



### 3. Capital Market Union

#### Purpose:

To mark the beginning of a three-month consultation period in the first half of 2015, the European Commission launched a green paper to simulate conversation about a proposed Capital Markets Union (henceforth CMU) that should take shape by 2019. The need for a CMU is clear; capital markets still remain shallow despite the European Union's founding commitment to the free-flow of capital in the Treaty of Rome. If the green paper's estimates are correct, 90 million additional euros would be available for business financing in the member-states if capital markets were as deep as the US.

Raising capital indeed seems difficult for businesses, especially compared to the US:

- The typical medium-sized business receives approximately five times more capital funding in the US than in the European Union (EU).<sup>[1]</sup>
- As a percentage of GDP, EU public equity markets are only half as large as the US public equity markets.
- In contrast to the US, domestic stock market capitalization in the EU remains very uneven. The authors of the consultation authors note that capitalization "exceeded 121% of GDP in the UK, compared to less than 10% in Latvia, Cyprus, and Lithuania."
- EU business financing remains dominated by banks, with firms relying on bank loans more heavily than their US counterparts. Bank loans comprise roughly 30% of total business financing in the UK, Denmark, Italy, Spain, and Sweden, compared to around 10% for the US.
- The financing landscape for small-and-medium sized enterprises (SMEs) in the EU is heavily dominated by banks. European SMEs often rely on financing from the same bank throughout their lifecycle, due to the difficulty of securing funds elsewhere. Although this long-term "relationship lending" could be optimal for high-risk, informationally opaque small firms, the European Commission is concerned that these businesses are over-leveraging with negative consequences in economic downturns. The authors argue that "bank lending makes the European economy, especially SMEs, more vulnerable when bank lending tightens, as happened in the financial crisis."

#### **Information Asymmetries**

The authors of the Green Paper speak of "important frictions that get in the way of providing finance 'especially for smaller or more medium sized companies, and for longer term projects such as infrastructure...'" One specific issue that the consultation identifies is the inability of banks and investors to appropriately monitor the risk profile of SMEs. Often, a bank or investor *would* invest in an enterprise if they had sufficient financial information to secure that their investment would not disappear immediately. But, as it stands, "13% of these applications are rejected..."

To facilitate the flow of information for SME financing and reduce general ambiguities that impede the flow of finance, the consultation suggests mandatory, standardized disclosure document. It also suggests implicitly<sup>[2]</sup> mandatory measures for the protection of minority shareholders.

Unfortunately, the argument that is put forward about information asymmetries lacks empirical evidence. In order for the market to fit the scenario described in the consultation, both healthy and unhealthy firms that seek financing must view the marginal cost of information disclosure to be greater than the marginal benefit. If financially healthy firms in the market for capital simply disclosed information, investors could simply assign a higher price to the firms' shares, and information would cease to be asymmetric. Empirical evidence shows, however, that SMEs that stand to benefit from information disclosures tend to do so voluntarily (Lardon and Deloof, 2014). In particular, firms registering on the "Free Market," or "Marche Libre" division of the EuroNext stock exchange (located in Paris and Brussels) voluntarily disclose information when it is beneficial in securing financing, despite the exceptionally-low listing requirements of the exchange.

Companies located outside of France and Belgium decline to list on the "Free Market" exchanges *not* because of some "market failure," but because of a home bias exhibited by investors. Simply, investors are more likely to pair with firms that originate from their own countries (Grinblatt and Keloharju, 2001; Hursti and Maula, 2007). Unfortunately, there is little that the European Commission could do to hasten the demise of home bias. A mandatory, standardized disclosure document, however, is a misguided solution that does not address the real problem.

#### **Informational Asymmetries: Proposals**

- The European Union should refrain from directives attempting to micromanage these policies and allow Europe's leading stock exchanges room to grow.
- If foreign firms were unburdened by cultural problems in investing in places like Brussels, Paris, or London, the problem of insufficient information disclosure could be solved by free-exchange. If faced with a "menu" of possible disclosure regimes, SMEs could choose the right amount of disclosure that leads to equity purchases by investors without overburdening the firm with a disclosure cost.

#### **Solvency Directive**

Given the significant assets held by pension and insurance companies, investments made by pension and insurance funds make up a large part of the capital market infrastructure in the EU. To this end, the consultation authors discuss a new directive relating to insurance fund regulation known as Solvency II. They argue that the new directive, scheduled to go into effect on January 1<sup>st</sup>, 2016, "will allow companies to invest more in long-term assets by removing national restrictions on the composition of their asset portfolio."

This abolition of national restrictions is a welcome step, but the Solvency II Directive goes far beyond this. The European Insurance and Occupational Pensions Authority (EIOPA), tasked with implementation of the directive, aims to make ensure that insurance companies always have adequate capital to match their operational risk profiles. Specifically, sufficient capital must be on hand to calibrate an insurance company's existing portfolio *plus* one year's expected new business at a VaR (value at risk) 99.5% over one year.

This means that, according to the models used, the capital on hand will mitigate unexpected shocks to the insurance company in 199 out of 200 cases. Sufficient capital is required on-hand to prevent the complete depletion of a firm's capital stock under virtually any modelled adverse scenario.

Predictably, the largest capital requirements pertain to the riskiest assets, making the directive more likely to decrease investment in cash-strapped SMEs desperate to sell off their equity. We can already see some of this effect by examining the risk-based-capital requirements of countries such as Canada, the U.S., and the Netherlands (Boon, Briere, and Rigot, 2014). Strangely, funds looking to invest in government bonds have to put aside *zero* capital in the process. This seems to imply that government debt should get a free pass regardless of the government's risk profile, a strange assumption in light of financial difficulties plaguing Greece and some other EU countries. Despite the European Systemic Risk Board repeatedly accentuating this problem, the concern remains unaddressed.

Due to the dire effect of capital markets and the probable shift toward the purchasing of government debt that will likely follow Solvency II, implementation should not be a part of the EU's capital markets program.

### **Solvency Directive: Proposals**

- The EC should abandon capital requirements and allow the optimal asset allocation of insurers and pension funds to be determined on the market.
- To regulate the risk, the EC should encourage the development of rule-making boards that lack formal regulatory power, such as the U.S.'s National Association of Insurance Commissioners (NAIC). Allowing for non-governmental organizations without a monopoly of force to propose rules encourages more thoughtful deliberation and less "one-size-fits-all" solutions. The NAIC, for example, has recommended heterogeneous approaches to risk accounting in contrast to Solvency II's proposed uniform VaR standard.

### **Capital Taxation**

The consultation authors note that, "differences in the tax treatment of different types of financing [...] may create distortions." Specifically, "differences in the tax treatment of debt and equity financing might increase the reliance of companies on debt and bank funding." The consultation is vague on a solution to this issue but claims that the Commission will take action to end any discrimination in tax treatment.

The decision to pursue debt or equity financing is biased by the vast majority of national tax codes that allow for corporate debt financing (ie. interest payments) to be written off. The negative implications for credit markets, however, are not necessarily obvious. Obtaining financing through lenders and depositors, after all, is simply another vehicle by which firms can raise capital. But not all firms are created equally; some firm characteristics allow for a capital structure that is friendlier to debt accumulation than others. In particular, large firms are typically able to enjoy greater leveraging than small firms due to having greater access to collateralizable assets. SMEs must often sell large chunks of their equity in the absence of these assets. This behavior is found in both dynamic capital structure models (ie. Kurshev and Strebulaev 2007) and in panel data (ie. Zare et al 2013). Thus, the debt tax bias over equity hampers capital formation in a group of firms that the European Commission sees as being in the direst of straits.

With this in mind, the consultation's critical view toward inequitable debt-equity tax treatment is well grounded. We agree that action should be taken in the long-term, with leeway as to how countries go about removing the disparity in treatment. Belgium, for example, reformed their code

to allow companies to deduct equity from their tax bills at a notional rate of interest. Another option is the Comprehensive Business Income Tax (CBIT) which removes the tax deduction on debt.

### **Capital Taxation: Reform Agenda**

- The European Commission should implement a directive requiring debt-equity tax treatment to be harmonized, without specifying the method. Our aforementioned methods (the Belgian equity model and the CBIT) are two ways that countries could use to achieve equality in their tax treatment.
- In order to ensure that reforms such as the CBIT do not quash capital markets by suddenly increasing taxation of corporate debt, the European Commission should require that removing any exemption must be accompanied by a lowering of the overall corporate tax rate for that nation.
- To allow countries maximum leeway in setting their taxation policies, the requirement that CBIT-like tax reform should be accompanied by corporate tax deduction should allow indirect corporate tax reduction. That is, corporations shoulder the burden of indirect taxes, such as energy and payroll taxes, as well as the direct levy on their bottom line. If countries see reducing indirect taxes as easier than reducing their corporate tax, they should be allowed the opportunity in the new directive.

### **Insolvency Regime**

The consultation authors note the “divergent national conflict-of-law rules regarding the internal functioning of a company,” and recommend “harmonizing substantive insolvency legislation.” Specifically, they point to “the lack of or inadequacy of rules enabling early debt restructuring [...] the absence of ‘second chance’ provisions, and the excessive length and cost of formal insolvency proceedings[...].”

Creating a national bankruptcy framework, however, invites the government to tilt the scales in favor of either creditors or debtors. In contrast to the US emphasis on firm reorganization (known in the US code as “Chapter 11”), many European member states have creditor-friendly provisions that make it difficult for a distressed firm to have a second chance. This trend has partially reversed in recent years, with countries like France, Germany, Spain, and Italy allowing insolvent companies to reorganize their assets and have a second-go at their operations (as opposed to liquidization). But while granting a generous reorganization option for debtors sounds reasonable, the impact on capital markets is not necessary positive. In debtor-friendly US states with high personal asset exemptions, for example, credit rationing is more pervasive. In this case, lending institutions came to the realization that debtors had broader leeway in repayment, and adjusted the price of credit upward to compensate for greater repayment risk in bankruptcy.

Bankruptcy law should thus be viewed as a volatile seesaw between debtor and creditor interests that could potential make financing options scarce for high-risk enterprises. Therefore, the European Union should tread lightly before attempting to implement a cross-national framework that is overtly debtor-friendly.

### **Insolvency Regime: Reform Agenda**

- In line with Rasmussen (1992), the European Commission should allow for a bankruptcy “menu” offered by the government, where firms could choose their own bankruptcy laws upon being chartered. A SME, for example, could voluntarily waive its ability to choose reorganization in the event of bankruptcy. Thus, a bank contemplating lending to a young

firm with a moderate-to-high risk profile need not fear a scenario where the firm declares bankruptcy hoists an unfavorable debt-restructuring plan upon the creditor.

- If the decision was enshrined in the business charter and made difficult to alter, the banks and other institutions could incorporate this into the price of credit for SMEs. This choice, however, should be made very costly to change, and should be binding regardless of the specific jurisdiction that the firm decides to do business in. Furthermore, a firm taking up the EU's offer to choose from the bankruptcy menu can choose to waive all potential state aid in the reorganization process (i.e., market re-entry educational resources) in exchange for a lump-sum payment. The resources for this lump-sum payment will be diverted from existing EU programs that currently subsidize SMEs going through the bankruptcy process.

## Conclusions

The capital markets of the European Union are fundamentally broken. If we think of companies as comprising the heart of the EU, then the capital market infrastructure is analogous to the many veins that supply blood to the heart. Yet, regulatory plaque and blockages keep capital from flowing efficiently, with dire consequences.

In the areas of reform we have analyzed, proposals made by the consultation will impede the development of deep capital markets.

In the area of information disclosure, creating a standardized product is a solution to a non-problem. Since firms *will* disclose information if they stand to gain from such a disclosure, making disclosures mandatory will only succeed in imposing onerous costs on small firms. We propose that the European Union continues to allow for unregulated basic and premium divisions of European stock exchanges, in order to facilitate flows of information necessary in capital market transactions. If the EC wishes to “nudge” exchanges toward adapting more divisions/listing categories, it should propose loosening information disclosure and financial product regulation on EuroNext and London Stock Exchange in exchange for more offerings from those financial companies. In the long-term, the EC should refrain from establishing a standardized disclosure product or a minority shareholder protection law.

We have also seen how the soon-to-be-implemented Solvency II directive will make it harder to raise capital by imposing “capital charges” on risky investments. It is therefore imperative that the risk-based capital regulations set forward in Solvency II Directive be relaxed as an interim measure. The oft-inappropriate value-at-risk (VaR) actuarial method for determining risk need not be imposed from the top and should be varied depending on the asset product being evaluated. In the long-term, government involvement in the risk-weighting of insurance and pension asset portfolios should be phased out, allowing freer investment in private equities according to market considerations.

Despite our critique of the consultation proposals put forward in the fields of information disclosure and risk-based capital regulation, we agree with the authors' assessment regarding discriminatory tax treatment. Prioritizing debt-based corporate financing over equity distorts capital markets by favoring large businesses that can more easily sell their debt. Furthermore, investors now have fewer possible equities to invest in as a result of the tax bias. The EU should issue a directive mandating the equality of debt-equity tax treatment across member- states, with deference to countries with regard to method. Should the member state choose to end the tax break on debt financing, however, the EU should ensure that either direct or indirect corporate taxes are lowered so as not to increase the overall tax burden over-night.

Finally, in the area of insolvency legislation, we advise caution on the European Commission's attempts to implement a cross national framework. If the scales are tipped too favorably toward debtors as opposed to creditors, the bias will likely be reflected in an increase in loan prices. Rather than imposing a one-size-fits-all solution, the EU should implement a directive allowing firms with a center of main interest (COMI) in the Union to choose from a menu of bankruptcy options, including the right to waive reorganization. This choice, however, should be made very costly to change, and should be binding regardless of the specific jurisdiction that the firm decides to do business in. Furthermore, a firm taking up the EU's offer to choose from the bankruptcy menu can choose to waive all potential state aid in the reorganization process (i.e., market re-entry educational resources) in exchange for a lump-sum payment. The resources for this lump-sum payment will be diverted from existing EU programs that currently subsidize SMEs going through the bankruptcy process.

Despite the regulatory plaque accumulating in the veins of Europe, the right treatment will make for a healthy Union and direct resources toward the most promising ventures and accompanying assets.

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[1] See <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2015:63:FIN&from=EN>

[2] The proposals are fleshed out more explicitly in the 2011 consultation.