What more needs to be done to strengthen equity funding

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Funding businesses through the crisis and beyond

We are in the midst of one of the greatest socio-economic crises in history. Never before have we been forced to rethink policy support systems across the entire economic spectrum. Never before has the scale of recovery efforts needed to absorb an economic aftershock been larger than the efforts required to tackle the impact of Covid-19: hundreds of thousands of businesses are suffocating from the effects of the economic lockdown and entire industries need to reconfigure their business model. And while we try to get the economy back on its feet, we are also obliged to prepare it for the challenges ahead.

Being better equipped for tackling this type of systemic shocks differently in the future depends on our ability to leverage the potential of innovation. We need to unleash the potential of technologies encapsulated in artificial intelligence, in decentralised networks and ledger technology, and in quantum computing, to increase the pace of medical responses to pandemic threats, to enable human-centric computing to boost digitalised business models, and to enable decentralised supply chain management in a globalised economy, to name just a few.

At the same time, we need to build the resilience of our society in the face of a climate crisis that, if not tackled with urgency, will dwarf the damage of Covid-19.

Our task list appears endless. Yet, it is no longer a matter of choice of what we are going to tackle first: Keep businesses afloat? Enable innovation to pre-empt similar threats? Combat climate change? We need to respond to all – and we need to respond now.

Rescue measures already taken in the form of guarantees are equipping businesses with the necessary liquidity to reconnect with profitability as the economy will pick up again. Non-dilutive equity support instruments will maintain companies bankable and eligible for debt funding. But for high growth and innovative companies, this will not suffice. Here, risk-taking equity solutions are key.

Europe has an immense unexploited potential to lead this transition. To unleash it, Europe needs to embrace innovation and grow beyond its attributed role as a technology incubator for other geographies. For innovative companies in Europe the longstanding promise of a seamless funding chain from seed to IPO and liquid capital markets finally needs to come true. From start-up to category leadership, European companies need a funding ecosystem that is at the scale of their global ambition. However, to achieve this goal, IFIs and NPIs, acting at national and supranational level, need to step up their own ambitions and target unaddressed market gaps in a concerted manner rather than compete amongst themselves for the lowest hanging fruit. This will be a step outside of our usual financial comfort zones.

To date, VC and private equity instruments have served the EU well, but we need to go a step further in their risk-taking and firepower if we are to generate the innovations that will effectively tackle tomorrow's societal and environmental challenges and keep Europe globally competitive. ●

Sebastien Raspiller

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Equity funding must be at heart of CMU 2.0

European banks, notably French ones, have been successfully mobilized to help businesses cope with a likely liquidity crisis at the climax of the lockdown. Still, if we all hope this stage of the crisis is now over, the ongoing economic meltdown may last much longer. In this context, our absolute priority must be to avoid turning a possible liquidity crisis into a solvency one. Yet, this dramatic period reminds us of how hard it can be for some companies, in particular SMEs, to benefit from equity funding provided through market-based solutions. This is why rebooting the Capital Markets Union is crucial to help our businesses diversify their sources of funding. This goal can only be achieved if we take bold measures to kickstart both supply and demand.

> *The upcoming review of Solvency 2 will be key.*

When it comes to supply, the recent economic challenges we have been facing must lead us to take tough measures to make a smarter use of the insurers' and banks' equity. Insurers must fully ▶

▶ play their role in financing the economy and providing long-term savings opportunities for retail investors. The upcoming review of Solvency 2 will be a significant step to meet this objective. At the same time, we must keep defending strong and competitive European banks, operating on global markets and able to provide complex corporate advisory and risk management services. We will then carefully check that the transposition of the Basel III standards does not eventually result in significant differences with some other countries that end up being detrimental to our financial ecosystem.

While banks and insurers have a huge role to play, individual savers should also be given the opportunity to contribute to the economic recovery. This is all the more needed as the current context of uncertainty has led the level of the saving rate to spike. In this view, France will carry on striving to promote pan-European funds in a more active way. Further work will be required to ease the passporting and the development of European labelled funds ELTIF and EuVeCA.

The demand for market-based sources of funding must also be fostered through easier processes. The proposals put forward in July by the European Commission for a quick fix of MIFID are a positive move to waive some reporting requirements which have proven costly and complex, without improving the financial markets stability. The Commission's Capital markets Recovery Package will also contribute to ease SMEs' access to financial markets by allowing the rebundling of research and brokerage for capitalizations under € 1 billion. In the longer run, it will also be necessary to strengthen entrepreneurs' trust in the financial markets. To meet this goal, transparency should be fostered through simpler and more standardized information. MiFID II and PRIIPs, should be better suited to individual investors' needs. In the same line, the recent Wirecard case must bring us to scrutinize the current organization of our supervision to make it better at all levels and more efficient.

Finally, although simplifying the access to market-based sources of funding is a priority, we must acknowledge that it cannot be a cure-all and that it is not always the best suited solution. There are cases in which the panacea will probably rather be to help banks benefit from the financial markets in order to lend to businesses. In that way, we must promote securitization by an ambitious review of impediments - notably prudential ones - to the development of the European framework for Simple, Transparent and Standardized securitizations (STS). ●

Märten Ross

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

To what extent can equity funding be realistically developed in the EU given the obstacles on the supply and demand side?

One should probably be realistic about the extent to which and how fast equity funding could develop. Reasons for that include supply side for capital (i.a. investor literacy) and also demand for changing equity structure from company perspectives (i.e. management literacy). Both sides are not helped by still high cost of equity investment, particularly for smaller companies and cross-border investments.

In addition, developing equity funding in the EU is probably coming more complicated in the aftermath of the COVID-pandemic. What is a bit paradoxic as the need to add fresh capital into companies is becoming actually more pressing.

While one reason for that is lingering additional uncertainty about the future potential returns created by the COVID-shock, also massive government financing schemes, needed as they are for macro reasons, could lower the demand for additional market funding. On one hand credit financing is possibly done one (further) notch too cheap relative to other forms of capital. And it is also clear that the capital injection schemes themselves hardly improve the cost structure and other investments constraints for wider public. Additional (speculative) question is whether governmental intervention into company holdings would add one further layer of uncertainty about finding out productive investments.

Do the adopted and newly proposed policy measures define an appropriate strategy for developing SME equity funding in the EU?

The measures proposed by High Level Forum are in good direction. One should continue working with costs hindering development of equity markets, both on issuing side and also with ones related to infrastructure. This does obviously matter for cross-border aspects, but not only.

Another question is if the SME is sufficiently well covering concept for equity financing problems as it attaches ▶

▶ more attention to M and S gets less prominence. While medium sized companies have better outlook to go public and diversify their equity structure, the excessive cost question is more problematic for the smaller companies (even with good growth prospects).

One question here is whether we are realistic on what to wait for happening with small enterprise market financing (either on growth or full markets). Successes of crowdfunding and some fintech sector approaches could point that these are more promising avenues to diversify capital raising for them and regulation could take direction from these.

What are the priorities and what further actions might be needed?

Clear priority is to work on lowering further the costs of market financing. While marketing and prospectuses side (potential overregulation and inconsistencies in implementing the rules) are important in this regard, further attention should still be attached to the costs imposed onto the investors and arrangers by present central securities depositories framework as there might be unnecessary barriers to registering and safe-keeping capital, i.a. expressed in a new forms. Linked to that - but important also separately - are the costs related to payment infrastructure for cross-border equity holdings. ●

Stéphanie Yon-Courtin

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More than a backbone: fleshing out equity funding for EU SMEs

"SME are the backbone of Europe's economy" earned a top spot amongst EU *clichés.* As the Covid crisis hits Europe, we need to move beyond slogans to ensure that our start-ups, entrepreneurs and SMEs get access to equity funding, for their very survival, and to be at the heart of the recovery.

Just as muscle is needed to put bones in motion, SMEs need appropriate funding sources to get moving. Banks are a prime interlocutor for SMEs in search for funding opportunities. They have played a crucial role in ensuring the smooth rollout of liquidity to SMEs and have gained an acute expertise of SMEs' needs and growth potential over the past decades. However, as their prudent financing capacity could deplete, they should also act as a bridge to identify alternative market-based funding sources. This is why I support Renew Europe's proposal for a pan-European credit referral system, to which SMEs can voluntarily subscribe when their loan request has been rejected.

Muscle alone is not enough: entrepreneurs need coaches in the early stages of their existence. Business angels, venture capital and equity crowdfunding can provide an appropriate mix of funding and coaching, that should be supported in the EU through the sharing of best practices, for example on relevant tax incentives. Member States should also prioritise the transposition of the Directive on preventive restructuring, to help entrepreneurs facing financial difficulties to receive support for their second chance.

With muscle and coaching, our SMEs will be in good shape for the marathon of public listing. The new SME growth market and a lighter prospectus regime should be positive overtime. More fundamental changes should follow: facilitating investment research on SMEs should be more than a temporary measure, and Member States should tackle at last debt-equity bias in taxation.

Just as tendons are connecting muscle and bones, smoother connections between SMEs and funding opportunities are required to better transmit the entrepreneurial motion to the EU economy.

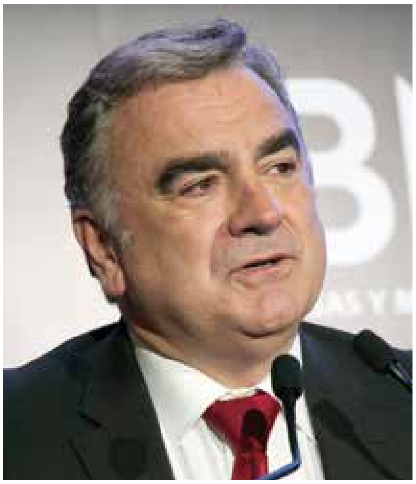
Through the SME lens, facing EU legislation is more of a hurdle race than a walk in the park. The definitions of SME in EU legal acts should be streamlined and reflect that diversity of the entrepreneurial landscape, including family and community businesses, self-employed workers, start-ups, cooperative businesses and mid-caps. Performing an 'SME test' for each CMU initiative is a welcome first step.

> *Fostering an equity culture for EU citizens as investors can bring SMEs closer to equity funding.*

From our viewpoint as EU legislators, SME related actions are at the core of many initiatives, but their visibility on the ground should be improved. Clear communication, involving all relevant actors at European, national and local level, will help making SMEs aware of the support available to them. The new EU SME envoy could also bring more visibility to SME-related concerns at EU level.

Fostering an equity culture for EU citizens as investors can bring SMEs closer to equity funding. Employee share ownership programmes, and easy-to-use digital tools allowing savers to act on their investments, are inspiring ideas to create a cohesive funding ecosystem, increasing financial awareness and reducing risk averseness.

With the muscle of equity funding, and the tendons of equity culture, the SME backbone will set in motion the EU economy recovery. ●



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Funding the way forward for SMEs

Following the last financial crisis, we are going through some of the hardest times due to the Covid-19 pandemic. SMEs will play a key role in the recovery after the Covid-19 crisis but a large number of them are finding it hard to raise capital.

In 2018 the European Commission proposed measures to reduce the administrative burden faced by SME Growth Market issuers, foster their liquidity and facilitate the registration of MTS as SME Growth Markets. The Capital Markets Union features new rules to ensure that smaller businesses in the EU have access to diversified sources of financing at each stage of their development. The idea of an SME IPO Fund that would specialise in IPOs of SMEs is very much welcome too.

In this scenario, it is essential to diversify financing sources and strengthen the balance sheet before bank financing dries up. Europe is heavily bank-based, and the lack of an equity culture is a major barrier to developing a solid SME IPO market.

Access to funding by SMEs lies too in the degree of visibility they reach via research coverage. Since 2018 the research quality and quantity of small and-mid cap stocks has shrunk, a trend that could be reversed if unbundling rules were changed.

SMEs must learn to finance themselves in the market. That involves not only having an attractive project, but also knowing how to pitch it at investors. This is why guiding them along the path to the stock market is key. On the opposite end, the low secondary market that smaller issuers' shares face after the IPO is another major barrier to SME IPO market development. Liquidity provision arrangements with investment service providers – market making - are necessary to increase and maintain efficient liquidity following the market debut.

The participation of retail investors in capital markets is paramount. There is a low level of retail investment across Europe, and increasing it is essential for boosting liquidity and should be promoted by incentivising the channelling of retail savings into SME Growth markets.

Policymakers recently agreed changes to requirements applicable to companies listed on SME Growth Markets. In line with the recommendation of the Next CMU High Level Group, further alleviations for SME Growth Markets should be considered. Special segments of regulated markets should benefit from access to SME Growth Markets and the threshold for companies for qualifying for SME Growth Markets status should be increased.

It is also essential to find the right balance between maintaining liquidity and trust in the market with reduced burdens for issuers paired with adequate levels of investor protection. SME Growth Markets should retain a certain level of flexibility whilst ensuring efficiency and integrity.

Another important consideration is the need to remove the tax bias in favour of debt to encourage equity investments. Rebalancing this scenario can encourage companies to strengthen their equity base and dissuade too high levels of leverage. Secondly, it should result in investors paying lower taxes on their equity investments, incentivising the provision of equity capital as an alternative source of funding. Furthermore, in the area of taxes, the implementation of tax incentives for SME investments should be promoted.

Supporting SMEs is strategic, which is why we must develop strong local SME markets. Much is at stake: they are the ones that have the greatest growth potential and the greatest capacity to generate sustainable and highly qualified jobs. ●

Cyril Roux

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SME Financing - a French insurer's perspective

Europe has long designed initiatives to develop equity financing of SMEs. The over reliance of European SMEs on banking credit compared to their American counterparts is a hindrance to growth, capital allocation and employment in the EU. Yet these EU initiatives are made somewhat ineffective by counteracting EU regulations: elevated information requirements of issuers embedded in the prospectus directive, and accounting standards e.g.

These initiatives are also up against insuperable national differences in language, legal regimes, including company law and insolvency law, and social expectations. Natural institutional investors such as EU insurers have two additional impediments to investing in this asset class: elevated capital charges stemming from EU regulations, and the adoption of IFRS 9, which obscures ▶

▶ the net income effect of their economic stewardship by mixing with it the change in market prices of listed equities held, including SMEs.

The pandemic has made this conundrum more acute. SMEs need more than ever a strong capital base to weather the protracted period of return to pre-Covid levels of economic activity. But investors are themselves in a weaker position to provide patient capital. The 750b€ Next Generation package proposed to the Parliament comes with reduced InvestEU and Horizon Europe programs and no Solvency Support Instrument. Next Generation monies will be disbursed at national level, alongside often larger national programs. So, despite the intense activity of EU institutions, most of the action takes place at national level. And the specific initiatives such as SME growth markets, SME listing package and CMU high level forum risk being made only incidental to the more consequential Covid-19 policy response.

> *Equity funding of SMEs is made in a crucible of conflicting forces.*

While paying lip service to the single market and economic sovereignty at European level, national governments clearly expect economic actors to support employment at home. Re-domestication of production and employment figures are dominant objects of political discourse at the national level. Accordingly, the investment space for SME financing in the asset allocation of insurers is increasingly taken up by semi mandatory investment in government schemes. French insurers have 'willingly' allocated this Spring more than 1.5b€ of assets under a government mandate; failure to do so would have been met by supplementary taxation. Hence SME equity financing by French insurers goes where they are told to invest.

Whatever remaining asset allocation space there is goes to private equity financing, which at least provide a respite from IFRS 9 volatility. In the coming years, the inability of SMEs to refinance the abundant state-guaranteed loans distributed by banks this Spring will lead to a new round of 'voluntary' investment by insurers in those companies. This is admittedly a far cry from market economics, and greater capital markets access for SMEs in Europe. ●

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Equity funding is key for Europe's recovery

Covid-19-is hitting enterprises across Europe. Companies in certain sectors have suffered liquidity shortfalls and equity losses to unprecedented levels which could easily produce systemic risks for the European Union. These companies need immediate help in the form of own fund injections in order to avoid bankruptcies. In this regard we welcome the recently proposed Solvency Support Instrument in the EU budget 2021-2027 which is designed to prevent insolvencies by supporting equity investments. In the framework of the European Fund for Strategic Investments (EFSI), it will use the EU budget to support equity investments in companies with solvency problems. Also the enhanced Invest EU-programme and the new strategic investment facility can be important contributions to support enterprises in their recovery phase. However these proposed measures have to be implemented and rolled out immediately. A swift adoption of the EU budget 2021-2027 by the co-legislators is therefore essential.

It is obvious that these new instruments can help to improve situation in the current COVID-19-crisis. However in a second step the European institutions should avoid new requirements in prudential regulation which impede institutional investor's ability, such as banks and insurers, to participate actively in equity funding. Without these institutional investors an efficient boost of equity funding will not materialize and the investors base for companies would be further narrowed. For this reason also the final report of the High Level Forum on Capital Markets recommends the European Commission to pay particular attention to the interpretation of the Basel III definition of speculative unlisted equity exposures so as not to impair the ability of banks to invest in long-term equity on terms which are economically efficient and prudentially appropriate. According to the current legal framework investments in such exposures would be assigned a risk weight of 100 % risk weights in the standardized approach. According to the new Basel framework these investments would have to assign 400% risk weights. According to the Basel III reform also other equity holdings have to be assigned a risk weight of 250% instead of current 100% risk weights.

> *Europe should avoid new requirements in prudential regulation which impede institutional investor's ability to participate in equity funding.*

And in a third step the enterprises of the European Union have to stay competitive at the global level. Staying competitive will require large investments in technology, as the innovation gap between the EU and other global economies is widening. A key factor for the competitiveness of an economy is the access to venture capital for innovative start-ups. For the segment of venture capital further steps need to be taken and larger amounts have to be allocated on a European level to strengthen Europe as an innovative market. ●