

FESE Feedback on The Effects of Financial Regulatory Reforms on SME Financing

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FESE welcomes the opportunity to respond to the Financial Stability Board (FSB) evaluation of the effects of G20 financial regulatory reforms on the provision of financing to small and medium-sized enterprises (SMEs). It is important that financial authorities carefully assess the impact of G20 regulatory reforms on financial intermediation to better determine if regulations are working in line with the authorities' intentions and the G20 objective of strong, sustainable, balanced, and inclusive economic growth¹. This framework for post-implementation evaluation is, therefore, most welcome.

In our response, we will focus on the European perspective while our colleagues at the World Federation of Exchanges (WFE) will provide feedback on SME financing at global level.

1. What have been the main trends in SME financing (i.e. types of financing, volumes, prices and maturities) since the financial crisis? How do these trends differ across jurisdictions (e.g. advanced vs emerging market economies) and sectors (e.g. high-tech vs traditional firms), as well as by firm size (micro vs small vs medium-sized firms) and age (e.g. start-ups vs mature firms)?

FESE Members have no comments on Q1.

2. What have been the main drivers of the observed trends in SME financing in recent years? How do they differ across jurisdictions, sectors, size and age of firms?

FESE Members have no comments on Q2.

3. Have financial regulatory reforms such as Basel III affected bank financing to SMEs (e.g. in terms of loan volumes, prices, maturities and collateralisation)? If so, how? How important have been their effects vis-à-vis other types of bank lending and compared to the main drivers identified in question 2?

FESE Members have no comments on Q3.

4. How does the impact (if any) of financial regulatory reforms vary across banks operating in different geographies and with different size and business models?

FESE Members have no comments on Q4.

5. What other G20 financial reforms or other domestic financial regulations (if any) may have impacted financing to SMEs and how?

¹ G20. (2009). G20 Leaders Statement: The Pittsburgh Summit. Pittsburgh: G20.

The European regulatory landscape for capital markets is outlined in the Capital Markets Union (CMU), a key initiative in the European Union's (EU) long-term endeavour to foster financial integration and resilience. Promoting the financing for innovation, start-ups, and non-listed companies and making it easier for companies to enter and raise capital on public markets are two of the six themes under which the main initiatives proposed in the CMU² are framed.

In an environment in which Europe must reduce its dependence on bank lending, economic growth can only be financed through a greater share of financing from capital markets. The need to develop market-based financing has been recognised at the highest political levels in Europe and was the core objective of the CMU initiative, but Europe's capital markets are still far from meeting these objectives as, by various indicators, European markets fail to catch up with their peers from the Americas or Asia³.

In general, lowering the dependence on bank-based financial systems and increasing cross-border capital market integration will foster a better growth performance and risk sharing. Exchanges improve the access of borrowers to funds, reduce their capital costs, and diversify their funding sources⁴. For example, market-based financial intermediation is associated with countries at the technological frontier⁵.

Support local ecosystems as a bedrock to capital raising

FESE is a keen supporter of the development of local capital markets and has set-up an internal workstream dedicated to smaller markets⁶. FESE believes that it is key to boost the development of smaller capital markets where the majority of companies are SMEs and the investment gap still remains broad.

² European Commission. (2015a). Action Plan on Building a Capital Markets Union. Brussels; European Commission. (2015b). Building a Capital Markets Union.

³ Allard, J.; Blavy, R. (2011). Market Phoenixes and Banking Ducks Are Recoveries Faster in Market-Based Financial Systems? (IMF Working Papers); Cournède, B., Denk, O., & Hoeller, P. (2015). Finance and Inclusive Growth, (14). <https://doi.org/10.1787/5js06pbhf28s-en>; Dombrovskis, V. (2018). VP's speech on European Banking and Capital Markets Union at the Ambrosetti forum panel "The Agenda for Europe." Cernobbio: European Commission; Draghi, M. (2014). Keynote speech at the Eurofi Financial Forum. Milan: ECB; European Commission. (2015). Economic Analysis Accompanying the Action Plan on Building a Capital Markets Union. Brussels; Hill, J. (2016). Speech by Commissioner Jonathan Hill at the Seventh Bruges European Business Conference "Capital Markets Union." Bruges: European Commission; Langfield, S., & Pagano, M. (2015). Bank bias in Europe: effects on systemic risk and growth (ECB Working Paper Series).

⁴ Levine, R. (2004). Finance and Growth: Theory and Evidence. NBER Working Papers, September 2004. <https://doi.org/10.3386/w10766>

⁵ Allen, F. (1993). Stock markets and resource allocation. In C. Mayer & X. Vives (Eds.), Capital markets and financial intermediation (pp. 81-108). Cambridge: Cambridge University Press. <https://doi.org/10.1017/CBO9780511752056.007>; Black, B. S., & Gilson, R. J. (1998). Venture capital and the structure of capital markets: banks versus stock markets. *Journal of Financial Economics*, 47(3), 243-277. [https://doi.org/10.1016/S0304-405X\(97\)00045-7](https://doi.org/10.1016/S0304-405X(97)00045-7); Demircuc-Kunt, A., Feyen, E., & Levine, R. (2011). The Evolving Importance of Banks and Securities Markets (World Bank Policy Research Working Papers); European Central Bank. (2018). Financial integration in Europe. <https://doi.org/10.2866/95244>; Hsu, P.-H., Tian, X., & Xu, Y. (2014). Financial development and innovation: Cross-country evidence. *Journal of Financial Economics*, 112(1), 116-135. <https://doi.org/10.1016/J.JFINECO.2013.12.002>

⁶ For FESE internal purposes, smaller markets are defined either as markets focused on SME and mid-caps or as markets in jurisdictions defined to have emerging or frontier market classification in commonly used frameworks.

To foster SME financing, the CMU should deepen local ecosystems and provide the tools and the regulatory framework for those market participants who want to grow and expand both at the national level and cross-border. However, in the recent waves of action to regulate the financial industry (e.g. MiFID, I and II, and MAR) have had the effect of:

- Driving up costs for all companies looking to go public, thus reducing the supply of small and mid-cap companies in particular.
- Disincentivising investment in smaller companies and in equity overall.
- Eroding the local ecosystems of smaller brokers, analysts, and advisers catering the needs of smaller companies and investors.

More concretely, FESE would like to highlight three principles that would foster SME financing:

1. Deliver a proportionate regulatory framework

For SME issuers, the current regulatory burden to access and remain in public markets can be overwhelming. More precisely, the **‘one-size-fits-all’ model**, mostly used in the context of EU level legislative frameworks, is less proportional for smaller markets and brings excessive and disproportionate requirements for listed SMEs. Not only do they face raising compliance costs, leading them to de-list and to resort to private equity, but these administrative barriers are also making the European public markets less attractive for SMEs who wish to list. Therefore, FESE encourages further EU-level actions to remove the regulatory barriers impeding investment in SMEs, in line with the European Commission’s goal to completing its CMU initiative. Whilst we support the recent EU proposal promoting the use of SME Growth Markets, which led to the adoption of important alleviations in both MAR and MiFID II legislative frameworks, further work can be done in tailoring requirements, in particular to SME bond-only issuers. Furthermore, longer deadlines for transposition and implementation to give more time to market participants to get ready for the changes could be beneficial.

2. Ensure a fair treatment of equity financing – Rebalance the current tax-based bias for the benefit of both companies and investors

Persistent tax-based biases towards bank financing remain in the EU. FESE encourages EU policy-makers to consider the different characteristics of public equity and debt markets when undertaking capital markets regulatory initiatives. In particular, some of the current fiscal arrangements in place act as a barrier to the development of public capital markets in Europe. FESE understands that taxation is the competence of the Member States. Nonetheless, Member States should be encouraged to use tax policies to stimulate long-term investing of listed equity of smaller companies and to ensure the fair treatment of debt and equity financing. FESE encourages Member States to review fiscal incentives against equity financing in Europe given the high potential positive impact such changes could deliver for the overall attractiveness of European public capital markets. Additionally, FESE welcomes the intention of the European Commission⁷ to address this issue via the Common Consolidated Corporate Tax Base (CCCTB).

3. Remove barriers to SME financing

⁷ European Commission. (2016). Impact Assessment Accompanying the document Proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CCCTB).

From an investors' perspective, the planned comprehensive assessments of the impact of Solvency II's capital charges, and MiFID II's inducement rules for equity research conducted on SMEs, are welcomed initiatives to incentivise further investment into SMEs. In regard to the latter, there is some evidence⁸ that coverage is diminishing as a result of the regulatory requirements for research to be independent. While the regulators' intention was commendable, the consequences might be that less research, enabling investment in SMEs, is carried out.

SME equity financing has never been easy as investment banks charge fixed fees for working on Equity Capital Markets (ECM) transactions. Following the implementation of MiFID II and MAR, we observed that SME transactions are blocked on the advisory side, but mainly on the distribution side. Also, due to the new unbundling rules, research needs to be financed by issuers, which creates additional hurdle for the ECM transactions.

6. Have financial reforms prompted a shift in the provision of SME financing, e.g. between banks and other financial institutions (substitution effects)? If so, how?

Public markets offer an easy access to companies wanting to raise capital and to all investors, retail and institutional, wishing to diversify their portfolios. However, despite the benefits of listing on stock exchanges, several barriers remain which inhibit the ability of EU public markets for SMEs to attract new issuers⁹. Traditionally, the various players who make up the ecosystem were incentivised to invest time and resources into building the demand for smaller IPOs. Yet, these services are disappearing and this erosion of the local dimension is reflected in the lower numbers of IPOs across Europe over the past few years¹⁰. EU policies can make a difference in preventing a further loss of the local and regional ecosystems, with policies that sustain the full spectrum of players serving smaller companies and their investors. EU policies should also deliver a comprehensive strategy on how to boost equity and non-equity financing at all stages of the funding escalator.

Furthermore, FESE encourages policy-makers to consider the different characteristics of public equity and debt markets when undertaking capital markets regulatory initiatives. In particular, some of the current fiscal arrangements in place act as a barrier to the development of public capital markets in Europe. From a company/issuer perspective, equity is more heavily taxed than debt in most countries, which disincentives equity investment¹¹.

7. Are there any other issues or relevant factors that should be considered as part of the evaluation?

⁸ See CFA Institute. (2019). 'MiFID II One year on' for the drawbacks with the MiFID II regime for investment research

⁹ European Commission. (2018a). Impact Assessment Accompanying the document Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 596/2014 and (EU) 2017/1129 as regards the promotion of the use of SME growth markets.

¹⁰ AFME. (2018). Capital Markets Union Measuring progress and planning for success; European Commission. (2018b). European Financial Stability and Integration Review 2018; Gao, X., Ritter, J. R., & Zhu, Z. (2013). Where Have All the IPOs Gone? Journal of Financial and Quantitative Analysis, 48(06), 1663-1692. <https://doi.org/10.1017/S0022109014000015>

¹¹ European Commission. (2018c). Tax Policies in the European Union, 2018 Survey.

There is a need to foster a culture of risk-taking among SMEs and SME investors to create more balanced public capital market structures. From both an investors' and entrepreneurs' perspective, it is key to develop an equity culture.

First, from an entrepreneurs' perspective, **key to influencing an equity culture is education**. Financial literacy rates vary widely across the EU¹². Citizens who lack basic financial concepts are not well equipped to make informed financial choices regarding saving, investing, and borrowing¹³. In fact, less than half of European households invest in any type of financial product with the notable exception of Sweden¹⁴. The promotion of public capital markets must go hand in hand with measures to sustain confidence in markets. In the coming legislative period, efforts should focus on improving financial literacy on the basis of facilitating access to direct investments. Public support is key, and this could take the form of:

- **Regulatory initiatives to support exchanges in their public good and educational activities.** This support could be used at different levels of market education: educating large companies about transparency and corporate governance, educating SMEs about listing in an SME market (benefits and obligations, establishing corporate governance and investor relation functions - longer lasting programs).
- **The use of EU structural funds to support listing of local SMEs**, e.g. with the creation of an 'IPO Fund' to tackle the investment gap, coverage of part of the listing and transaction costs, co-investments by state funds—currently, state funds focus only on private-equity style investments.

Second, it is essential to bring many of the smaller EU markets on the radar screen of investors to develop them further. In the long run, this increased visibility will have the effect of improving liquidity. Smaller markets are particularly impacted by the effects of passive investing, their inclusion in a broad market index has become increasingly important. The classification of markets is a key input in the process of index construction as it drives the composition of the investment opportunity sets to be represented. However, the classification of countries according to their development does not always reflect that certain conditions might be fulfilled through the participation in the Single Market and the application of the EU legal framework. In addition to the current methodologies, we would favour, where reasonably applied, a **regional approach** in assessing the economic development of smaller markets.

Furthermore, as stressed in the report of the Vienna Initiative¹⁵, a friendly business environment is key to ensure a prompt development of capital markets. Authorities should adopt a cross-cutting approach and analyse the various sectorial regulations, e.g. Solvency II and IORPs that could prevent or limit investing in smaller markets and SMEs by institutional investors. For instance, a review of equity capital charges under Solvency II should be a clear priority for EU policy-makers in order to remove one of the important biases against equity investment. Today, capital requirements do not take into account a long-term view regarding investments: policymakers should investigate and address this.

¹² Klapper, L., Lusardi, A., & Van Oudheusden, P. (2015). Financial Literacy Around the World: Insights from the Standard & Poor's Ratings Services Global Financial Literacy Survey.

¹³ European Commission. (2018b). European Financial Stability and Integration Review 2018.

¹⁴ European Commission. (2018d). Distribution systems of retail investment products across the European Union.

¹⁵ Working Group on Capital Markets Union. (2018). EBCI Vienna Initiative. London.

Additionally, FESE already stressed the importance of a favourable tax treatment to boost retail investors' participation in capital markets, but this is key also for companies. The tax regime which applies to listed companies, including SMEs, plays an important role in the decision of companies to list. A fair tax treatment, in the form of lower taxes and easier tax procedures, would incentivise companies to go public and would help maintain on the stock market those companies which are already listed.

In conclusion, there is a clear need for more far-reaching initiatives if the EU truly wants a fully integrated union in its capital markets, which would act as an attractive alternative to bank financing for channelling funds to firms.

The Federation of European Securities Exchanges (FESE) represents 35 exchanges in equities, bonds, derivatives and commodities through 19 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of February 2019, FESE members had 8,634 companies listed on their markets, of which 13% are foreign companies contributing towards the European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access the capital markets; 1,323 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union.