financial supervisors. Participants suggested an EU-wide CCR and harmonized credit-scoring standards.

Some jury members highlighted that achieving harmonised credit registries would

be challenging due to differing bankruptcy, tax and accounting laws in EU member states. Also, existing market practices are very different across the EU: some countries, like the UK, use private credit referencing agencies, while others use bank databases. Partial sharing of these data among banks is possible in some countries (as “black lists”), but there are very strict data protection requirements.

Considering all these barriers, participants thought that a voluntary credit register for those larger SMEs who want to access funding could be a quickest way forward.

5. *Harmonising accounting rules*

“Financial information is the lifeblood of capital markets” has been repeated into a cliché – still we are far from having comparable financial information across EU Member States. This is partly due to historic differences in GAAPs and in differing tax systems driving different accounting needs. Against this background, harmonising accounting rules for SMEs would be seen as going counter to simplifying administrative burden. It would require small firms to learn and apply new rules that are different to the existing GAAP. In some cases it may go counter to earlier EU rules to significantly ease reporting requirements for micro-firms²².

What could be done? In the CMU consultation, question 8 asks about developing a common EU level accounting standard for small and medium-sized companies listed on MTFs. To do this, the logical approach would be to allow for the voluntary use of IFRS for SMEs. However this seems to go counter to recent regulatory decisions: the estimate of EFRAG about the non-compatibility of IFRS with EU law, the recent introduction in the UK and Sweden of a significantly amended IFRS for SMEs version. These discrepancies would all need to be reconciled. Member States could show they were serious about finding a solution by agreeing on the long pending common

corporate tax base. This would remove an important barrier from accounting harmonisation.

6. *Increasing the availability of information on financing options*

Participants were sceptical about EU harmonisation in the area of financial education and information. Rather they thought that the European Commission could add value by signposting investors to information sources and helping to spread best practices. The specific ways suggested to increase the availability of information on funding sources for SMEs:

- Establish a more coordinated availability and consistency of borrowing and investing information for SMEs on a pan-European basis.
- The European Commission should support a European Finance Guide – similar to the UK Business Finance Guide – to be co-ordinated by leading pan-European professional and industry bodies
- Help small firms understand the range of specialist finance options available to them. Debt finance may not always be the right option for a small firm. Entrepreneurs need to better understand the balance between debt versus equity finance and to improve their firms' investment readiness.
- Consistent industry-based definitions for SMEs (European Commission, Prospectus Directive, MiFID definitions compared to industry-specific definitions from the SBA)
- Produce easy-to-understand 'how to' guides for SMEs
- Create a 'one-stop shop for SMEs like the US Small Business Administration by merging existing initiatives and providing access to required information in a user-friendly way
- Facilitate primary listings, secondary market and stockbroker research for SMEs

CONCLUSIONS

The main impact of the CMU initiative so far has been more political than economic. The CMU, however symbolic, is a commitment to the Single Market, and to keeping the UK in the EU. It signals a return to a more traditional EU activity of 'market building' by creating the necessary legal principles and political trust that enable industry to invest and thrive. If the CMU contributes to a more positive political outlook that encourages companies to invest in Europe, it has already achieved a lot.

Lord Hill is cautious to emphasize he champions a 'bottom-up' approach for the CMU with market-driven solutions wherever possible. Still, most of the measures the Green Paper proposes or seeks views on are not bottom-up activities, but rather classical top-down EU legislation, seeking to harmonise pan-European capital market rules. At the same time, the Green Paper was largely silent on the infrastructure and the enforcement needed to erect a genuine CMU. If this remains the case in the Action Plan to be published in September, this would reinforce the priority for market-driven solutions.

There is a theoretical debate whether the EU would need to "rebalance its excessive dependence on bank financing" and rely more on market finance. This debate will remain at a mostly theoretical level as the majority of EU markets have a historic preference for bank finance, which is not about to change. In some countries (e.g. German, Hungary) the recent experience of retail investors and regulatory changes point to an increasing willingness of retail investors to keep their money in bank deposits perceived as safer than investing in fund products.

On the level of specific initiatives, the CMU will aim at low-hanging fruit instead of politically sensitive reforms to underlying structures like insolvency regimes, taxation or accounting. In line with this, boosting securitization and allowing for easier listing are expected to be the first major initiatives.

Each is seen as a welcome, though not revolutionary change. The major impact to investment may come from measures on medium-sized and high-growth firms. SMEs, while politically important, offer less obvious solutions and very few low hanging fruit.

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Endnotes

- ¹ The views in this paper are a collation of contributions from the simulation game participants. The game was held under the Chatham House rule, therefore the authors will not quote participants. The full list of participants is available here: <https://ec.europa.eu/eusurvey/files/6301fc73-db25-429b-b75f-fee94cf1bdd>
- ¹ http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf
- ² Anderson, N, Brooke, M, Hume, M and Kürtösiová, M, 'A European Capital Markets Union: implications for growth and stability', Bank of England Financial Stability Paper No. 33, 2015
- ³ <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P8-TA-2015-0268&language=EN>
- ⁴ <http://ec.europa.eu/eusurvey/publication/capital-markets-union-2015?language=en>
- ⁵ The policy proposals in this article do not represent the views of the Konrad Adenauer Stiftung or of Standard Chartered Bank. They are a summary of the points raised during the simulation game.
- ⁶ Wolff, G, and Véron, N. *Capital Markets Union: a vision for the long term. Bruegel Policy Contribution ISSUE 2015/05 April 2015.*
- ⁷ BlackRock, 'The European Capital Markets Union: An Investor Perspective', ViewPoint, February 2015
- ⁸ <http://www.ft.com/cms/s/0/67b0de42-ce49-11e4-9712-00144feab7de.html>
- ⁹ <https://www.treasurers.org/cashsurvey14>
- ¹⁰ See also the [IPO Report](#) issued by EU IPO Task Force supported by EuropeanIssuers, EVCA & FESE on 23 March 2015
- ¹¹ IKB: German Market Outlook 2014
- ¹² <http://www.bruegel.org/publications/publication-detail/publication/660-mind-europes-early-stage-equity-gap/>
- ¹³ AFME-BCG, *Bridging the growth gap*, 2015: <http://www.afme.eu/Funding-Economy/>
- ¹⁴ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf
- ¹⁵ <https://factcheckeu.org/factchecks/show/276/angela-merkel>
- ¹⁶ http://trade.ec.europa.eu/doclib/docs/2010/november/tradoc_146955.pdf
- ¹⁷ <http://www.bis.org/publ/cgfs52.pdf>
- ¹⁸ AFME-BCG, *Bridging the growth gap*, 2015: <http://www.afme.eu/Funding-Economy/>
- ¹⁹ http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/Mission/Services_rendus/gb/i115gb.pdf
- ²⁰ http://www.ecb.europa.eu/pub/pdf/other/150421letter_giegold_theurer.en.pdf
- ²¹ <http://www.bankofengland.co.uk/publications/Pages/news/2014/165.aspx>
- ²² http://europa.eu/rapid/press-release_MEMO-13-540_en.htm



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