SESSION SUMMARY - BERLIN SEPTEMBER 2020

What more needs be done to strengthen equity funding in the EU?

1. State of development of EU equity markets and on-going domestic initiatives

1.1 Characteristics of small domestic equity markets in the EU

Two speakers emphasised the limited size of certain domestic equity markets in the EU and the role played by SMEs.

An official explained that the success of the equity market in Estonia is a mixed picture. An appropriate market infrastructure is in place and sufficient credibility has been achieved for example with steps taken to ensure market transparency and integrity. Initiatives aiming to develop a pan-Baltic capital market in addition to EU integration efforts have also allowed the increase of the scale of certain segments and have supported the development of both bond and equity markets. The pension system, which is an important element on the supply side has also been successfully reformed and the environment for investment funds has been improved. Estonia's public equity market however remains relatively small with low transaction volumes and limited liquidity and it is mostly composed of small and medium-sized companies (SMEs). This does not mean that companies are poorly capitalised or not lucrative. In addition the deals carried out, where companies have raised equity in the market, have been quite successful. But the capital market appears to be more active outside the usual public market domain, with relatively high levels of risk capital raising and crowdfunding activity in equity-like finance, even on the retail level. There may however be a spill-over of this activity to the public market. This tends to indicate that the system of taxation might actually play a bigger role in financing than public capital markets. Digitalisation has supported equity markets to a certain extent also, however alternative channels seem to be benefitting more from technological change than the public market.

An industry representative added that the Austrian market has similar characteristics, with a high proportion of small SMEs (87% of all Austrian enterprises have fewer than 10 employees) and equity finance and capital markets that are relatively under-developed.

1.2 Measures put in place in larger markets: the example of the French market

Two speakers highlighted the measures that have been put in place in France to stimulate the domestic equity market.

An official explained that France has developed a comprehensive strategy and set of reforms to attract both foreign investors and domestic retail savers. A 30% flat tax was implemented, which fosters equity revenues and incentivises investors to invest more in the French market, because that extra revenue can be reinvested in the country. This has been very successful for attracting foreign investors in particular. France is also implementing a long-term strategy to decrease the level of corporate tax, with a level of 25% targeted for 2022. This reduced level of taxation should help SMEs to scale up and invest more. Another improvement has been to treat carried interest as capital revenues rather than remuneration, which has fostered significant investments.

The PACTE legislation ('plan d'action pour la croissance et la transformation des entreprises') is another initiative that has been put in place in France, the official mentioned. It introduces a new individual pension product aiming to channel both employee and retirement savings towards equity funding with incentives and extensive communication. The objective is to increase the contribution of employees to the value creation of their companies. The tool is very flexible so it can be used in SMEs, as well as large companies, and it can adapt to the cycle of the economy, being more ambitious when there is a positive cycle.

An industry representative noted that whilst the PACTE legislation has succeeded in creating a new product with commercial success it is still relatively marginal, because the public pension provision is very generous in France. Life expectancy, from when individuals start receiving public annuities, is 24 years and the average pension is higher than the average level of salaries. The only way to have more widescale retail investment in equity would be to decrease public pensions. However reforming the pension system is challenging in France and has so far been postponed.

2. Main remaining issues and challenges

2.1 Remaining issues to be tackled regarding the access to equity markets

An official indicated that although a number of steps have been taken by the EU to improve the functioning of equity markets, they may not be sufficient. Financial literacy is a first problem, in particular that of the managers of companies seeking funding. It means that raising capital through equity markets remains quite a distant objective in their minds, particularly in the current context of the Covid crisis, with extraordinary measures such as subsidies and credit to the market being put in place. The overall cost of raising funding on equity markets (prospectus and market research costs, regulatory requirements…) is also stopping SMEs from considering public market financing as a prime option. These problems exist both for small and larger markets and are worsened by cross-border fragmentation of infrastructures and rules. Digitalisation may however help to address some of these issues and also help to improve links between infrastructures in the EU.

An industry representative agreed that the cost of participating in capital markets for small enterprises (notably regulatory costs) must be considered. Very often SMEs have limited collateral, irregular cashflows, higher risks and are not able to provide sufficiently reliable and comparable financial information, which are all decisive points for investors. Some of the measures discussed at the EU level, for example in the context of the Capital Markets Union initiative (CMU) may therefore need to be adapted to smaller SMEs.

Another official added that another challenge is attracting the younger generation to the equity market. The PACTE legislation introduced some measures for parents to encourage their children to invest in equity and to keep that investment when they are growing up. An official agreed that there is a need for education in this area since young people are those who could benefit the most from building up equity investment over time.

An industry representative noted that fiscal incentives are also an issue and need to be defined in a coherent way. Tax incentives have been implemented to encourage equity investment, but at the same time governments have been discouraging the distribution of dividends during the Covid crisis, lowering potential revenues for retail investors. Large institutional investors such as insurance companies also face problems: although there is a plan for reducing corporate tax, an additional tax of €1.5 billion has recently been imposed on French insurance companies, which is a huge amount. Although insurance companies can pay this amount, that is money that cannot be invested in SMEs, which in the end results in even more taxes for everyone if these SMEs run into difficulties. To grow equity funding there has to be a stronger belief in market forces and more coherent policies.

2.2 COVID-related opportunities and challenges

An official considered that the development of equity markets is brought to the fore by the Covid crisis. Europe has been hit by an extreme supply and demand shock. There is an opportunity to rebound thanks to the measures and reforms proposed, but this requires immediate investments and using available sources of funding, including equities, in a balanced way.

An IFI representative explained that at the end of 2019 i.e. before the Covid crisis, there was an estimated amount of about € 250 billion missing in equity financing in the EU. This concerned very young enterprises, as well as more mature ones at a pre-IPO stage, needing equity to grow. The COVID-19 crisis has since created a liquidity crisis for most companies in Europe and the world, which EU member states have handled quite well. There is also a solvency crisis starting, as well as a potential investment crisis, which could be quite detrimental to the economy. Most corporates, small or large, will substantially increase their debt to equity ratio and it will be difficult for them to borrow more and invest in the next few years. This latter risk may be the most detrimental to the economy going forward.

An industry representative added that there may also be a crowding out effect because of the crisis, with big companies appealing to the market for more equity, limiting the possibility for SMEs to raise money. Another industry representative suggested that the risk around COVID-19 could potentially be systemic if significant liquidity shortfalls and equity losses were observed throughout the industry.

3. Policy measures proposed for further developing equity markets in the EU

Speakers on the panel generally considered that the appropriate measures for developing equity markets have been put forward in the initiatives underway at the European level (CMU, MiFID II, Next Generation EU package).

An official stated that the CMU High-Level Forum (HLF) issued a report with 17 recommendations, at least six of which can be brought back to the theme of greater equitization. The challenge however is the implementation of these measures and providing the appropriate incentives.

3.1 Measures for facilitating access to the capital markets and developing the equity ecosystem

A public representative set out a list of concrete measures to help equity financing for SMEs that has been agreed by the ECON Committee of the Parliament and should be taken up by the Commission in its new CMU action plan. The list is ambitious and includes three key points.

The first measure is facilitating investment research for SMEs, the public representative explained. This should already be part of the MiFID quick fixes, with different solutions on the table. The second point is to streamline the definition of SMEs across EU legislation. For example it is difficult for them to understand whether they qualify for specific EU support schemes at present. The third point is to ease issuance requirements for SMEs that are ready to go public. The creation of SME growth markets was a first step, but an ambitious pan-European plan for initial public offerings (IPOs) should be proposed, with, for example, a simpler prospectus for SMEs at least during the COVID-19 crisis, and tax incentives for investing in equity. These measures can only work however if European citizens are ready to invest. This is why it is also necessary to foster the development of an equity culture in the EU. It needs to be easier for citizens and particularly the younger generation, as investors, to understand how their savings can play a direct role in the real economy. For example, a mobile app could be provided, allowing investors to check in real time where their money is going and to vote directly or via proxy voting in order to participate in the governance of the companies they have invested in. The Commission is also being asked to propose initiatives on employee share ownership, building on domestic initiatives such as PACTE in France mentioned previously.

An industry representative agreed that most of the CMU measures are very positive, as well as the MiFID quick fixes. Reviewing the unbundling measures which significantly affected the coverage of SME equity research is essential. The Spanish exchange for example has been obliged to fund independent analysts to cover companies that were no longer followed by brokers. SMEs that go to the market for financing are indeed dependent on the analyses and recommendations provided by medium and small brokers who are a key element of the ecosystem that supports the funding of SMEs (also including specialised lawyers, intermediaries and advisors). It is hoped that these measures will help to revive SME equity research. US capital markets are often taken as an example in the EU. Beyond the fact that they are more developed, one key characteristic is the ecosystem in the US and the fact that in every city there are brokers offering equity and commercial paper issued by the local companies. That is how the US market works, with citizens encouraged to invest in companies operating in their region. SME success stories rarely start with large investors; often the first funding comes from smaller investors part of a specific ecosystem, who know the sector or activity and help the company to grow.

'Moving the needle' further in the SME equity market would require stronger incentives, the industry speaker believed and notably changing significantly the taxation system with an equal taxation of debt and equity, because otherwise debt will continue to be preferred by issuers. An official noted that the relative taxation of debt and equity could be an issue to be handled by the OECD.

Another industry representative indicated that the HLF report includes interesting proposals for developing equity financing, but these will take a long time to implement and will not solve the funding needs of smaller SMEs in the short term. For example, the proposal to implement a European single access point for issuers to company financial and ESG data is relevant, but it requires a significant standardisation of reporting. There are also useful proposals in the CMU report regarding ELTIF (European long-term investments) funds, but these will also be long to implement.

An IFI representative added that the funding of smaller SMEs that are prevalent in certain member states is a specific issue that needs addressing with innovative solutions, beyond public support, such as new channelling instruments. These instruments include fintech platforms that may be able to provide quasi-equity quickly to a large population of SMEs.

3.2 Adjustment of prudential requirements for institutional investors

Several speakers suggested that the prudential treatment of equity investment in insurance company and bank balance sheets needs to be reviewed.

An industry representative considered that the reasons why insurers under-invest in EU capital markets had been appropriately identified in Recommendation 3 of the CMU HLF report, which proposes reviewing Solvency II capital and risk margin calibrations and accounting rules. This is not only about capital charges but also the way the Solvency II framework is built. The overall charge for equity is such that there is no possibility for insurers to invest and even with some relief on capital charges, the current interest rate environment makes the solvency of insurance companies so low that it is impossible for them to invest in equity. There is a need for relief on some other elements, such as the interest rate charge and the risk margin, as explained in the HLF report. In particular there are € 180 billion trapped in the risk margin that cannot be invested. The report also mentions IFRS 9 and IFRS 17, suggesting that insurers should work with the IASB on this. This has been done but the IASB has made its decision. Europe now has to make the necessary carve out to allow insurers to invest in equity.

A public representative noted, regarding Solvency II, that the negotiating team will look at incentives and the overall balance of the package in the future review. Incentives for equity financing are very important, especially for SMEs that need to have sufficient trust in the future to grow and create jobs. The coverage of the pandemic risk in insurance contracts plays a part in this and also needs to be debated in the context of the Solvency II review.

Another industry representative suggested that if Basel III is being implemented, the current risk weights assigned to equity financing by banks have to be maintained because Basel III is increasing them up to four times, especially for smaller enterprises.

An official emphasized that there will be attempts to promote an ambitious review of Solvency II and an adequate but cautious revision of Basel III that remains consistent with the approach taken by other jurisdictions.

3.3 Measures related to the post-COVID recovery package

An IFI representative noted that the Juncker plan, the European programme put in place following the financial crisis to stimulate economic growth, has had positive effects on the equity market. Although it was initially focused on providing guarantees and loans, equity or quasi-equity products were brought into the programme and represented more than 40% of the delivery of funding. The Council decisions on the EU recovery package (Next Generation EU) at the end of July are another important step forward, particularly with the joint funding capacity through the Commission that has been proposed for the first time. The way the €700 billion of grants and loans of the package has been attributed to the countries is also remarkable. For the first time this money will be allocated - according to a specific set of metrics - to the countries that need the financing most, and there will be less investment made through the pan-European and European institutions.

This approach seems relevant, the IFI representative believed, considering the number of projects that are cross-border in their nature and need European rather than national financing. One example is the hydrogen project. The biggest countries have announced significant investment in this new technology and there are no real European projects at present, even though there are similar challenges across Europe for providing the necessary infrastructure. A second example is private equity and venture capital, which are critical for fostering growth and innovation in Europe. There is at present more of a national approach to this business, even though this is an area where a European approach would be very relevant, notably because fund managers mostly operate on a cross-border basis. With this package in place, more European initiatives around equity should be federated so that they are more impactful and made consistent with the European approach to climate change and digitalisation.

An industry representative considered that the solvency support instrument in particular will be quite important for the smaller enterprises. ■