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THE CAPITAL MARKETS UNION FROM THE PERSPECTIVE OF SMEs FINANCING IN THE EU – EXPECTED BENEFITS, CONSTRAINTS AND RISKS

UNIA RYNKÓW KAPITAŁOWYCH Z PERSPEKTYWY SEKTORA MŚP W UNII EUROPEJSKIEJ – OCZEKIWANE KORZYŚCI, ZAGROŻENIA I RYZYKA

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Summary: The article is devoted to the project the Capital Markets Union (CMU) in the EU from the perspective of financing of the small medium enterprises. The EU Capital Markets Union is an important part of the Investment Plan for Europe of the Chairman Jean-Claude Juncker, and its goal is to effectively stimulate economic growth in the EU by increasing the availability of financing for businesses by the capital market and diversification sources of financing. European households are expected to be more active on the capital market by investing in financial instruments of this market. After the Brexit, there may be some difficulties in achieving the objectives since British capital market is the largest one in the EU. However, Brexit may also be a chance to keep the Union together and acceleration of the capital markets unification process. The author characterizes the problem of access to finance for enterprises from the SME sector in the EU. Then, he focuses on the financial markets and the structure and the effect of the Capital Markets Union in the EU. The article is based on a variety of sources, especially documents of the European Commission concerning the Capital Markets Union as well as literature on corporate finance and capital markets.

Keywords: Capital Markets Union, Investment Plan for Europe, household savings, SME financing, market-based financial system model.

Streszczenie: Artykuł poświęcony jest projektowi „Unia rynków kapitałowych (CMU) w UE z perspektywy finansowania małych i średnich przedsiębiorstw". Unia rynków kapitałowych jest ważną częścią Planu Inwestycyjnego dla Europy Jean-Claude'a Junckera, a jej celem jest skuteczne stymulowanie wzrostu gospodarczego w UE poprzez zwiększanie dostępności finansowania dla przedsiębiorstw przez rynek kapitałowy i dywersyfikację źródła finansowania. Oczekuje się, że europejskie gospodarstwa domowe będą bardziej aktywne na rynku kapitałowym poprzez inwestowanie w instrumenty finansowe tego rynku. Po Breksicie mogą pojawić się pewne trudności w osiągnięciu celów, ponieważ brytyjski rynek kapitałowy jest największym rynkiem w UE. Ale Brexit może również być szansą na utrzymanie Unii razem i przyspieszenie procesu unifikacji rynków kapitałowych. Autor charakteryzuje problem dostępu do finansowania dla przedsiębiorstw z sektora MŚP w UE. Następnie koncentruje się na rynkach finansowych oraz strukturze i efekcie unii rynków kapitałowych w UE. Artykuł opiera się na różnych źródłach, w szczególności na dokumentach Komisji Europejskiej dotyczących unii rynków kapitałowych, a także na literaturze dotyczącej finansów przedsiębiorstw i rynków kapitałowych.

Słowa kluczowe: unia rynków kapitałowych, Plan Inwestycyjny dla Europy, oszczędności gospdodarstw domowych, finansowanie MŚP, system finansowy oparty na finansowaniu rynkowym.

1. Introduction

The Capital Markets Union (CMU) has been described by Mr Juncker as one of three "unions" of the European Union (EU) next to Energy Union and the Digital Single Market [Veron, Wolff 2016]. CMU is currently pursuing as a part of the European Commission's Investment Plan for Europe (EC IPE) that is planned for the period 2015-2017 and focuses on removing obstacles to investment, providing visibility and technical assistance to investment projects and making smarter use of new and existing financial resources. The main objective is to increase the CMU market financing of the SMEs sector through capital market instruments and also enable them to access to other EU countries markets easily. Bank dominated financing of economic growth and its effect of the growth of European economies and the lack of bank funds for the SMEs led to the development and publication of the Green Paper and Action Plan for the building of the Union Capital Markets. The aim of the article is to present the concept of the CMU including the principles, objectives, pillars and instruments, implementation plan, its critical evaluation, and to present the opportunities and risks associated with the financing of companies on the capital market in the EU. The hypothesis of the article is as follows: EU capital markets will not be able to effectively increase corporate finance of SMEs in the EU if it is not be accompanied by other structural reforms of EU economies. The article uses literature on Capital Markets Union, as well as statistics relating to the financing of companies in the EU.

2. Financing problems of SMEs in the European Union

SMEs have a key role for a balanced spread of the benefits of economic activity in society. Their contribution to employment and economic growth makes it important to solve the problems faced by SMEs. Therefore many countries have formed the bodies having legal personality by using public resources to support SMEs.

The main problem of SMEs in the Europe, unlike multinationals and large business, are the financial problems. "European SMEs are structurally more leveraged and charged with higher interest rates than large firms. Moreover, the crisis has deeply affected their fund-raising capacity, as banks reduced credit supply while non-bank funding was unavailable to most SMEs" [Ciani, Russo, Vacca 2015]. So it can be said that SMEs are more vulnerable to crisis. "Credit sources tend to dry up more rapidly for small firms than for large companies during economic downturns [ECB 2013].

Large companies can have easier access to external resources with their strong financial structure. "Larger and older firms face the lowest risk of having loan applications rejected" [Holton, Lawless, McCann 2014]. Unlike large enterprises, SMEs try to obtain financing by using their internal resources rather than finding outside sources. "The analysis of country clusters reveals that regardless of the region, European SMEs are for now mostly internally-financed, meaning they do not use external debt" [Demary, Hornik, Watfe 2016].

There is still significant divergence across countries regarding the difficulties in accessing external sources of finance. "Some 31% of SMEs in Greece, 13% in Italy and 12% in Ireland and the Netherlands mentioned that access to finance was the most significant problem, compared with around 6% of SMEs in Austria and Germany and 8% of SMEs in Finland" [ECB 2015].

The problems encountered in finding external resources directly affect SMEs ability to make investments. In a study including 118.000 SMEs in Europe in the period of 2005-2008, "[...] investment is sensitive to the availability of internal funds and interprets this as being indicative of a wedge between the cost of internal and external financing" [Ryan, O'Toole, McCann 2014]. To finance the fixed assets by using long-term sources of investment is crucial to avoid liquidity problems. SMEs face different problems to access long-term resources and in particular, long-term debt. "Firms in countries that protect creditors and enforce existing laws are more likely to obtain long-term bank debt. In addition, when the institutional environment is relatively weak, an increase in economic freedom increases the likelihood for SMEs to obtain loans of longer maturity" [Hernández-Cánovas, Koëter-Kant 2011].

A comparison with the US shows that the structure and sources of finance are a key challenge for Europe. While regulated entities such as banks and insurers are the main suppliers of finance in Europe, the US benefits from a greater diversity and flexibility of funding sources. In the US, private pension funds, fund managers and other types of investors (e.g. angel investors, hedge funds, private equity and venture capital) provide a significantly larger proportion of funding to firms than in Europe. The fundamental difference in corporate funding between the U.S. and Europe is that European companies rely more heavily on bank lending. Overall, some 80 percent of corporate debt in Europe is in the form of bank lending, with just 20 percent coming from the corporate bond markets – almost opposite to the U.S.

Figure 1 shows the comparison of funding between USA and the EU.

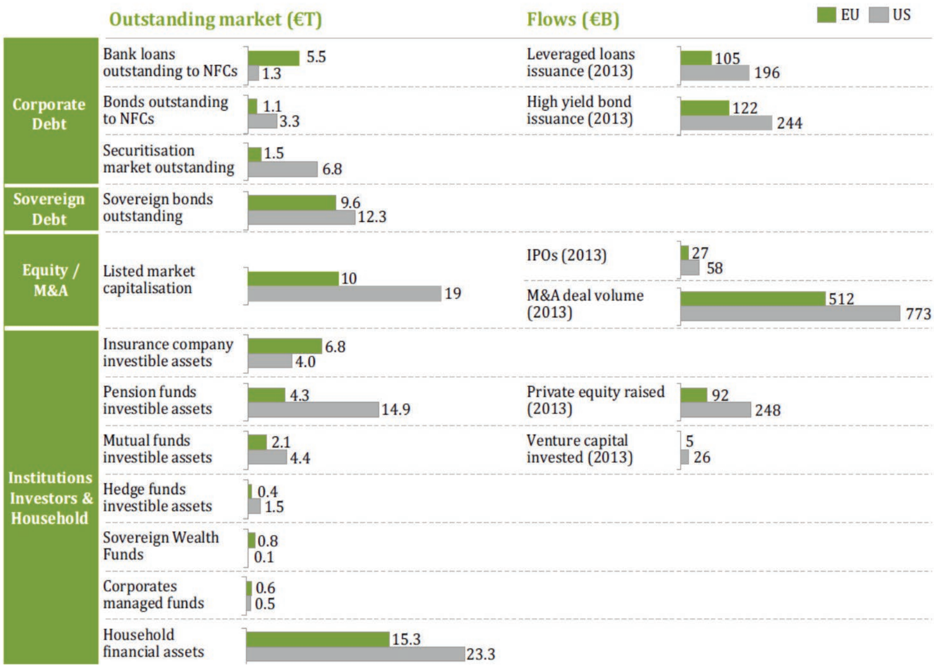

Figure 1. The European Union and the US: different structures and sources of finance

Source: [AFME 2015].

3. EU Capital Markets and The Capital Markets Union

Capital markets have expanded in the EU over recent decades. Total EU stock market capitalisation, for example, amounted to US Dollar 7.2 trillion (around 52% of GDP) by the end of 2014, compared to US Dollar 3.2 trillion in 1994 (47% of GDP)]. The total value of outstanding debt securities exceeded €22.3 trillion (171% of GDP) in 2013, compared to €4.7 trillion (74% of GDP) in 1992. Public equity markets in the US are almost twice the size of those in the EU (as a percentage of GDP) and are three and a half times bigger in Switzerland. Private equity markets in the US are also around twice the size of those in the EU, whilst private placement markets for bonds are up to three times bigger in the US. At the same time there is wide variation in capital market development across EU Member States [European Commission, 2015c]. Furthermore:

- public equity is almost double in size (138% of GDP vs. 64.5% in the EU), and so are private equity markets,
- private placement is up to three times bigger ($50 billion vs. €15 billion in the EU),

- corporate (non-financial) debt securities are three times as large (40.7% of GDP vs. 12.9% in EU),
- corporate high-yield securities (in terms of issuance volumes) are more than 2.5 times as high (€187 billion vs. €68 billion in EU),
- the EU member states capital markets differ in the level of development measured by capitalization/GDP and the value of debt securities (bonds)/GDP taking capitalization/GDP into consideration.

There is also a wide variation in capital market development across EU Member States as it can be seen in Figure 2.

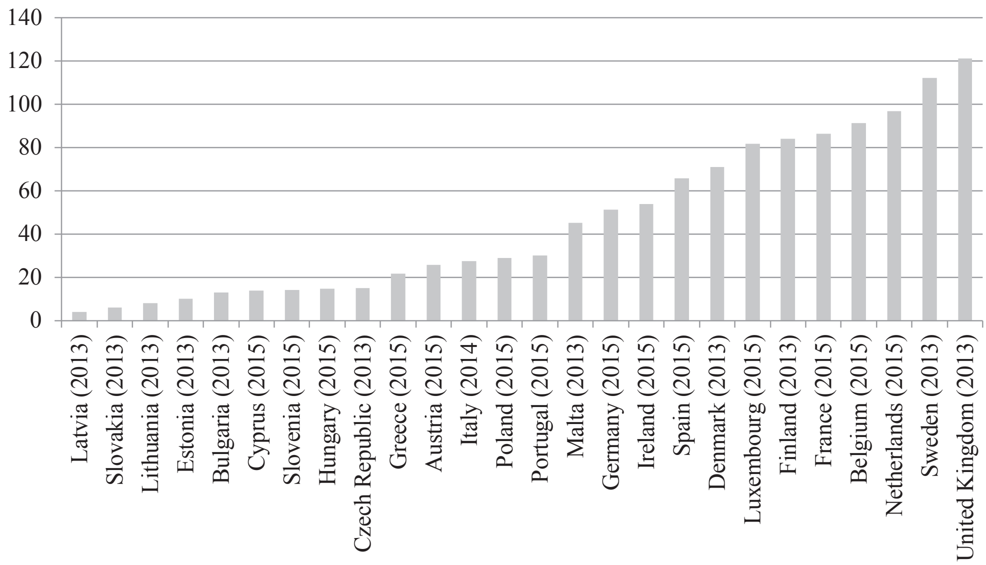

Figure 2. Market capitalization of listed domestic companies (% of GDP) in the EU countries

Source: [European Commission 2015b].

For instance, domestic stock market capitalisation exceeded 121% of GDP in the UK, compared to less than 10% in Latvia, Cyprus and Lithuania.

The phrase "Capital Markets Union", may be new but the idea is not. As Table 1 shows, better integration of Europe's capital markets is a policy objective intertwined with the creation of the Single Market, dating back to 1957 Treaty of Rome. A mere 58 years later, Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union, took office with great expectations on removing critical barriers to more integrated capital markets and developing a more strategic plan to remove longer term barriers in the short and medium term. Steps in capital markets integration in the EU between 1957 and 2015 are summarized in Table 1.

Table 1. Steps in capital markets integration in the EU

Regulations/Report/Papers	Scope
Treaty of Rome (1957)	Founding treaty establishing Free Movement of Capital
Single European Act (1987)	Provides impetus to integration of capital markets
Treaty of Maastricht (1992)	Free movement of capital becomes a Treaty right
First Giovannini Group Report (2001) Second Giovannini Group Report (2003)	Identified 15 barriers to integrated financial markets Second report presents a strategy for removing 15 barriers to efficient clearing and settlement arrangements that were identified in the 2001 report.
Single Market Act I/II (2011/12)	Renewal of EU Single Market to boost growth
Green Paper Building a Capital Markets Union (February 2015)	Idea of integration capital markets in EU countries and removing barriers in SME financing by capital market
An action plan for a Capital Markets Union (September 2015)	Lists the actions and indicative timeline to build Capital Markets Union by 2019

Source: [Cicero 2015].

Recommendations, which were then used in the construction of the project of Capital Markets Union, came from the High Level Expert Group on SMEs and infrastructure financing (HLEG), established in 2013 by ECOFIN. They were adopted in February 2014 by the European Parliament resolution on the financing of long-term European economy [European Parliament 2014]. The Group was established to develop recommendations, the implementation of which should increase access to capital markets for SMEs and long-term infrastructure financing in Europe. The final report on the work of the group lists the following instruments to stimulate investment in the EU – equities and corporate bonds, securitization, covered bonds, offers on the private market. The Giovannini Group was a group of financial market experts, formed in 1996 to advise the European Commission on financial market issues. In particular, the work of the Giovannini group focused on identifying inefficiencies in the EU financial markets and proposing practical solutions to improve market integration. The Giovannini Group's two reports (2001, 2003) identified a total of 15 specific barriers that prevent efficient EU cross-border clearing and settlement. The barriers are divided into 3 groups:

1) Technical requirements/market practices:

- diversity of IT platforms/interfaces,
- need to maintain multiple membership of settlement systems,
- national differences in rules governing corporate actions,
- differences in the availability/timing of intra-day settlement finality,
- impediments to remote access,
- national differences in settlement periods,
- national differences in operating hours/settlement deadlines,
- national differences in securities issuance practice,

- restrictions on the location of securities and
- restrictions on the activity of primary dealers and market-makers.

2) Taxation:

- withholding tax procedures disadvantaging foreign intermediaries and
- tax collection functionality integrated into settlement system.

3) Legal certainty:

- national differences in the legal treatment of securities,
- national differences in the legal treatment of bilateral netting and
- uneven application of conflict of law rules.

On 30 September 2015 Action Plan on Building a Capital Markets Union was announced and two initiatives were taken: the new rules on securitization and new rules on approaches to infrastructure projects in the light of Solvency II, harmonised EU-Wide insurance regulatory regime. In December, 2015 the Green Paper was announced on retail financial services, which includes Capital Markets Union as an important project in terms of building a single market for retail services in the EU – in particular the instruments of investment and pension funds.

3.1. Aims and principles of the CMU

The visionary project of the European Union on the integration of the capital markets is expected to produce following outcomes as it is stated in the Green Paper [European Commission 2015c]:

- improving access to financing for all businesses across Europe (in particular SMEs) and investment projects such as infrastructure,
- increasing and diversifying the sources of funding from investors in the EU and all over the world and
- making markets work more effectively and efficiently, linking investors to those who need funding at lower cost, both within Member States and cross-border.

Figure 3 shows the pillars of Capital Markets Union.

Capital Markets Union should be based on the following key principles [European Commission – Fact Sheet 2015]:

- it should maximise the benefits of capital markets for the economy, jobs and growth,
- it should create a single market for capital for all 28 Member States by removing barriers to cross-border investment within the EU and fostering stronger connections with global capital markets,
- it should be built on firm foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced,
- it should ensure an effective level of consumer and investor protection and
- it should help to attract investment from all over the world and increase EU competitiveness.

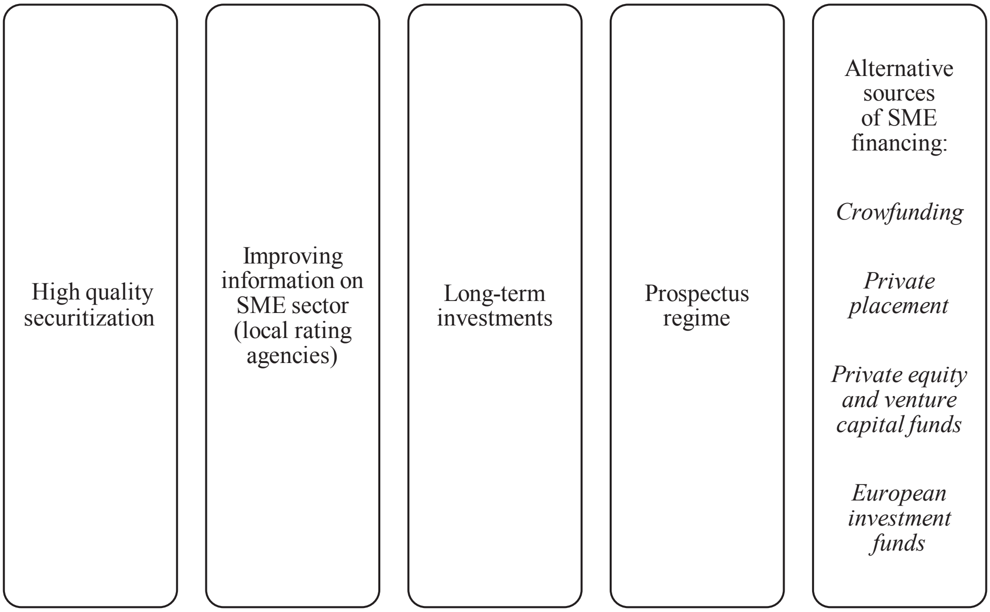

Figure 3. The Capital Markets Union Pillars

Source: [Abascal, Alonso, Pacheco 2015].

3.2. Instruments and pillars of the CMU

The EU capital markets imply multi-faceted efforts to deregulate the financial markets in the EU, increase the activity of individual investors, transferring household savings accumulated in the form of deposits in banks, stimulating the development of the already known forms of financing (securitization of high-quality bonds, venture capital and private equity funds VC/PE) and supporting the development of relatively new forms of financing – private loans (peer-to-peer) and the financing community (crowdfunding). Activities under the CMU can be divided into three parts:

1. On the demand side for capital (to stimulate SME businesses to raise capital through the capital market) – to support the development of efficient and liquid markets in issue securities and alternative instruments: the issue of capital market instruments, equity, equity and debt, bonds, term Investment Funds (ELTIF).
2. On the supply side of capital (stimulating investors to become more active in the capital markets) – to promote long-term savings in order to promote investment in capital markets, by using the savings of individual investors gathered on secure bank accounts through their greater use of high-quality securitization, private placement, P2P, crowdfunding, venture capital funds VC/PE, the European long transfer to the capital market. However, it requires:

a) restoring confidence and increasing transparency of markets,

b) a broad-based educational campaign implemented at national and pan-European levels by the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA),

c) the internationalization of individual investments (so far 94% of Europeans have not acquired security outside the home country), a barrier in more internationalization of investments could be home-bias[1],

d) increasing the level of protection for individual investors.

3. On the capital market infrastructure – transaction and post-transaction, which streamline the process of transfer of capital in the economy of subjects surplus to deficit, the promotion of capital market infrastructure to support activities in the field of securities trading and capital markets:

a) transaction – regulations concerning the functioning of central clearing houses (CCP Central Counterparty Clearing House), including their recovery and resolution (R&R),

b) post-transaction regulations on central securities depositories (CSD).

3.3. Implementing schedule of the CMU

In Action Plan on building Capital Markets Union 6 main areas of implementing CMU project were designated, which were divided into 19 actions and 33 sub-actions [European Commission 2015a]:

1. Financing for innovation, start-ups and non-listed companies:
- support venture capital and equity financing,
- overcome information barriers to SME investment,
- promote innovative forms of corporate financing.

2. Making it easier for companies to enter and raise capital on public markets:
- strengthen access to public markets,
- support equity financing.

3. Investing for long term, infrastructure and sustainable investment:
- support infrastructure investment,
- ensure consistency of EU financial services rulebook.

4. Fostering retail and institutional investment:
- increase choice and competition for retail,
- help retail investors to get a better deal,
- support saving for retirement.

5. Leveraging banking capacity to support the wider economy:
- strengthen local financing networks,
- build EU securitisation markets,
- support bank financing of the wider economy.

[1] The observation that individuals hold too little of their wealth in foreign assets is called "home bias" [Lewis1999].

6. Facilitating cross-border investing.

- remove national barriers to cross-border investment,
- improve market infrastructure for cross-border investing,
- foster convergence of insolvency proceedings,
- remove cross-border tax barriers,
- strengthen supervisory convergence and capital market capacity building,
- enhance capacity to preserve financial stability.

Actions and sub-actions are closely subordinated to the purposes of Capital Markets Union and rely mainly on a review of existing solutions and their evaluation in terms of barriers to SME financing and cross-border movement of capital, and create and stimulate the development of new instruments. The schedule of work on the CMU assumes its full implementation by 2019.

3.4. Expected benefits, constraints and risks of market-based financing of SMEs by implementing CMU

Today, the effects of the global financial crisis are still ongoing. Countries have been trying to produce new policies to ensure sustainable economic growth and to encourage investment. In this context, supporting SMEs since they are the smallest building blocks of the economy has become extremely important for policy makers. "The European Commission has been keen to stress the benefits of a CMU for small and medium sized enterprises (SMEs) in a post-crisis world. Thus, one of the ambitions of the proposed CMU is to offer SMEs better access to finance [Schammo 2015]. The current crises have led to increased volatility and more fragile economies. CMU idea aims to be a solution to the negativities in such an environment. "The biggest objective, therefore, of the Capital Markets Union (CMU) plan is to increase financial resilience, ensure that capital is put to productive use, connect savings more efficiently to growth, channel investments to projects that need financing and give companies greater choices for funding" [Bruges European... 2016].

The integration of capital markets in the EU also aims at enabling the financial unity after the political and economic unity. In this way, the strengthening of the channels reaching funding sources, increasing transparency and the obstacles for investment may be possible. "More integrated capital markets are expected to improve the long-term funding of Europe's corporate sector. The idea is to enable companies to choose from a more diverse range of funding options and to gradually bring down barriers to cross-border investment" [Elsinger et al. 2016].

Increased liberalization is known to be a catalyst for the economic growth. CMU that allows EU countries to specialise in their area of expertise would foster economic activity throughout the EU. "One necessary condition for the sustainability of such a framework, however, is ensuring that barriers for entering into specific markets are removed in order to maintain competition among EU countries" [PWC 2015]. "Capital markets integration also benefits from the availability of aggregate market statistics, either for analysts to monitor market and macroeconomic trends that can impact different sectors or for policy-makers to monitor the aggregate impact of financial reforms and to ensure the accuracy of legal rules" [Valiante 2016]. "Like any ambitious policy project, the CMU initiative contains substantial risks and will likely produce winners and losers. However, where it succeeds, it can improve the financing environment for SMEs and consequently stimulate the creation of growth and jobs in the EU" [Demary, Hornik, Watfe 2016].

The success of intended unity by CMU will depend on the combination of different markets by right methods. Otherwise, the life of unity that is not set on solid foundations is bound to be short. "In order to achieve deeper and deliverable integration within the CMU one needs first to achieve comparability, standardisation and convergence across the legislative and non-legislative building blocks that build up an integrated financial system and a dynamic Single Market. These are key elements that policymakers may wish to consider in how best to balance delivering the legislative framework and new market infrastructure making up CMU going forward" [Huertas 2015]. Also the unity of differently scaled market inclusion can be a barrier to work in harmony. "One of the main obstacles is the size and the fragmentation of capital markets within the EU. Although there is substantial EU law already adopted and implemented in the area of capital markets, there are still many provisions and rules that differ across EU Member States. This barrier shall be also overcome to a certain extent by the Capital Markets Union. However, the small size of some national capital markets may not be easily tackled trough legal or administrative measures. The small size of these markets does not allow their deepening and liquidity, hindering also the possible financing to SMEs. Small markets may not also realise economies of scale and they may not attract easily the consumer and investor confidence" [Simeonov 2015].

To reach the intended target of CMU, SMEs must make structural changes over time. "Enhancing access of SMEs to bond and equity markets — one of the declared goals of the capital market union suggested by the president of the European Commission — is an important complementary solution. However, a working capital market union will still only work in conjunction with real banking integration because, even with more highly developed and integrated bond and equity markets, most SMEs in Europe will remain bank-dependent due to their small size and opaqueness" [Hoffmann, Sorensen 2015]. There are also some shortcomings of SMEs compared with large enterprises. "Despite their major contribution to the real economy and their importance for the recovery, the spectrum of funding alternatives available to SMEs is constrained compared with large enterprises. As a result of their organisational features and business strategies that are rarely publicly disclosed, SMEs are usually not as transparent as large enterprises. This informational opacity limits their access to standardised public markets for equity and debt" [Kaya 2014].

CMU will make it easier to manage the risks posed by the financial crisis-induced volatility. But the finance science suggests that risks can be minimized by making diversification. The problems in managing the risks raising from the idea of unity must not be ignored "While the CMU has the potential to create a more shock-resilient, decentralised investment system, linking savers and firms across borders, it will most likely come with its own systemic risks. For instance, there is a significant risk that home-bias can flare up in periods of stressed market conditions, bringing about the panicked repatriation of funds. Furthermore, excessive harmonisation of systems can destroy their diversity and resilience, and to be successful, the CMU will have to steer clear of this danger while trying to create a single European capital market" [Fouché, Neugebauer, Uthemann 2016].

Table 2. Market-based and bank-based financial system in the context of SMEs financing

Criteria	Market-based financial system	Bank-based financial system
Main source of the economy financing	Financial markets, mainly capital market and stock exchange	Bank credit
Information production	Banks produce private information	Markets produce public information (price) based on liquidity
Corporate governance	Directly & by reducing free cash	Through voting, take-over, price-linked compensation etc.
Risk diversification	Financial markets – cross-sectional risk	Financial institutions – intertemporal risk
Arguments in favour of type of system	Banks are ineffective because of: • excessive control – extracting rents, which limits innovation, • excessive conservatism, • bank managers act in own interests – inefficient corporate control • lack of customized hedging instruments, • strong pro-cyclical character of credit supply by banks, risk of ever-greening and zombie-lending. Lack not only of public equity, but also private equity on capital markets: • venture capital, angel financing etc. less developed in Continental Europe than U.S., • supply and demand-side constraints.	Markets are ineffective because of: • a free rider problem, • poor incentives to exert corporate control, • deficient control device, • difficult to intertemporally diversify risk. Bond market financing has partly replaced bank financing during the European crisis.

Source: [Beck 2015].

Table 2 presents a comparison of financial system models taking into account SME finance. Generally, different firm segments are catered to by different segments of the financial system:

- SMEs' financing patterns: pecking order, life-cycle hypothesis,

- smaller firms limited to banks,
- mid-sized firms having somewhat larger choice,
- larger firms connected to both banks and financial markets.

4. Conclusions

The uncertainty following the Brexit vote within the European Union and the possibility of the Union to become a loose federation may lead to a slowdown or even a setback in the uniformization and single market practices within the EU. However, Brexit could be expected to be a factor accelerating the integration of EU capital markets since CMU can be seen as an opportunity for the European companies suffering from bank-dependent financing to reach capital markets and cross-border financing [State of the Union 2016].

However, it should not be forgotten that the CMU may bring about a similar systematic risk like in the single currency. Moreover, the legal and administrative differences among the EU countries and the different sizes of the capital markets are also emerging as some difficulties in achieving the targeted integration.

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