Capital Markets Union supports economic growth and employment

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A broader funding base especially for growth-oriented small and medium-sized enterprises would boost economic growth and employment. Cross-border capital flows would promote private risk sharing in Europe. To support these objectives, the European Commission has designed and partly implemented a Capital Markets Union. So far, the project to build a single market for capital has advanced at a relatively good pace, but now there are some difficult issues ahead, such as harmonisation of taxation and insolvency law. Although the toughest challenges still loom ahead, this should not be allowed to prevent completion of the initiative.

Capital Markets Union necessary to finance growth companies

The role of capital markets in financial intermediation is much less significant in Europe than, for example, in the United States.[1] In Europe, banks are the prime source of finance, but a broader funding base that extends beyond the banks would, in the opinion of the Commission, be more sustainable in terms of the resilience of funding in times of crisis.[2] Together, banks and capital market participants could offer sufficient funding in a manner best suited to withstanding fluctuations in the economy.

Currently, economic growth and a majority of new jobs are generated by small and medium-sized growth companies. Their access to funding is, therefore, essential for ensuring continuation of favourable economic developments. Many growth companies today operate in the service sector without any major equity holdings or real assets. Lacking collateral, a significant turnover, or a traditional business model, they have rather slim chances of obtaining a loan from banks and should, consequently, have the possibility to raise funding on the capital markets. Unfortunately, many European capital markets are thin, which leaves them unable to offer funding in any substantial amount. Moreover, the banks in some EU countries may be struggling and therefore have limited capacity to support the real economy.

The funding situation of small and medium-sized enterprises (SMEs) is not as constrained in Finland as in some other EU countries. The credit for this goes to public entities such as Finpro, Finnvera, Tekes and Tesi (Finnish Industry Investment Ltd) and the solid banking sector. Even so, access to early corporate funding in particular may also be challenging in Finland, for the reasons cited above. At present, private angel investors or venture capitalists are not in a position to finance all promising ventures.

Resolving these two problems, access to capital and continuity of funding, calls for vibrant and well-functioning capital markets. Capital Markets Union (CMU) is a joint initiative of the European Commission and EU Member States designed to broaden the sources of market-based funding and increase the supply of bank credit especially for SMEs and infrastructure projects. With this initiative, national and EU authorities are creating a regulatory framework within which private entities can implement the Capital Markets Union. The ambitious goal is to complete the framework by 2019.[3]

The Capital Markets Union Action Plan contains 33 initiatives, ranging from reports and consultations to legislative changes. The topics include development of cross-border retail financial services and harmonisation of insolvency law, the corporate tax base and withholding tax procedures. The diversity of the measures covered makes it difficult to condense the initiative into a statement that is both easily understood and comprehensive.

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1. For further discussion of the size of the European banking sector, see e.g. the report of the European Systemic Risk Board (ESRB).
2. For further elaboration on this, see the European Commission's paper with an economic analysis of the Capital Markets Union.
3. Capital Markets Union is not an isolated initiative, but complements e.g. Banking Union and the digital single market. Furthermore, the Capital Markets Union will of course constantly evolve, but even so the aim is to have the basic framework largely in place by 2019.

Capital markets supplement bank finance

In the aftermath of the financial crisis, the operation of banks and the markets became the subject of closer attention. It was understood that only a financially solid banking sector can deliver sustainable financial intermediation. The requirement to capture the risks of the banking sector as a whole was, on a tight schedule, introduced into banking regulations, especially prudential regulations. This would prevent spillover of the problems of a single bank to the broader banking sector.

The purpose of the new regulations was to ensure that banks would not run into problems so easily and – were this to happen – that public funds would not, in the future, have to be used to rescue them. In response to the regulations, the banks have, however, cut back on their riskiest operations. Meanwhile, the European capital markets have not developed sufficiently to make up for this reduction in banks' operations. This has brought about a shortage of finance especially for growth companies, as the banks and capital markets have been unable to support them sufficiently.

Indeed, one aim of Capital Markets Union is to increase the share of market-based finance and broaden the range of funding sources. One of the major tasks is to ensure that there are sufficient regulations in place for these funding sources and that due provision is made for the risks inherent in the business. However, to be able to offer finance at a reasonable cost, the capital markets must not be too heavily regulated. In the case of capital market funding, similarly as in bank funding, it must be borne in mind that slightly weaker but sustainable growth is always better than somewhat stronger growth followed by considerable downturns at regular intervals.

With the establishment of Capital Markets Union, banks' risk weights for infrastructure investments will also be lowered, as has already been done for SME lending. In principle, the lower risk weights should stimulate bank lending for infrastructure investments and to the SME sector. This reform, however, also means that risk weights will no longer be solely based on calculation of risk, but also on the social importance of the business. This principle will certainly be discussed in the talks on increasing the volume of sustainable finance in the context of Capital Markets Union.

Under Capital Markets Union, the tax treatment of equity relative to that of debt will also become subject to review. Currently, expenses incurred from debt servicing are tax deductible for businesses. This tax deductibility may be used for tax avoidance purposes, but even without this dimension, there is a clear distortion between debt and equity. Capital Markets Union will align the tax treatment of equity with that of debt, thus increasing the amount of equity and reducing corporate debt. Still, it will not be easy to change taxation, however justified the objective.

Capital Markets Union treads on the territory of national legislators – with good cause?

For the EU to be a true Capital Markets Union, the content and interpretation of legislation should be sufficiently uniform across the participating countries. This is partly to be achieved through adjustment of Regulations and enactment of Directives that leave as little scope for national interpretation as possible. However, some harmonisation will also be required in areas traditionally regarded as being within the realm of national law, such as insolvency law and taxation.

One key proposal of Capital Markets Union is to first review and thereafter possibly harmonise the loan enforcement regimes in terms of delays, costs and recovery value when managing defaulting loans. At its shortest, the delay is some months in certain countries, whereas, at its longest, it can take as long as ten years. It goes without saying that if the differences are significant and the process unclear in some countries, capital flows across the countries will remain limited. Any losses from banks' non-performing loans and, by extension, the market values of these loans, would develop favourably if the longest periods of debt realisation could be shortened.[4]

Capital Markets Union also seeks to harmonise the principles of business restructuring applied to companies in temporary financial difficulties whose business is on a solid footing, to allow them to remain in business. Another aim is to ensure that honest entrepreneurs will get a second chance if their former business has failed.

Single EU-wide legislation, including insolvency and taxation law, would serve to boost cross-border investment and financial service provision. This would channel resources more effectively and boost private risk sharing in Europe, with funds flowing from capital surplus areas to capital deficit areas. Private burden sharing would provide a more market-oriented solution than public mutual solidarity.[5]

Concurrently with the harmonisation of national legislations and practices, supervision of the capital markets should also be harmonised and improved. The bulk of the EU's capital market operations is located in the United Kingdom, but after Brexit some operations are likely to move under the supervision of various national authorities. Some cross-country differences in legislation and supervisory practices may hold back the process of integration. Harmonisation of capital market supervision is, therefore, an integral element of Capital Markets Union.

Regardless of the many benefits involved, harmonisation of these complex issues traditionally regarded as falling within national competence is expected to be very difficult. For the CMU initiative to move forward it is important that the few roadblocks do not kill off the whole initiative. The Commission itself currently considers that 19 of the 33 initiatives are already in place.[6] Let us not be lulled into a false sense of complacency, as Europe needs a Capital Markets Union and there is a long road to go, especially after the Brexit vote. However, the Commission has a clear roadmap. Now the same resolve should also be mobilised at national level by Member States.

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4. This does not mean that the position of debtors would be unreasonably weakened, if the processes are transparent and known to all and if suitable minimum requirements and consumer protection rules are in place.
5. When a private investor makes cross-border investments, only part of the investor's holdings will be affected by risks in individual countries. Losses are divided among investors in several countries, which reduces the interdependence of the countries and their resident investors. Private risk sharing makes the financial system more resilient overall.
6. See the speech by Commissioner Dombrovskis on 25 April 2017.

Tags

funding, economic growth, employment, small and medium-sized enterprises (SMEs), Capital Markets Union (CMU)