Alternative Investments

Capital Markets Union – Providing Investment for Growth and Jobs in Europe

European capital markets and the funding problem facing SME's

Key elements of the European Commission's action plan for capital markets union (CMU) are now beginning to take shape, and the current key challenge is to maintain the scale of ambition while delivering concrete actions. In its Green Paper on CMU, the Commission set out a compelling case to meet Europe's challenges around jobs, growth and competitiveness by better linking savers with investment needs.

Why is this a priority for Europe now? The financial crisis in recent years has proved one thing - there is a crying need to put European-wide legislation in place to prevent this sort of crisis from happening again. The crisis also showed that Europe's small and medium-sized companies (SMEs) rely heavily on banks for funding and that too little focus was on funding from capital markets.

An indication of the over-reliance of European SME's on bank funding is shown by one stark statistic - American SME's receive five times more funding from capital markets than their European counterparts.

The question that the European Commission has attempted to answer, is how to unlock capital market funding for investment in European companies. Economic growth, and jobs, across the EU will increasingly depend on that funding logjam being broken.

CMU is the European Commission's response to the problem. The Commission's main focus is to improve access to finance for businesses, particularly SME's, and aims to achieve this goal by reducing the fragmentation that currently exists in financial markets. This, the Commission believes, can be achieved by diversifying sources of finance away from the traditional reliance on bank funding and by strengthening cross-border capital flows.

There is now an acceptance that the regulatory burden across the European Union is not only onerous but counter-productive, and the Commission's approach now is to regulate only where it is necessary. It is estimated that the new Commission will propose only one-fifth as much legislation in 2015 compared to the annual legislative output of the previous Commission - and will review two and a half times more existing legislation than the previous Commission.

In terms of new legislative proposals, one key element of the new Commission's strategy is to build a single European Capital Market and to this end it published a Green Paper on CMU in February 2015 where it set out a road map towards achieving CMU by 2019.

But the difficulties in achieving CMU should not be underestimated

The Green Paper does not play down the difficulties ahead in achieving CMU by the 2019 target date and experience over the years has highlighted the obstacles and stumbling blocks that lie ahead - not least in the differing insolvency, corporate and securities law and tax treatment across the various member states.

The Green Paper does not address these issues specifically other than saying that they require further analysis. But it does set out some pragmatic measures which it believes can be achieved in the short to medium term to build a single European Capital Market from the bottom up.

So how will a single market for capital be achieved?

First of all it might be useful to define exactly what we mean by "Capital Markets". Capital Markets is, in essence, a catch-all phrase applying to most sources of finance other than bank debt. It includes activities such as venture capital, private equity, stock markets and initial public offerings, corporate bonds, corporate debt securitisation as well as debt funding from non-bank entities such as investment funds, leasing and consumer finance companies and non-securitisation special purpose vehicles (SPV's).

In their Green Paper, the Commission identified five key issues that need to be addressed in order to progress the CMU project.

1. Develop proposals to encourage high quality securitisation and free up bank balance sheets for more lending.

2. Review the existing Prospectus Directive to make it easier for businesses, especially smaller ones, to raise finance and reach investors outside their own country. The Prospectus is a necessary gateway for firms looking to raise debt or equity funding, but it is important that the requirement to issue a Prospectus is not so onerous that it actually acts as a barrier to accessing capital markets.

3. Improve the quantity and quality of credit information on SME's to make it easier for capital markets companies to make an investment decision, partly through the development of a minimum pan-European set of standards for credit reporting and assessment. This is crucially important in allowing a capital market

company in one EU member state assess the creditworthiness of an SME in another.

4. Work with the industry to put in place a pan-European private placement regime to encourage direct investment in smaller businesses. A framework for this already exists in France and Germany which has stimulated the use of private placements as a financing option.

5. Support the take up of new European Long Term Investment Funds (ELTIF's) to channel investment into infrastructure and other long-term projects. The new regulatory framework for ELTIF's means that these funds should be particularly appealing to investors such as insurance companies and pension funds who need a steady long-term income stream and capital growth.

What specific measures is the European Commission looking at?

The Commission wishes to broaden the investment pool by attracting more retail, institutional and international investors, given that the traditional sources of non-bank finance from life insurance, insurers and pension funds has dried up in recent years.

To this end, the Solvency II Directive has incorporated infrastructure as an approved asset class and this now allows insurers to invest in ELTIF funds. It is also now proposed that the IORP II Directive covering pension providers, will allow pension funds to invest in long-term assets on unregulated markets.

Personal pensions are also seen as a potential source of finance for capital markets, but it is important for their own protection that retail investors fully understand what they are investing in so they can make an informed choice. The Commission intends to publish a Green Paper on retail financial services later this year, and this should go some way in clarifying the situation as it applies to personal investors.

The Commission also wants to improve access to finance for companies at different stages of development, from start-up companies looking for seed capital to more developed companies looking for finance for expansion

Various suggestions have been made so far in this regard, including:

- The development of a more integrated European market in covered bonds.
- Developing a market for "green" bonds to fund environmental, social and corporate governance investments.
- Developing alternative sources of finance such as angel investment, venture capital, peer to peer lending and crowd funding.

The Commission also wants to make markets work more efficiently through improvements to market infrastructure and securities law, new technologies in the finance sector and improved data and reporting frameworks.

Opportunities and challenges

Nobody should underestimate the significance of CMU for Ireland as it has the potential to further boost Ireland's position as an international financial services centre, not to mention contributing to the 10,000 additional jobs that the recently-published IFSC strategy document *Visions and Targets for IFS 202*0 believes is an attainable target.

For individual Irish firms in the various sectors within capital markets, there are both opportunities and challenges. Opportunities will arise in the context of increased business and challenges will arise servicing this business, particularly in relation to having adequate data infrastructure systems in place to support the additional activity. For SME's, there is potentially the prospect of entire new sources of funding, while for savers and investors there will be a wider range of investment products no matter what their appetite for risk.

So where do we go from here?

Just five months after the publication of its Green Paper in February 2015, the Commission has received more than 700 responses, an indication of the importance given to the proposal by the various stakeholders. In September, the Commission will publish an Action Plan with more concrete proposals emerging at some stage after that.

The concept of CMU may have been on the European agenda for many decades, but it is now gathering momentum. We at KPMG believe that while not all issues pertaining to CMU will be resolved, enough progress will be made in the short to medium term to create a new and coherent framework linking investors and savers with new and exciting forms of investment. All parties can only benefit from that.

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