

A Capital Markets Union for Europe: The Relevance of Banks and Markets

Authors: Markus Demary / Matthias Diermeier / Heide Haas

Phone: +49 221 4981 -732 / -605 / -742

E-Mail: demary@iwkoeln.de / diermeier@iwkoeln.de / haas@iwkoeln.de

Abstract

The establishment of a Capital Markets Union (CMU) is a high-priority project of the European Commission. CMU should foster additional non-bank sources of finance, mobilize private savings more efficiently and enhance capital market integration. Although more integration is needed, the Commission's proposal misses the role of systemic functions in a CMU. First, banks are important intermediaries specialized in credit relationships and small and medium-sized companies gain from long-term relationships with banks. Second, overcoming financial fragmentation needs sound sovereign debt markets with stable sovereign finances. In a CMU sovereign risks have to be treated adequately in bank regulation. Third, it should be assessed in advance which sources of non-bank finance will be demanded by companies and will become systemic. We recommend an integrated financial supervision for the CMU. Therefore, the European Banking Union should cover all European Union members' systemic relevant banks. In order to mobilize private savings while coping with the CMU's complexity, the EU should foster financial literacy.

Keywords: financial aspects of economic integration, financial regulation, investment and savings, relationship-banking, sme finance

JEL-Classification: F02, F33, F36, G21, G28, G30, G38

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1. Introduction

Following the initiation of the European Banking Union, Commission president Juncker proposed a new project in terms of financial integration: a Capital Markets Union (CMU). While the Banking Union focused on the establishment of a single regulatory rule book and a centralized bank supervision and bank resolution system for the Eurozone banking sector, the CMU is about dismantling barriers within the EU to free-up capital for investment. Compared to many other countries, banks are highly significant for corporate financing in the EU. In order to build up a more diversified supply of sources of financing, the Commission aims to strengthen capital markets as a complement to banks (European Commission, 2015). According to estimates by the commission, 90 billion Euro of funds would have been available for financing companies between 2008 and 2013 if Europe's markets for venture capital were as deep as markets in the US. In the future, a genuine CMU should allow EU companies to raise capital, issue bonds and invest seamlessly across the EU.

Although the Commission's plans have not been completely specified, the potentials of the concept by itself are already discussed heavily. Giovannini et al. (2015) argue that the underlying causes of the low level of investment in Europe have not yet been identified and that many of the policies currently being pursued are therefore based on perception rather than on fact. In their view it is in particular unclear whether the financial system is the source of the investment deficit or whether it is caused by a low demand for capital. Moreover, they question if the problem is of a permanent or a transitory nature.

In our view the CMU's future success heavily depends on the answers to the following research questions:

1. Do investment and savings currently meet in an inefficient way and will the CMU overcome these inefficiencies and effectively enhance investment?
2. Can we mild the financial market fragmentation in Europe through the CMU?
3. Do SMEs need alternatives to bank finance, like non-banks and capital markets?
4. Will SMEs, especially the smaller ones use non-bank funding sources?

To answer these questions, this article explores the basics of supply and demand in corporate financing in the EU, focusing on SME finance. The following chapter gives an overview on the different sources of funding and presents funding channels in the EU. Chapter 3 analyses the source of the renewed financial market fragmentation in

Europe and how it affects SMEs. In chapter 4 SMEs' current access to finance and financing channels in the EU are presented and we analyse if and how SMEs will demand funds from non-bank sources. We conclude in chapter 5 and present our policy recommendations.

2. Diversified sources of funding

The European investment potential arises from institutional and retail savings as well as international investments into the European Union. The CMU needs to address specific channels for savings to efficiently meet investment demand. Therefore, the differences between the different groups of investors must be considered carefully. Whereas retail investors mainly focus on safely transforming savings into future purchasing power, institutional investors strive for longer term and riskier investment projects.

2.1 Institutional Investors

Adding up to 15.4 trillion Euros, the assets under management according to data of the European Fund and Asset Management Association take up one third of the world market and rank second after the US. Although this amount stresses the importance of institutional investors in Europe, a closer look reveals a stark dependency on the UK. As a matter of fact, assets under management in the UK amount up to 5.5 trillion Euros – 2.82 times its GDP.

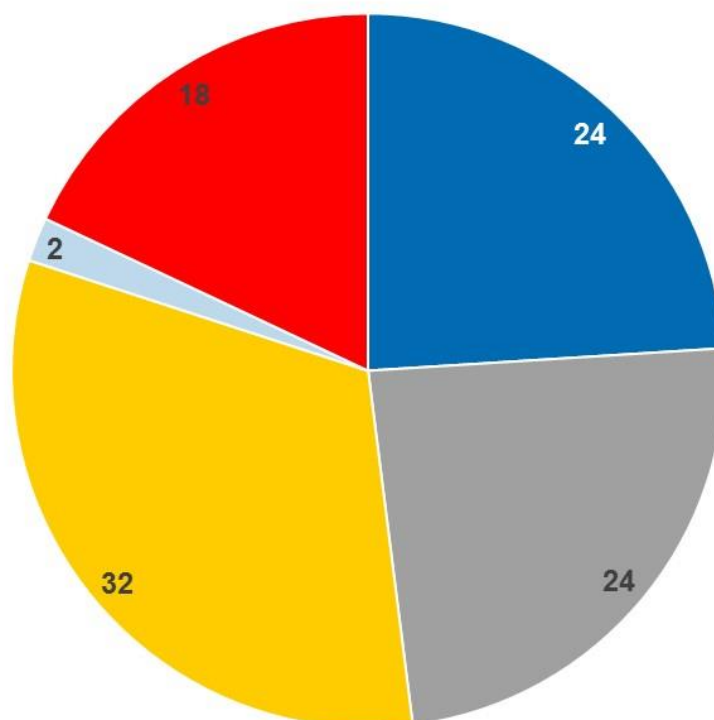
Figure 1 shows how these assets are distributed throughout the different players in the market. Basically, 76 percent, 11.7 trillion Euros, are administered by institutional investors such as insurance companies and pension funds, whereas the rest, 3.7 trillion Euros, are held by high-net-worth individuals. Of the entire amount of assets under management, 46 percent consist of bonds followed 29 percent held in equity and 10 percent held in money market instruments (EFAMA, 2014).

Especially insurance companies and pension funds are highly regulated in their investment decisions. At the same time, however, they contain a big potential as the demographic change pushes more and more European investors from obligatory pay-as-you-go to private fully funded pension schemes. Solvency II, being revised through Omnibus II and taking effect from 2016 on, will try to channel more money from insurance companies into long run projects. By acting much more professionally and long-sighted than retail investors, in general, institutional financiers are able to take a significantly higher amount of risk. Usually, institutional investors can roll over their debt and invest in projects far beyond an individual's investment scope. The European Long-Term Investment Funds (ELTIF), for instance, are a newly created instrument in order to steer investments into long run projects. Deposited money will be locked up for a significant amount of time with limited chances to withdraw before the appointed project end. To improve ELTIF's attractiveness for insurance companies and pension funds, they will receive a preferential treatment once

Solvency II takes effect. Unfortunately, ELTIF are specifically marketed to retail investors, although institutional investors are much better suited for corresponding long run investments.

Figure 1: Clients of the European Asset Management Industry

In percent of assets under management



■ Retail Investors ■ Pension Funds ■ Insurance Companies ■ Banks ■ Other Institutionals

Source: EFAMA (2014)

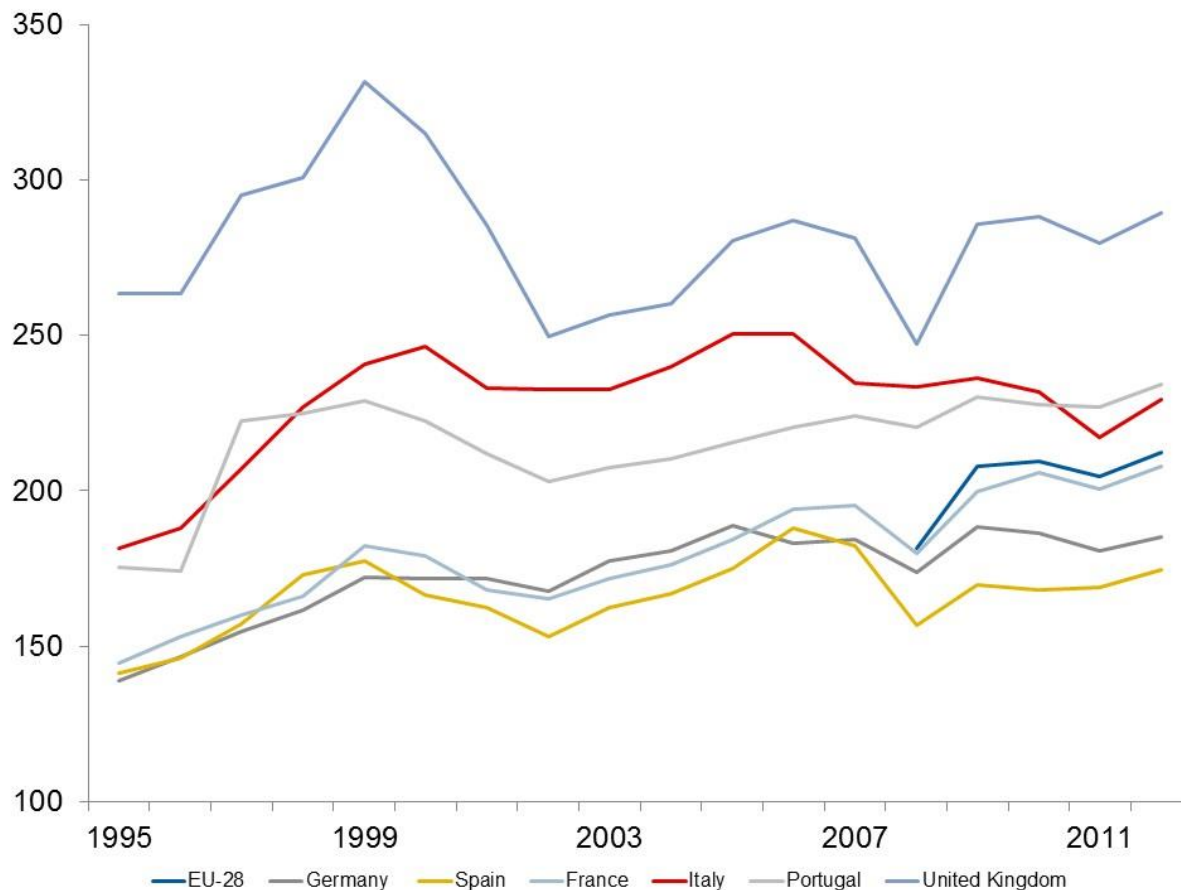
2.2 Retail Investors

European households hold financial assets amounting to 28 trillion Euro¹. Their sheer potential makes them one of the most important stakeholders of the CMU. However, again it must be taken into account that fundamental differences exist among EU member countries. Figure 2 shows selected countries households' financial assets in percent of GDP. The United Kingdom's households stick out in these statistics, holding close to three times the UK's GDP – whereas the European average settles slightly above 200 percent.

¹ See Eurostat's national annual sector account financial balance sheet database.

Figure 2: Household's Financial Assets

In percent of GDP



Source: Eurostat

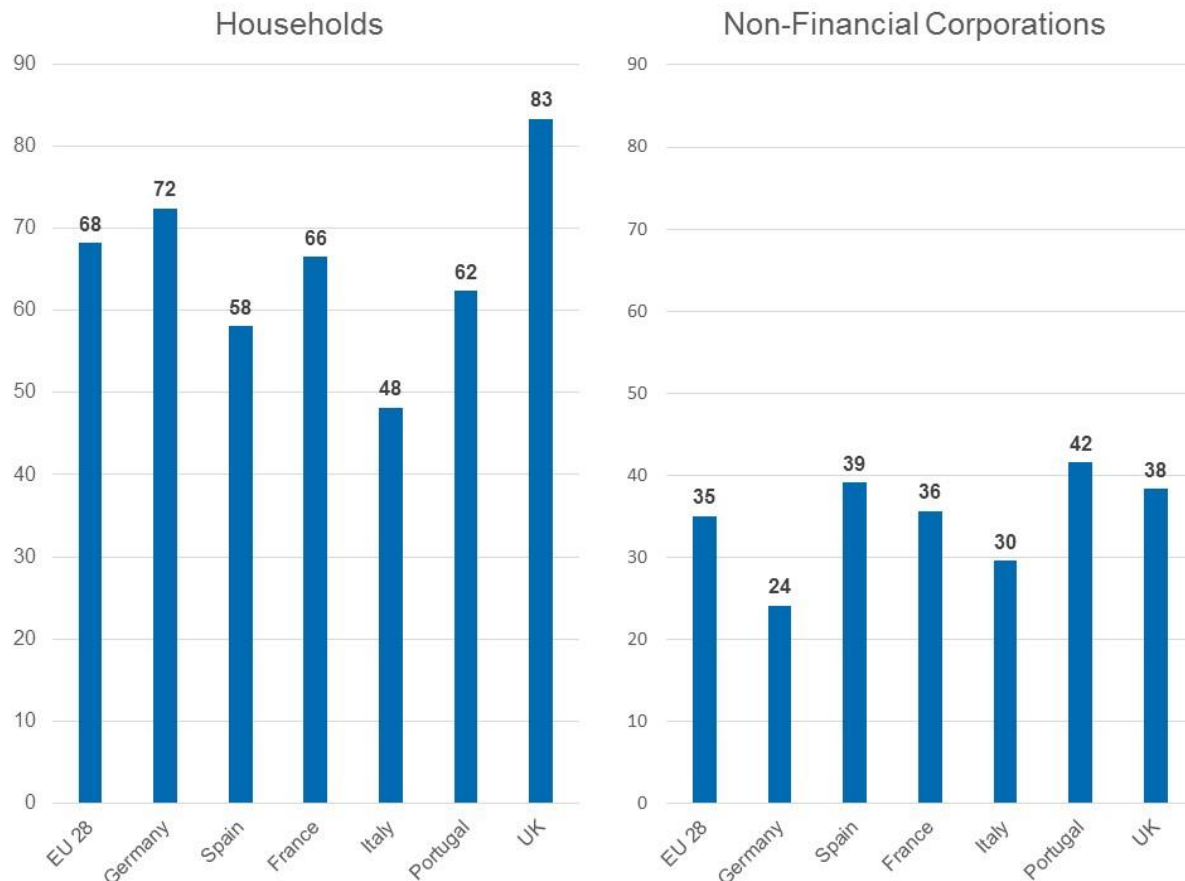
Comparing households' financial assets, it should be noted that, in fact, a strong concentration of financial assets in specific countries does not necessarily mean that these households are comparatively rich. In Germany, for instance, households hold comparatively little financial assets. However, the German savings rate in percent of disposable income lies at 16 percent – 5 percent higher than the EU average. This means German households turn out to be rather conservative in their saving-consumption decision, but do not excessively invest in financial assets. By and large, for a comprehensive analysis of retail investors' wealth and indebtedness, real assets and the level of debt need to be taken into account. Exploiting OECD data, it turns out that also southern European countries' households hold a high share of real assets in their portfolio – mostly dwellings². Hence, these households – taking out long-term loans for house purchases – end up with higher debt to financial assets

² Unfortunately the OECD's data on households' real assets is rather incomplete.

ratio which makes them more likely to be forced to liquidate real assets in order to service financial obligations.

Figure 3: Intermediation Ratios

In percent of financial assets, 2012



Source: Eurostat, Cologne Institute for Economic Research³

The relative importance of financial assets in the UK, in contrast to continental Europe, is also reflected in the importance of the UK's financial intermediaries. Not only do households hold more financial assets than in EU member states, they also have the highest share of intermediated assets – more than 80 percent of households' financial assets are held through a financial intermediary (see figure 3). Mostly, this is due to a huge amount of life insurances that UK households bought from UK insurance companies. Interestingly, the percentage of shares and other securities in the financial portfolio remains relatively low in comparison with continental Europe.

The intermediation ratio of non-financial corporations also appears to be comparatively high in the UK. And indeed, the UK's non-financial corporations hold

³ See Jäger (2006) for a definition of intermediation ratios.

up to 60 percent of their financial assets in shares and other securities. In general, it should be noted that non-financial corporations – in contrast to households – interact with the capital market much more directly. Thus, amounting to over 14 trillion Euros, this sector seems to be rather important for CMU’s design.

By and large, fundamental differences exist between the different types of investors. Whereas households mostly save in order to safely transfer purchasing power into the future – e.g. through the acquisition of life insurances and dwellings –, corporations and institutional investors focus on profit oriented investments also by applying more risky instruments. Hence, the capital markets union should not try to drive retail investors into risky capital market investments at all cost that do not match their risk aversion preferences. In contrast, measures that strengthen household’s trust in approved financial products and institutions should be at the CMU’s centre. Good governance guidelines and behaviour must be put on the agenda, signalling retail investors the professional financier’s willingness to inform their clients comprehensively about financial products and risks. What is more, EU-projects like “Consumer Classroom” trying to strengthen the participant’s financial literacy are heading into the right direction. In principle, however, the CMU needs to be channelled through intermediaries and more professional investors than households. ELTIFs are one example discussed above where intermediaries can easily collect money from retail investors in order to finance long-term investment projects. Additionally, institutional investors are much better able to evaluate the respective risks adequately than retail investors.

Unfortunately, from strengthening professional investors, EU-member states with strong financial intermediaries might benefit most. Nonetheless, Jochem and Volz (2011) show that countries within the EMU have low home biases in their portfolio investments, which means that several countries could profit from a concentrated financial sector in only a few economies. Taking a deeper look at the IMF’s Coordinated Portfolio Investment Survey shows that financial integration is relatively high throughout the Euro area countries. Nevertheless, southern European countries like Greece and Spain have a significantly higher home bias. Again, this means that investors from countries where the monetary transmission mechanism works well through banks do already invest freely in other economies, whereas investors in countries affected by the credit crunch prefer their own country for their investments. Easing the home bias for southern European portfolio investments will hardly help them to overcome refinancing issues at home. In fact, low investments in southern Europe might rather reflect investor’s risk assessment than an intermediation issue.

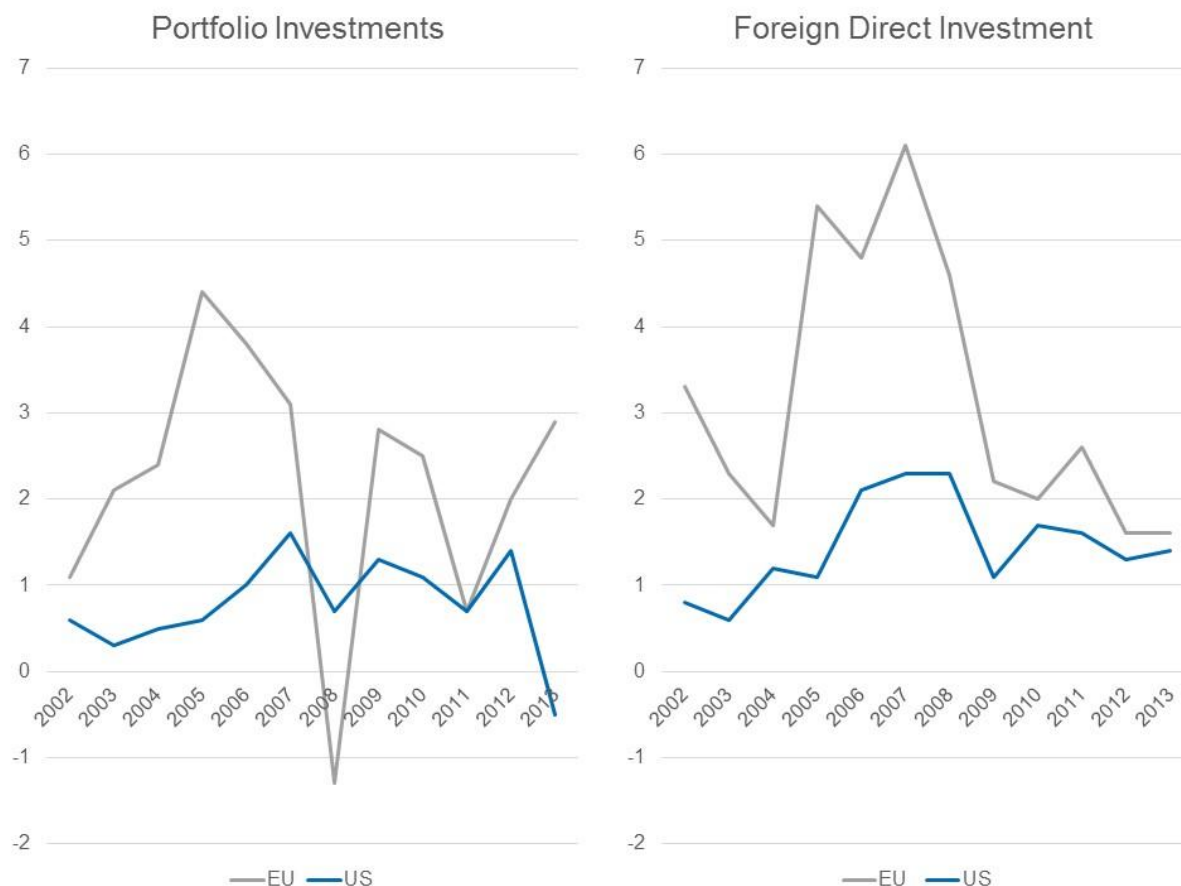
2.3 International investors

Making European Countries more attractive for international investors is the key factor in the European Commission’s investment strategy including the CMU and the European investment plan. Indeed, IMF data shows a strong drop in net foreign direct investment inflows into the European Union after 2007. However, relative to its

GDP in the period after the financial crisis, European countries still managed to attract FDI net inflows of around 2 percent of its GDP (see figure 4). Although the gap between the US and the EU narrowed substantially during this period, Europe is still ahead in the competition for investments between the world's two biggest economic areas.⁴

Figure 4: International Investments

Net inflows, in percent of GDP



Source: World Bank – World Development Indicators, Cologne Institute for Economic Research

In general, international investors can play a major role in overcoming the structural lack of investments in different European countries. Unfortunately, channelling cash flows into SME's and long run infrastructure projects through first-risk assumption by the state – as suggested by the European investment plan – will only be able to bridge a transitory lack of investors. Financial intermediaries such as the European Fund for Strategic Investments are not suited to structurally attract more FDIs⁵. Altogether, especially countries struggling with the aftermath of the crisis need to

⁴ See Cooke and Noble (1998) for the argument that developed economies compete for different FDI inflows than developing countries.

⁵ See Diermeier and Hüther (2015).

progress implementing structural reforms in order to improve the economy's overall competitiveness.

Another important fact, noted by the European Commission, is the low share of portfolio investments into the EU in comparison with cross-border portfolio investments within the EU. Whereas the Commission is right to remark the relatively high within-Europe portfolio flows, it is rather due to the discussed high financial integration within Europe than to the lack of foreign portfolio investors. In fact, throughout the last decade, the US attracted more net portfolio investments relative to its GDP than the European Union only during the height of the financial crisis in 2008. Although EU FDI net inflows are extremely diverse, the relatively high aggregate stems from high investment rates in the former Soviet countries.

Finally, both measures of international investments – FDI as well as portfolio equity investments net inflows – show a strong European competitiveness in comparison with its main competitor, the US. If there is the political will to strengthen the European position further, however, the distribution of the respective investments inside the European Union should be examined carefully. For the lack of investments in several member states could be alleviated by offering investors a level playing field with the same legal rules for all member countries. In this regard, standardizing the legal framework and improving investor protection should take the centre stage. Driving private investors into complex financial products or risky equity funding of foreign corporations could not be in their best interest. In contrast, the CMU needs intermediaries with extensive financial knowledge. International investments into the EU are still comparatively high and should not be focussed on by the CMU.

3. Financial Fragmentation and Access to Finance

The CMU aims at reducing financial fragmentation in Europe, triggering cross-border financial flows and fostering access to finance especially for SMEs. According to Kraemer-Eis et al. (2013) there are 21.3 million SMEs in Europe employing 88.6 million workers and producing 3,357 billion Euro of gross value added. SMEs access to finance is therefore crucial for growth and employment in Europe. In contrast to larger companies, SMEs depend more on long-term relationships to banks and might be facing tighter financing conditions when banks get into distress (ECB, 2013a). Driving forces that restricted access to finance for SMEs and fostered financial fragmentation were the Global Financial Crisis from 2008 and the Eurozone banking and sovereign debt crisis from 2010. Both led to a contraction in credit supply, especially in cross-border lending, which lead to a fragmentation of the Eurozone's financial markets along national borders. Up to now, the Eurozone is in a state of an unresolved balance sheet recession. Against this background, it is understandable that the Commission aims at fostering additional financing channels for SMEs. In the

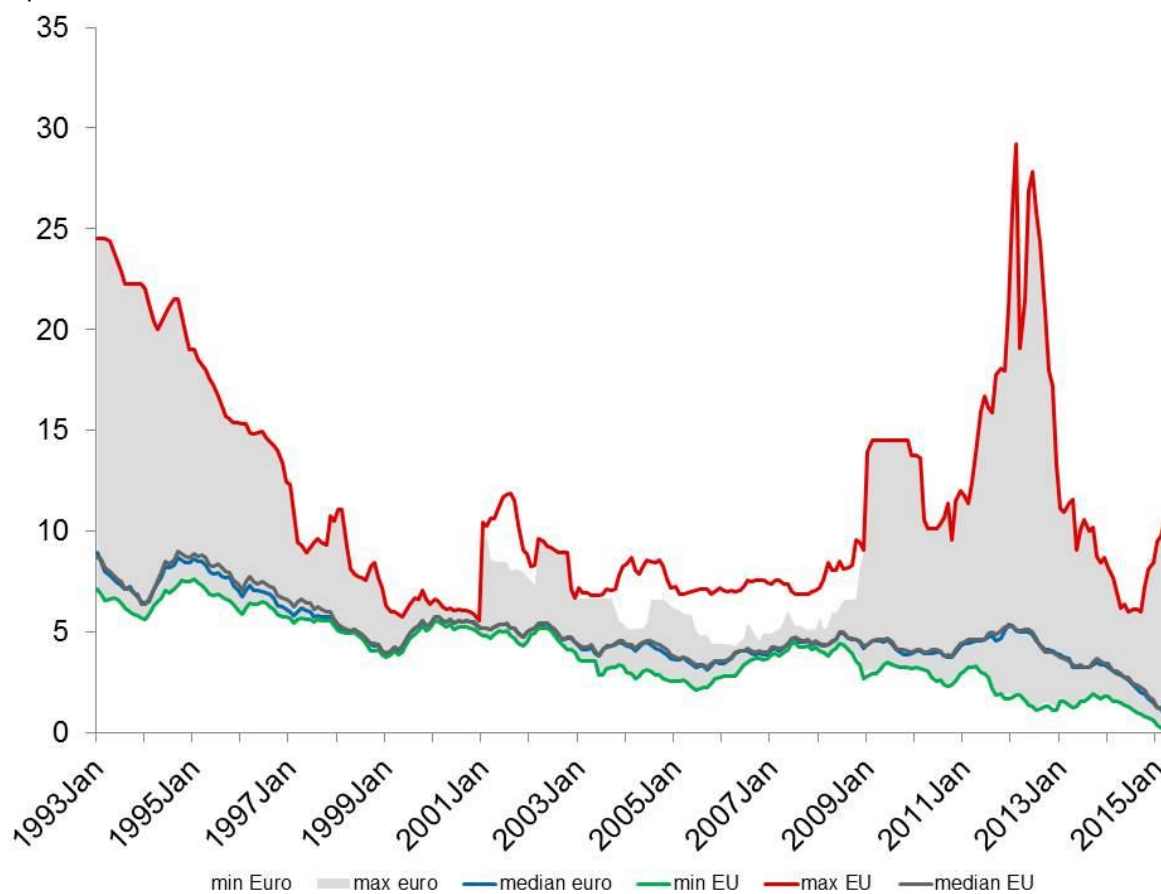
following sections we will analyze the origins of financial fragmentation, how SMEs suffer from financial fragmentation and if the policy measures proposed by the Commission have the potential to reduce financial fragmentation in the EU.

3.1 The Origins of Renewed Financial Fragmentation

After a longer period of financial market integration in the Eurozone, financial fragmentation gained momentum when market participants became increasingly pessimistic over the Greek government debt sustainability in 2010. After a long period of interest rate convergence in Europe and especially in the Eurozone, yields on sovereign bonds began to diverge. While yields on German bonds started to decrease, the yields on Greek sovereign bonds exploded as a result of a capital flight from risky Greek bonds to the German sovereign bonds (figure 5). Yields on sovereign bonds of further crisis countries like Ireland, Italy, Portugal and Spain, then started to increase, too. The skyrocketing bond yields were stopped only after the ECB announced its bond buying program Outright Monetary Transactions (OMT) in 2012.

Figure 5: Diverging Sovereign Debt Yields

In percent



Source: ECB

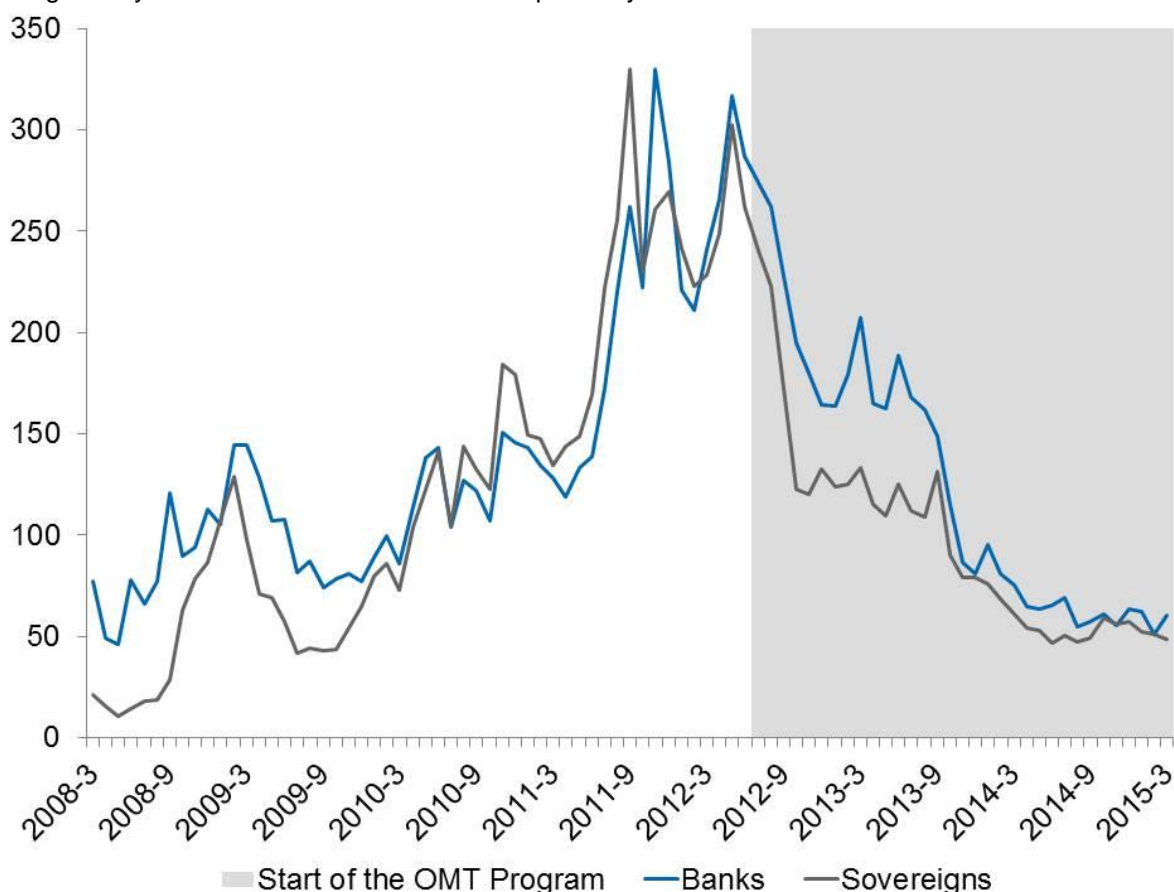
Whereas Eurozone countries faced similar risk premiums on their sovereign debt before the crisis, expectations of an exit of one or more countries from the monetary union fuelled the divergence of interest rates. While there is an ongoing dispute, whether these increases were justified by means of fundamental economic data or due to self-fulfilling expectations, there is a common denominator that deteriorating sovereign bond prices have detrimental effects onto the solvency of banks and because of the overly bank-based financial system in Europe, on the real economy, too. The CMU should also cover problems arising from sovereign debt markets and their interaction with financial stability.

The consequences of deteriorating sovereign bond prices on the solvency of banks can be inferred from a juxtaposition of credit default swap premia for sovereigns and for systemic relevant banks. These are given in figure 6 as weighted averages over Eurozone sovereigns and Eurozone banks that are seen as large and systemically relevant. As can be inferred, the credit default swap premia move jointly up and down with a correlation coefficient for their yearly changes of 0.8. The joint movement of sovereign and bank default risks is due to the following driving forces:

- Firstly, when the default risks of sovereign bonds rise, bond prices deteriorate and lead to losses in banks' bond portfolios and worsens their balance sheets. This effect is significant for Eurozone banks, because the regulatory package CRD IV (Capital Requirement Directive IV) allows banks to finance their exposure to Eurozone sovereign debt without using any bank equity capital. Hence, banks have low equity buffers against losses from deteriorating sovereign bond prices. Secondly, deteriorating bond prices worsen banks' funding position in money markets because banks use sovereign bonds as collateral in repurchase operations (repos). Deteriorating collateral values lead to higher repo haircuts and thereby to worsened funding positions for banks. Thirdly, higher sovereign default risk signals market participants, that the distressed sovereign lacks the potential to rescue its banks under distress, which leads market participants to assume higher bank solvency risks.
- When banks' default risks increase, market participants expect a more likely government intervention to rescue failing banks. These expected interventions are due to the fact that banks take out systemically relevant functions to the economy like payment systems and lending to the real economy. Due to the size of banks' balance sheets, government interventions to rescue banks are costly and might endanger the solvency of the sovereign.

Figure 6: Credit Default Swap Premia for Banks and Sovereigns

Weighted by GDP and banks' total assets respectively



Source: Bloomberg, Eurostat, Cologne Institute for Economic Research

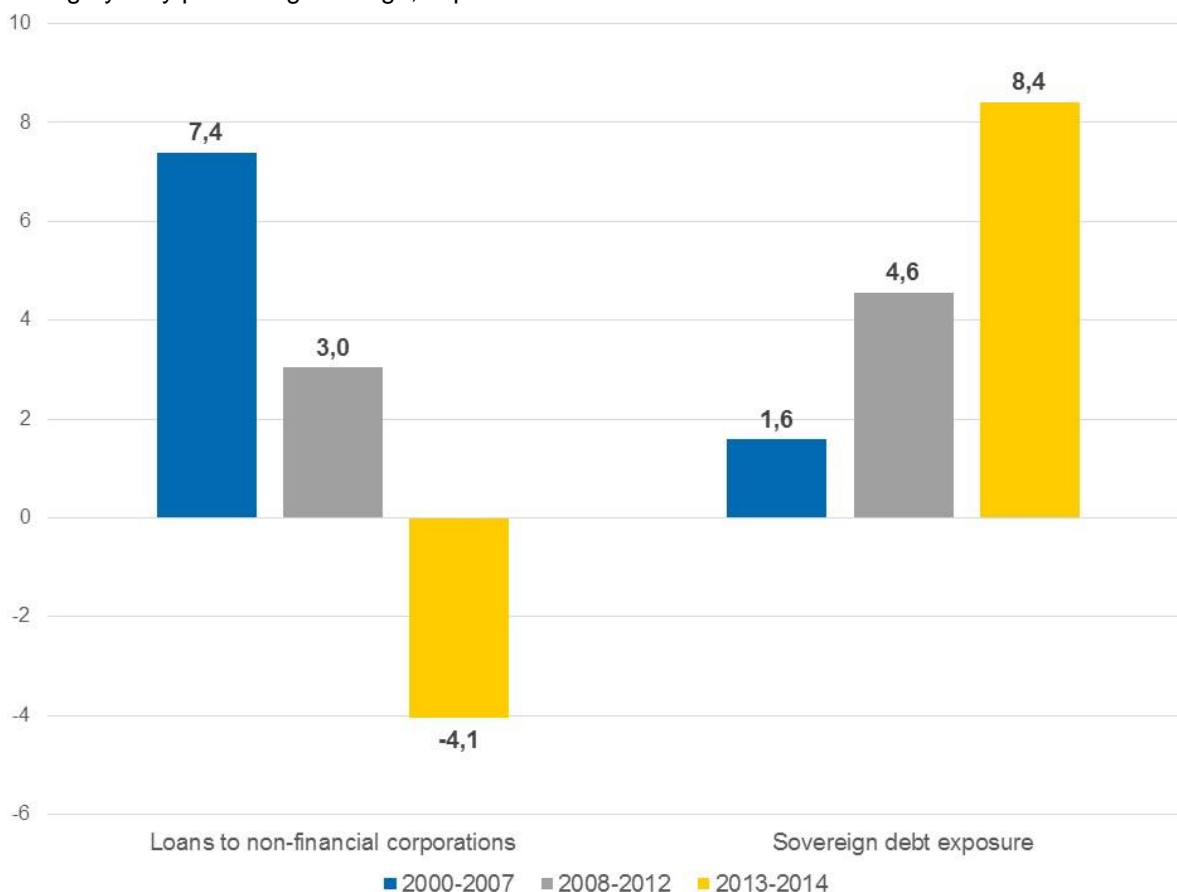
The bank-sovereign-nexus is a two-sided problem and is often referred to as a vicious circle. The nexus from banks to sovereigns is already dampened through the introduction of the Bank Restructuring and Resolution Directive (BRRD) which applies to all European banks and the Single Resolution Mechanism Directive (SRMD) which applies to the Eurozone. However, a dampening of sovereign risks to banks is not achieved. Up to now there are only discussions about a risk-sensitive capital requirements regulation for sovereign bonds from Euro Area member countries. To address this trigger to financial fragmentation will be crucial to regain and maintain financial integration. The systemic risks arising from sovereign bond markets should therefore be treated adequately in the CMU.

3.2. Banking Crisis and Credit Crunch

Banking crises lead to credit crunches, since banks that suffered losses on their equity capital have to cut lending in order to fulfil their regulatory capital requirements which are pinned down as a ratio of bank capital to risk-weighted assets. Since it is nearly impossible for banks to get capital from markets in distressed periods and it is unlikely that banks cover losses with retained profits in times of crisis, they have to decrease their risk-weighted assets. Whereas exposure on Eurozone sovereign debt is treated in bank regulation with a risk-weight of zero, credit to households and non-financial corporations is treated with a positive risk-weight. Hence, banks in distressed situations reduce lending to the real economy, while they keep their exposures on sovereign debt constant or even increase them (figure 7).

Figure 7: Bank-Lending to Non-Financial Corporations and to Sovereigns

Average yearly percentage change, in percent



Source: ECB, Cologne Institute for Economic Research

Empirical results to bank lending during the crisis can be summarized as follows (Central Bank of Ireland, 2015):

- The cut in bank lending explains approximately half of the decline in real GDP in the Eurozone and the USA (Gambetti/Musso, 2012).
- Banks' restricted access to money markets during the market stress in the years 2007 to 2009 has led to a significant decline in bank lending to non-financial corporations (Hempell/Sorensen, 2010).
- Banks reduce their lending, when the economy worsens and when it is expensive for them to raise new equity capital (Hyun/Rhee, 2011).
- Raising equity capital is mostly for those banks expensive which are endangered not to fulfil their regulatory capital requirements (Hyun/Rhee, 2011).
- Banks which were hit by the crisis cut their lending more strongly compared to banks that were less hit by the crisis (Chava/Purnanandam, 2011).
- Non-financial corporations which mostly relied on bank credit suffered more due to the crisis compared to corporations which had access to alternative sources of funding (Bofondi et al., 2013).
- Corporations which were customers of distressed banks faced tougher credit restrictions compared to corporations which were customers of non-distressed banks (Bentilia et al., 2013).

It cannot be concluded beyond any reasonable doubt that additional non-bank funding sources and capital market funding would have been unaffected by the crisis. Instead, a well-functioning CMU needs stable bank business models. A regression analysis with individual data from the IW-bank monitor (Demary, 2014) reveals finds that some bank's business models were not sustainable because they relied too much on short-term funding (table 1).

Table 1: Determinants of Bank Credit Supply

Percentage change of loans from 2011 to 2012

*: statistically significant on a 5 percent level, **: statistically significant on a 1 percent level

	coefficient	t-statistic
constant	7.130	1.859
percentage change in equity capital	0.145**	3.566
percentage change in debt capital	0.357**	5.198
tier-1-ratio over 9 percent	-7.414*	-2.245
fraction of short-term debt and repos	-0.250*	-2.441
profit in 2008	9.968**	3.606
observations	79	

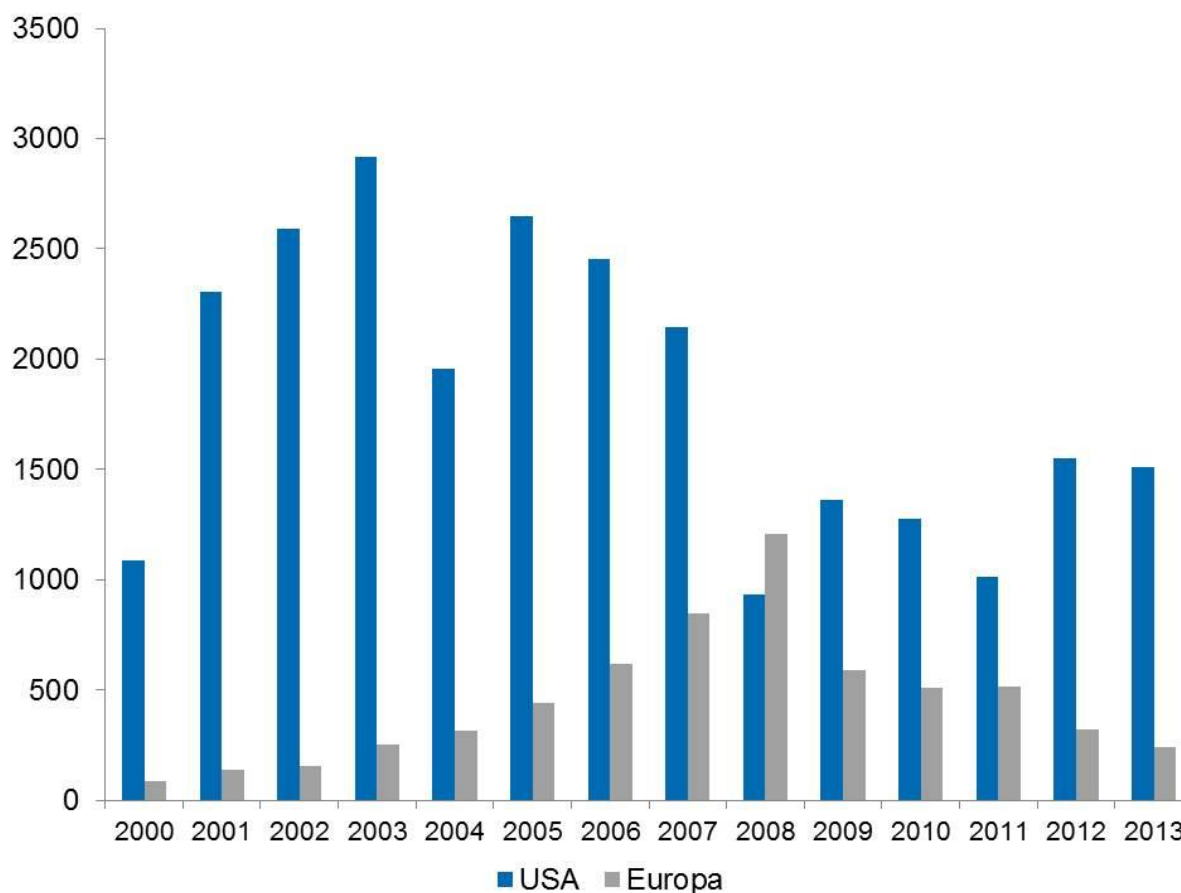
goodness-of-fit	0.660	
f-statistic	28.322**	

Sources: Bloomberg, Cologne Institute for Economic Research

Controlling for other effects, banks that relied more on short-term funding had to cut lending in the years 2011 and 2012 more, compared to banks with more stable funding models. Surprisingly, it is more the cross-border active banks that relied on short-term funding, while more locally oriented banks relied more on stable funding sources. Especially the locally oriented banks in Germany did not cut their lending during the crisis, since they were less dependent on disturbances in short-term lending markets. Thus, reduced lending is not a problem of banking per se, but instead a problem of bank business models that rely too much on short-term market funding. The CMU should therefore foster stable bank business models instead of substituting them with alternatives.

The decline in credit was accompanied by a decline in securitisations in Europe (Figure 8). Although much of the Eurozone banking crisis is resolved, securitisations have not been revived. Securitisation is an important instrument for banks to pool credit risks. For reviving bank lending, reviving securitisations will be necessary. However, the Commission should foster high-quality securitisations.

Figure 8: Securitisations in Europe and the USA
 Yearly Emissions, in Billion US-Dollar



Source: Nassr/Wehinger (2014)

Summing up, even a CMU needs stable banks. Therefore, the CMU needs a unified approach to bank regulation and supervision. The European Banking Union should be enlarged to all 28 member states and cover all EU systemic relevant banks. Moreover, supervision of banks, non-banks and capital markets need a unified approach, too, because non-banks and capital markets are as likely as banks prone to financial crises. Therefore, macroprudential regulation and supervision will play a crucial role in the CMU. Since, the emergence of macroprudential risks in one member country can lead to negative externalities in other member countries, macroprudential supervision should not be mainly conducted by national supervisory agencies. The CMU needs a unified approach to financial supervision, with a supervisory agency that is responsible for financial stability and financial integration in the whole CMU.

3.2 Fragmented Financing Conditions

The Eurozone banking and sovereign debt crisis led to a renewed fragmentation of the Eurozone's financial markets along national borders. Financing conditions

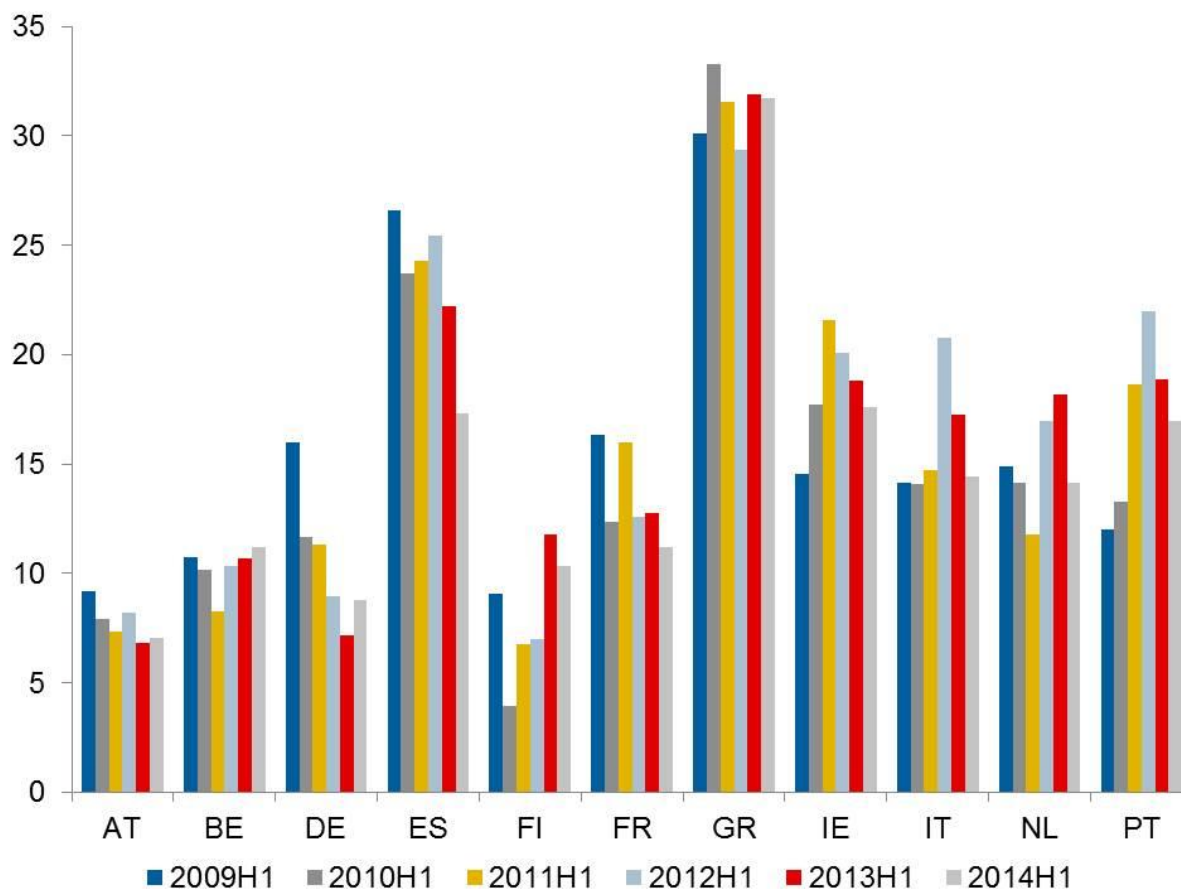
became more and more nationally bounded as cross-border financing broke-down. Especially in the Eurozone SMEs in periphery countries reported access to finance as their most pressing problem (figure 9). Because of progress in bank restructuring and corporate debt restructuring in the Eurozone countries as well as through the improving of the overall economy, financing conditions recently improved for SMEs.

The financing conditions of non-financial corporations normally worsen, when the financing conditions of the sovereign has worsened. Market participants commonly regard the sovereign's rating as a benchmark for ratings of non-financial corporations. With diverging Eurozone sovereign bond yields, thus, financing conditions for non-financial corporations diverged along national borders leading to a decline in financial market integration with less strict financing conditions in the core of the Eurozone and more restrictive financing conditions in the periphery.

Figure 9: SME's Most Pressing Problem

Question: What is currently the most pressing problem to your company?

Answer: Access to finance, in percent of all answers

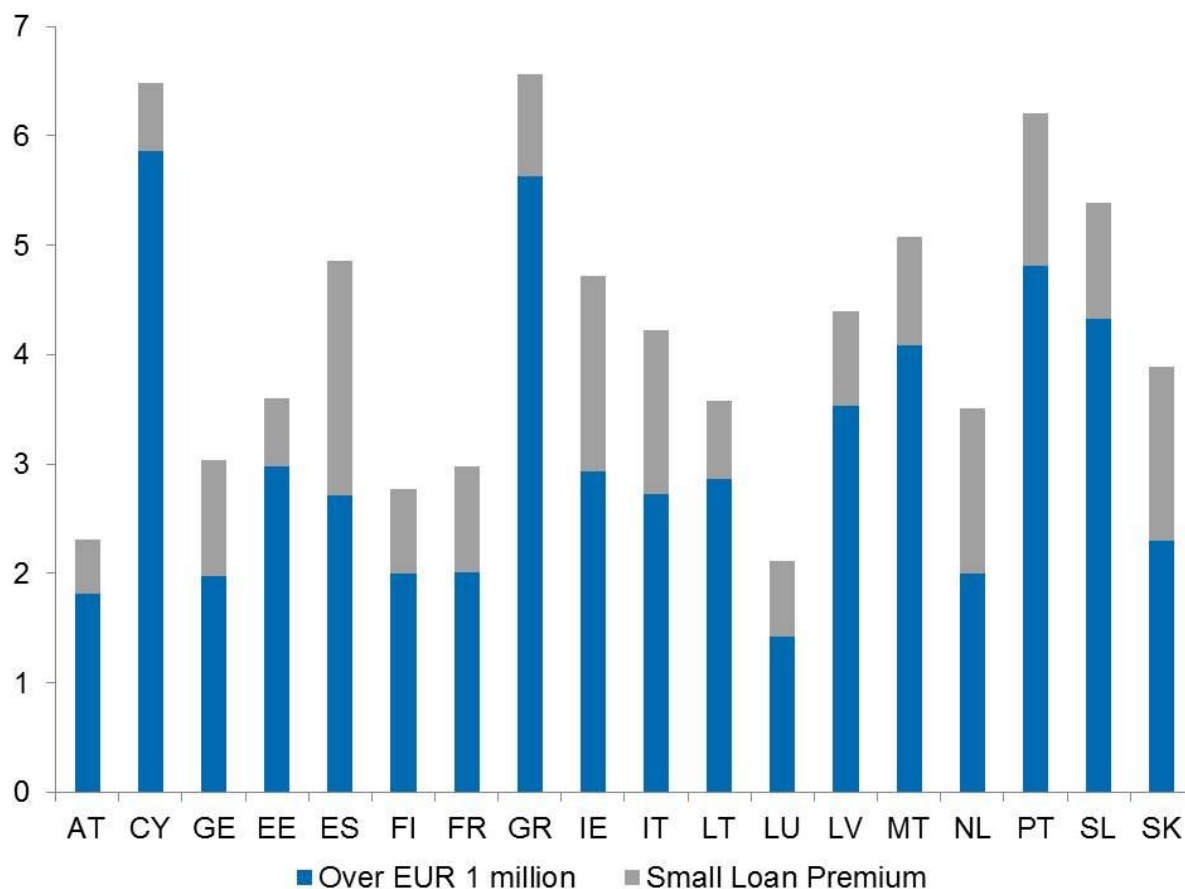


Source: ECB, Survey of Access to Finance of Enterprises

SMEs normally face higher financing costs compared to larger corporations. This can be seen from the difference between the interest rates of small and larger loans, i.e. the small loan premium banks charge to SMEs. However, there are national differences in this small loan premium. This small loan premium is higher in Ireland and Spain and lower in Austria and Germany, revealing the fragmented financing conditions that hit SMEs in the Eurozone periphery stronger compared to the core of the Eurozone (figure 10).

Figure 10: Interest Rates on Small Loans

Average over 2012-1 to 2015-3, interest rates on loans with a volume of up to an including EUR 1 million

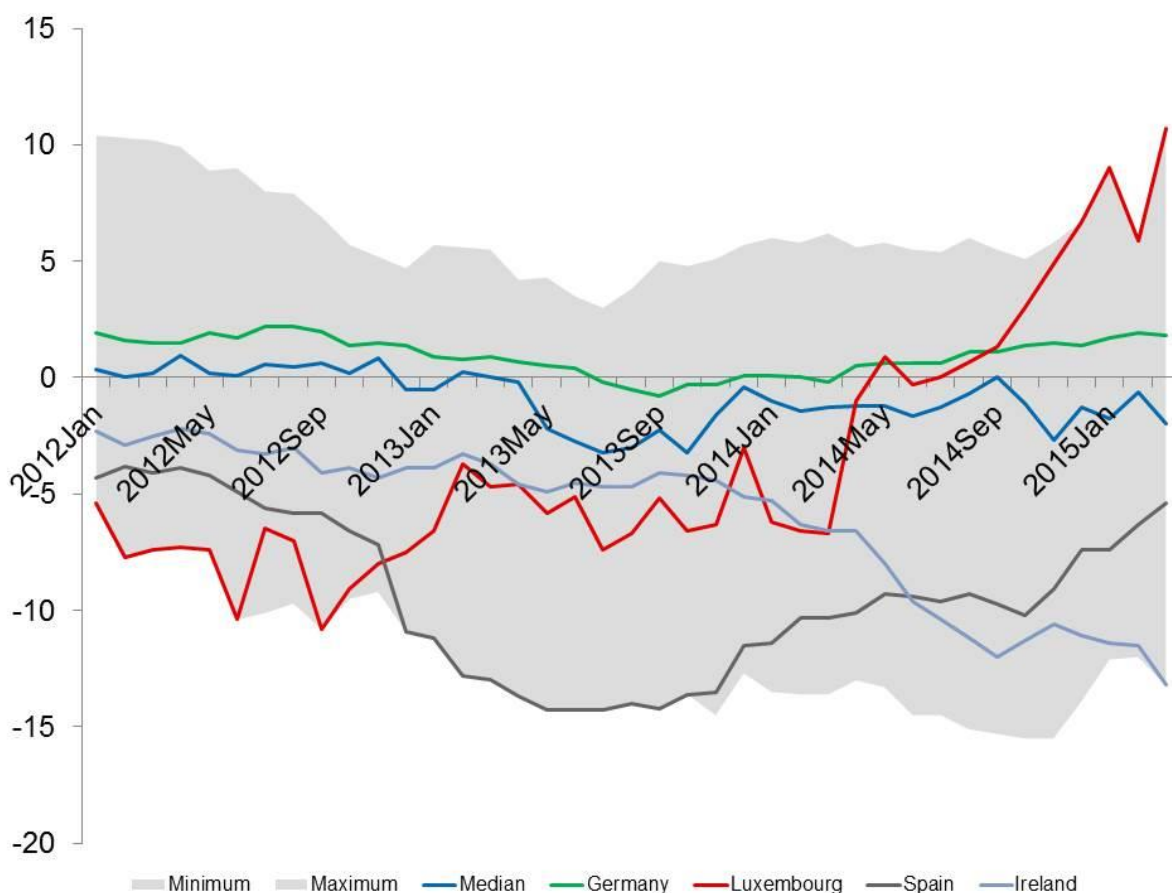


Source: ECB, Cologne Institute for Economic Research

Non-financial corporations not only faced tougher financing conditions from increased interest rates, but also because banks cut their lending in response to the banking and sovereign debt crisis and the deterioration of their own balance sheets. Up to now, the median growth rate of credit to non-financial corporations in Europe is still negative (figure 11). It is slightly positive in Germany, but highly negative in Ireland and Spain, where banks had to cut lending because of credit booms that went bust that generated immense losses for banks. Up to now, Eurozone banks face large amounts of non-performing loans in their balance sheets, which make it difficult for them to lend for an extended period of time. To revive credit intermediation in these countries bank restructuring will be extremely important.

Figure 11: Loans to Non-Financial Corporations

Annual growth rate of MFI loans to non-financial corporations



Source: ECB

According to Wagenvoort and Torfs (2013) the financial crisis created a shortage in the availability of international funds for the corporate sector. While SMEs faced credit constraints, large companies changed to domestic financial markets as a source of funding (ECB, 2013b). It cannot be concluded beyond any reasonable doubt that firms in a CMU will turn to domestic financial markets in a crisis fostering financial fragmentation along national borders. A CMU should aim at fostering financial integration and aim at avoiding financial fragmentation. Therefore it should not foster alternative financing sources at the expense of stable bank business models. Rather it should apply a unified approach with a strengthening of the cross-border lending of banks with stable business models. To achieve stable banks as well as stable markets, the CMU needs a unified approach to financial supervision covering banks, non-banks and capital markets.

4. SMEs' demand for financial resources

Assuming that not every production necessarily creates an equal quantity in demand, the success of a capital markets union, however, depends not only on a sufficient supply of finance, but also on its demand. This assumption is supported by research

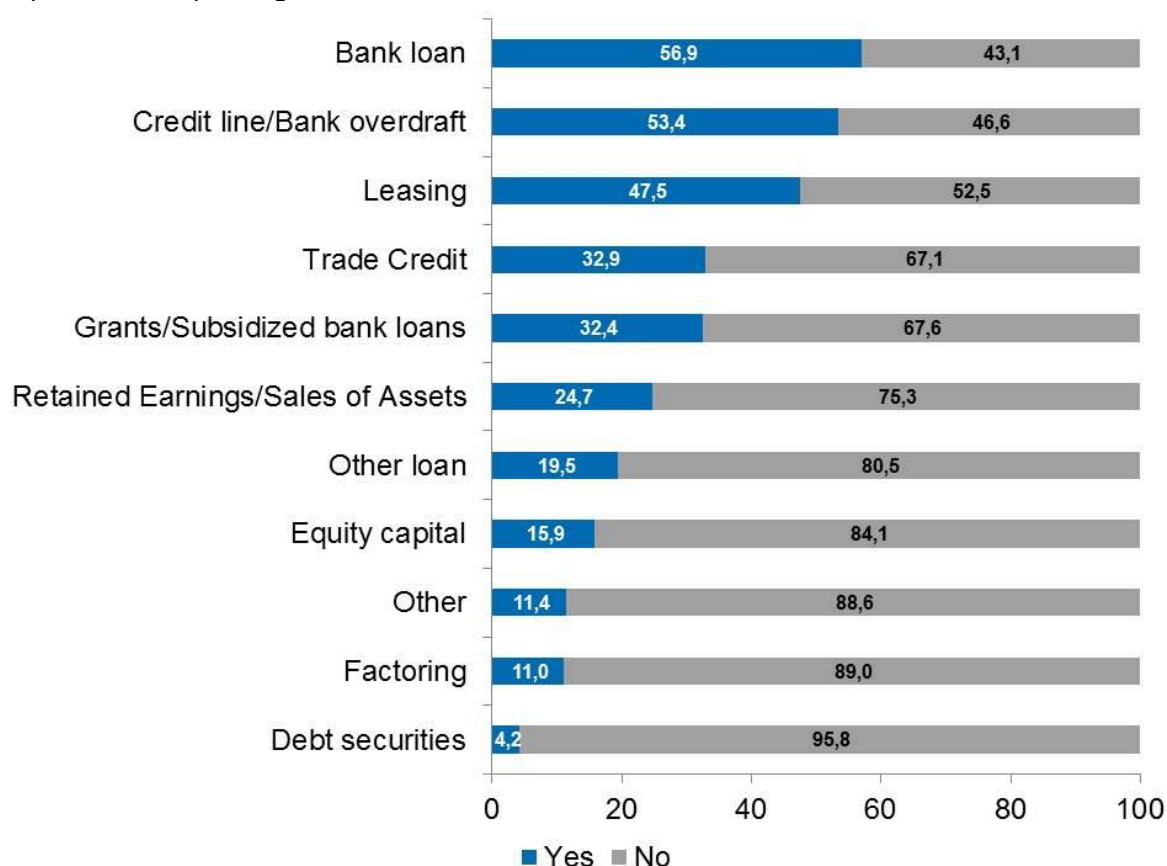
results of the Deutsche Bundesbank, which show that loan demand both runs ahead and lags behind credit growth {Deutsche Bundesbank 2009 #1154}. The key question is: If a genuine CMU would allow companies to raise capital, issue bonds and invest seamlessly across the EU, would companies really make use of these possibilities?

4.1 Banks as settled credit suppliers

Only a small percentage fraction of SMEs in Europe uses capital markets as a source of funding. Most of them rely on bank credit and bank overdrafts (figure 12). Moreover, SMEs rely on leasing and trade credit, whereas trade credit is more related to working capital (ECB, 2013b). Carbo-Valverde et al. (2014) find that financially-constrained companies depend more on trade credit. Moreover, they find that this dependence increased during the financial crisis.

Figure 12: SMEs Funding Sources

In percent of responding SMEs



Source: Eurostat

Compared to bond finance, bank loans are more attractive to SMEs. In general banks have superior abilities in screening and monitoring lenders than single actors on capital markets. Especially in case of longer-term relationships with their clients,

banks have more access to comprehensive data on the lenders' credit history. Due to more detailed available information compared to markets, banks are able to tailor better suiting loans at lower costs to SMEs. As Harhoff and Körting (1998) show for the SME segment of the German economy, lending is typically heavily concentrated on one or two financing institutions, whereby many smaller enterprises maintain exclusive lending relationships.

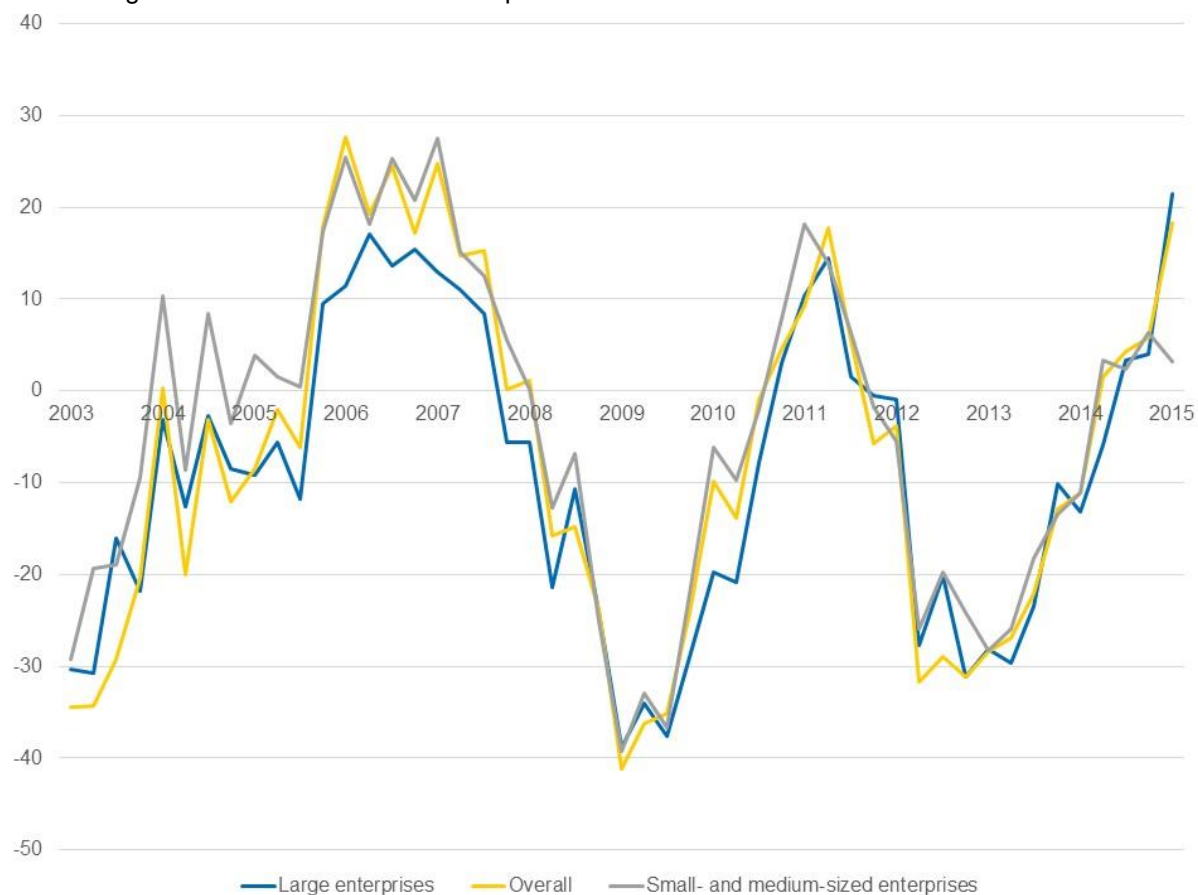
Consider, for example, the case of an SME which is internationally extremely successful with its single product, e.g. special screws needed in manufacturing. This highly demanded product generates stable cash-flows to the company. For an international bond investor it might be difficult to judge the success of this business model. This difficulty is also due to the fact that even the company names of most SMEs, and even extremely successful SMEs, are less known among financial market experts, since traders normally concentrate on large multi-product companies in their investment decisions rather than on single-product firms.

Other than banks, financial market participants have no incentive to monitor lenders since free-riding on other market participants is possible. Think of the efficient market hypothesis that claims that all information about a company is already contained in the market price. Here, the Grossman-Stiglitz-paradox applies. When the market price contains all relevant information, no market participant has any incentive to do research on the company or to engage in monitoring (Grossman/Stiglitz, 1980). Since banks engaging in loan intermediation have other than markets, in which debt contracts are traded instead, an incentive to monitor creditors and to engage in long-term relationships. Therefore, banks play a special role in SME finance.

As banks are the mayor lenders to SMEs, the results of the ECB's Bank Lending Survey (BLS) should be a good indicator for the development of credit demand inside the euro area. For the first time in over three years the BLS carried out in the fourth quarter of 2014 reported a marked increase in demand for bank loans among non-financial corporations. This result applies to enterprises of all sizes, whereas credit demand of small and medium-sized enterprises grew to a lesser extent (figure 13). At the same time, banks expect a further increase in demand for loans to enterprises in the second quarter of 2015.

Figure 13: Changes in Demand for Loans or Credit Lines to Enterprises in the EU

Weighted net percentage (tightened minus eased or reverse) based on the share of each country in the total loan outstanding amounts of the area aggregate and of each bank in the total loan outstanding amount of the BLS banks sample



Source: ECB, Cologne Institute for Economic Research

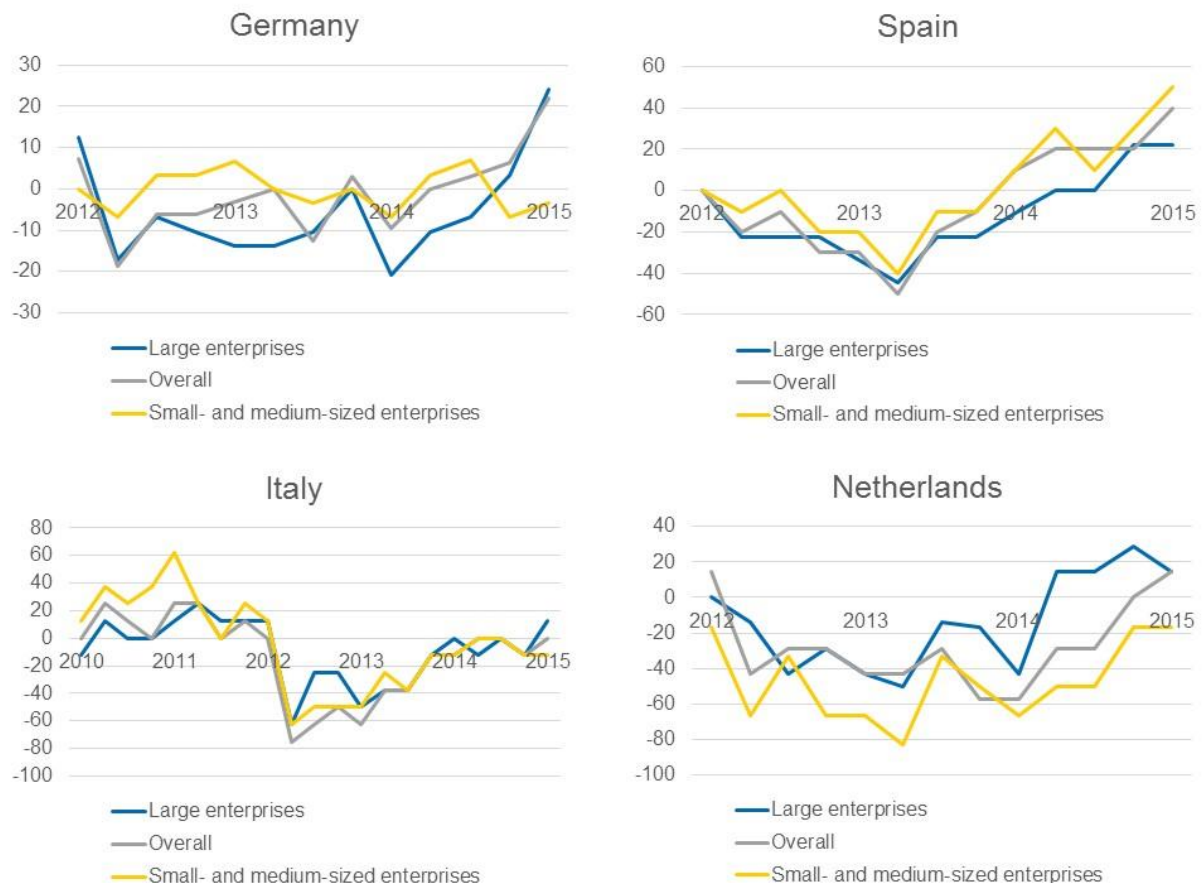
Banks identified enterprises debt and corporate restructuring as the main factors that affect loan demand. Demand was certainly also bolstered by the continuing fall in lending rates. According to the ECB, in particular, firms' internal financing sources and the issuance of debt securities by enterprises contributed negatively to loan demand (ECB, 2015).

At the first glance, these aggregate results indicate an additional benefit that might be created by the additional supply of more financing options in the EU – especially when banks were incapable or unwilling to provide further loans. Viewed from different national perspectives, however, BLS results reflect country-specific differences. These particularly become apparent in the changes of demand by small and medium-sized enterprises (figure 14). Initially, it is clear that SME's loan demand rises again in different EU countries accompanying the emerging recovery of the economy. Furthermore, loan demand is less volatile in Germany compared to the other countries pictured above. Apart from the relatively low impact of the financial

crisis on the German economy, this reflects the particularly stable financing behaviour of German SMEs (see EY, 2013).

Figure 14: Changes in Demand for Loans or Credit Lines to Enterprises

Net percentages of banks reporting a positive contribution to demand (frequency of tightened minus that of eased or reverse)



Source: ECB, Cologne Institute for Economic Research

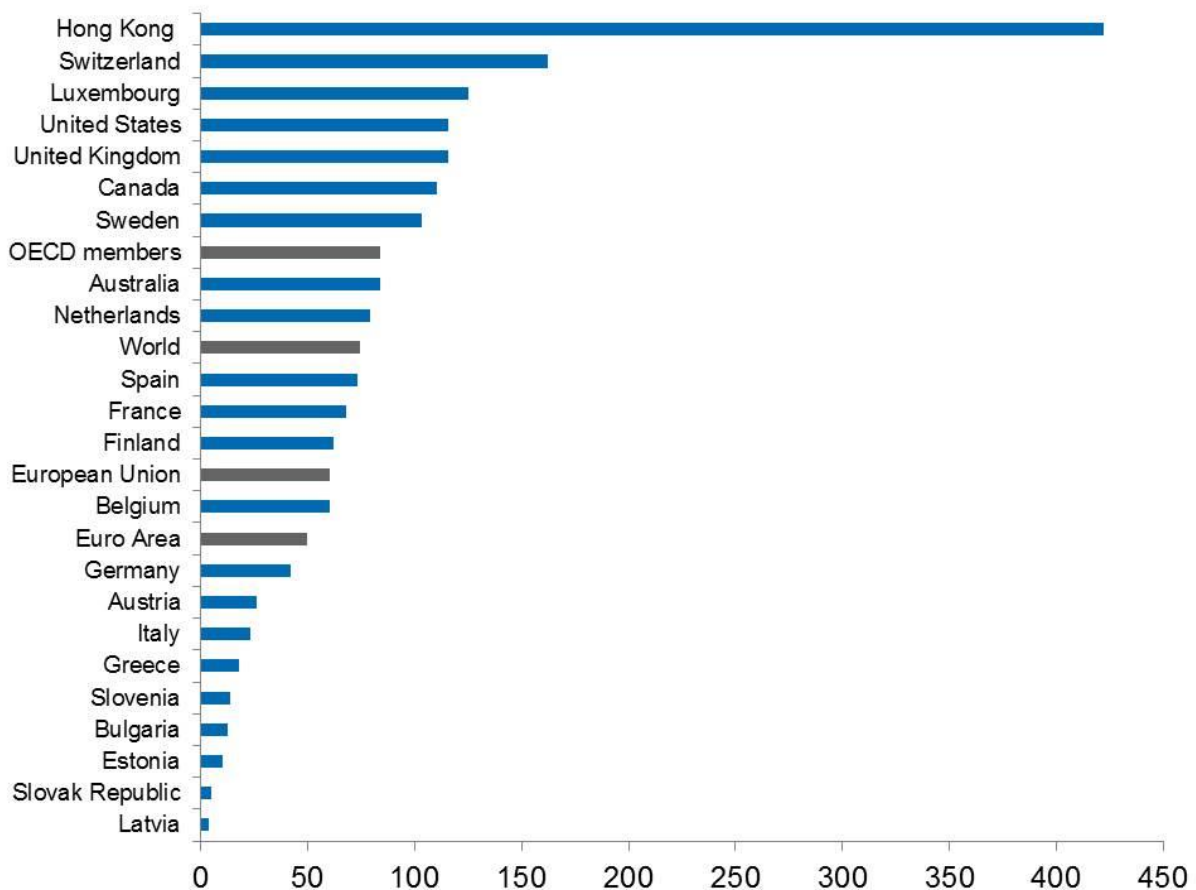
As pictured in chapter 3, credit supply and its conditions differ among EU-countries. Along with different developments in demand, we see that at present SMEs in countries such as Italy and Spain have fewer options for meeting their rising credit demand than those in northern Europe. As their national banking sectors are struggling, it is more difficult for SMEs to obtain loans at favorable conditions. In this context, it should be expected that more SMEs look for alternative ways to finance. Following the Commission's proposal, we nor observe alternative financing options: stock as well as bond markets and private placements.

4.2 Stock Markets and Bond Markets

When companies decide to issue bonds or equities, they gain the possibility to access capital markets. In capital markets they face a broad audience of investors instead of a single funding institution. Moreover, instead of banks, investors in capital markets not necessarily engage in long-term relationships. In the EU and especially in the Eurozone stock market capitalization is low when measured in relation to GDP. Compared to the size of the US stock market, only Luxembourg, Sweden and the UK have a comparable stock market capitalization (figure 15).

Figure 15: Stock Market Capitalization

In percent of GDP



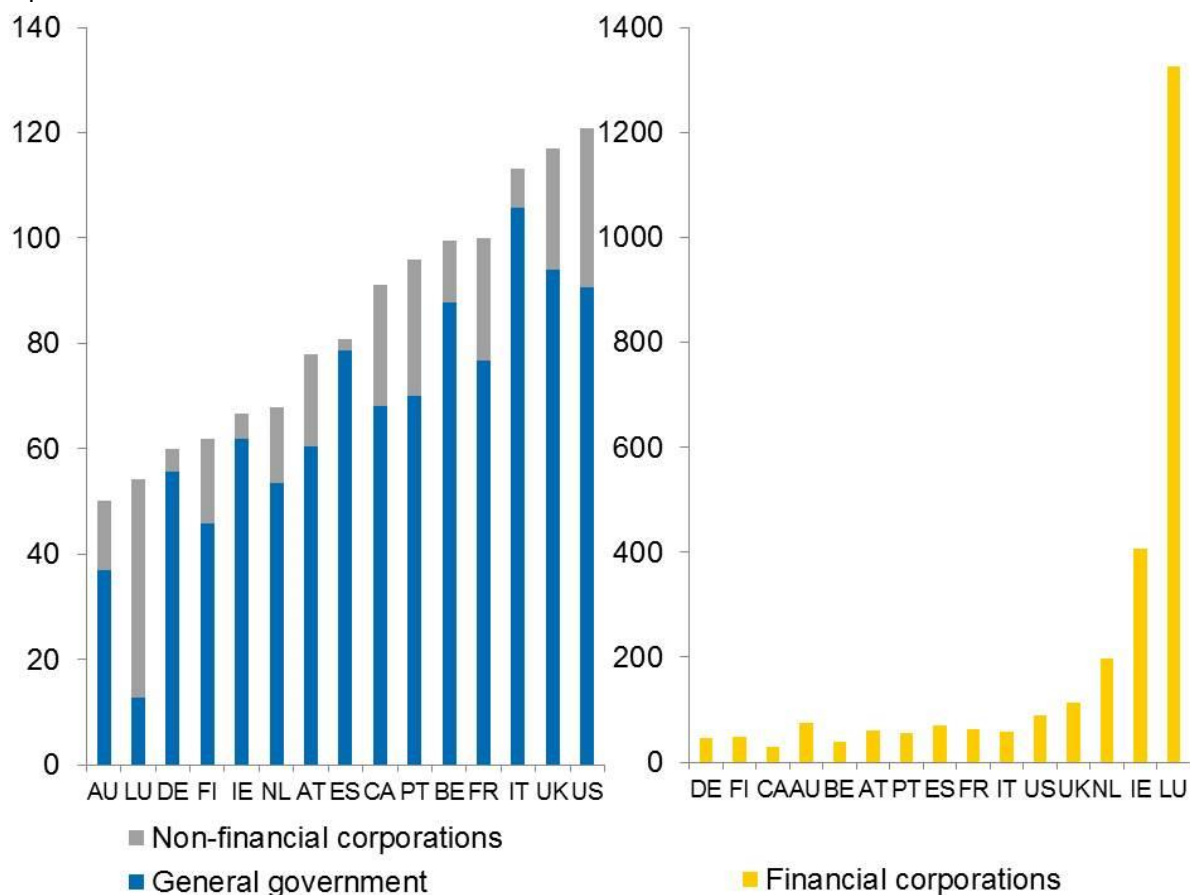
Source: World Bank, Cologne Institute for Economic Research

A different picture emerges when looking at bond markets. The US has the largest bond market for sovereign bonds and non-financial corporations followed by UK. But also Italy, France, Belgium and Portugal have, normalized by their countries' GDP, large bond markets. Debt securities issued by non-financial companies are relatively small in Germany compared to the US, UK and France and even to Austria, Finland and the Netherlands. In comparison to other countries, Europe as a whole seems not to have smaller bond markets compared to the USA when measured in relation to the

national GDP (figure 16). It is more the case that companies use less often capital-market instruments compared to the US companies.

Figure 16: Bond Market Capitalization

In percent of GDP



Source: Bank for International Settlements, World Bank, Cologne Institute for Economic Research

To understand why stock and bond markets differ among countries we have to consider the fact that economic activities always take place within social and political structures that have developed over a long period (see Hüther et al., 2015). The roots of the current financing conditions can be traced back to the time of industrialization and today's differences between financing systems evolved towards the end of the 19th century. A closer look at the historical development of finance in general shows that the usage of different financial instruments needs a long process of learning of all market participants.

Thus, turning to capital markets is very different from relationship-banking, since companies have to signal their creditworthiness in an absolutely different way to international investors. It is therefore unlikely that SMEs in all European countries would make use of these instruments once they are encouraged to do so. Higher

stock and bond market capitalisation will not only need deeper and more integrated European stock and bond markets. Instead, it needs a large number of SMEs intending to increase their company size, since this is necessary to be known to investors – especially on an international level.

4.3 Private Placements

In general, private placements are a flexible way for companies to raise funds in capital markets. Issuing IOUs, like the German “Schuldscheindarlehen”, are normally conducted by means of a bank which places the IOU in the capital market. These papers are attractive investments for institutional investors with long investment horizons, like pension funds and insurance companies. In contrast to standardised bonds, “Schuldscheindarlehen” are non-fungible assets, which means that they cannot be transferred to new creditors simply by purchase. Instead, an act of transfer is necessary. “Schuldscheindarlehen” are not constructed with the intention to get liquid and tradable assets. The advantage for companies resides in the possibility to construct a tailor-made contract reflecting their financing needs and it gives them flexibility. IOUs are, thus, not a substitute to bonds and bank credits, but a complementary financial instrument.

Like most financial contracts, IOUs are characterized by asymmetric information between the issuer and the buyer of the contract. For companies, issuing IOUs in private placement markets, it is therefore essential to signal their creditworthiness. This can best be done by referring to a long-term relationship to the bank that places the IOU for the company. By and large, companies can prove their creditworthiness to the capital market by referring to their relationship-bank that was engaged in repeated credit assessments of the firm (Diamond, 1991).

Barriers for cross-border private placement lie in the asymmetric information between the issuing firm and potential buyers of the IOU. Relationship-banking can foster cross-border private placements if banks themselves operate cross-border. On the other hand overcoming cross-border barriers by standardisation would reduce the flexibility to tailor contracts that serve the individual needs of companies. After all non-standardised IOUs cannot be seen as perfect substitutes, but as complements to bonds and bank credits.

4.4 Enhanced Credit Information

The diversity of SME’s business models in Europe makes it more difficult and more expensive to assess their credit risks compared to the credit risk of larger and

exchange-listed corporations. To their disadvantage, credit information is unevenly distributed across Europe as can be seen from the World Bank index, which measures the depth of credit information (table 2). According to the index, in Germany, Lithuania, Poland and the United Kingdom credit information is the highest, while it is the lowest in Luxembourg and Malta. Average values in the depth of credit information can be found in Croatia, Denmark, Finland, France, and the Slovak Republic with a value of 6, Belgium, Bulgaria, Hungary, Latvia and Sweden with a value of 5 and Cyprus and Slovenia with a value of 4. Slightly better than average credit information can be found in Austria, the Czech Republic, Estonia, Greece, Ireland, Italy, the Netherlands, Portugal, Romania and Spain.

Table 2: Depth of Credit Information Index

0 = low to 8 = high

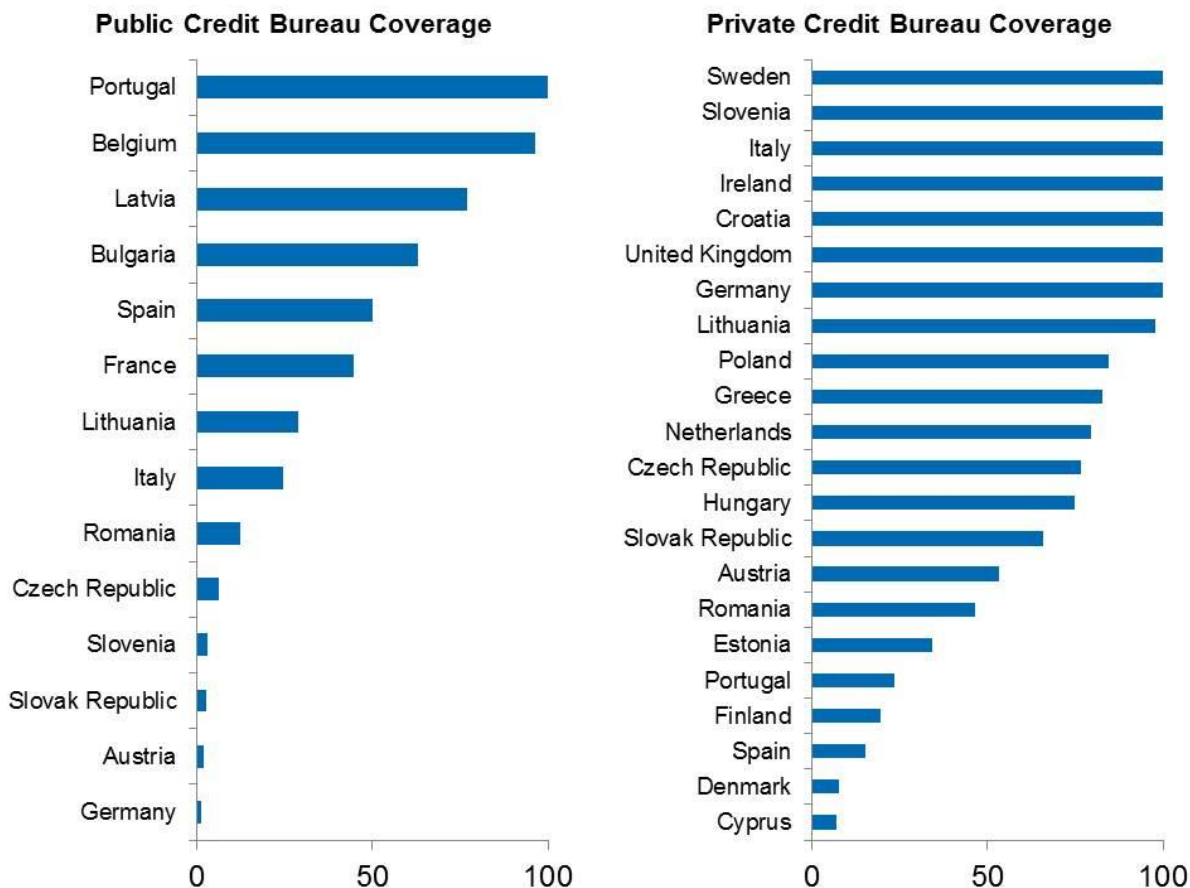
Index	Countries
8	Germany, Lithuania, Poland, United Kingdom
7	Austria, Czech Republic, Estonia, Greece, Ireland, Italy, Netherlands, Portugal, Romania, Spain
6	Croatia, Denmark, Finland, France, Slovak Republic
5	Belgium, Bulgaria, Hungary, Latvia, Sweden
4	Cyprus, Slovenia
3	
2	
1	
0	Luxembourg, Malta

Source: World Bank

The member countries do not only differ in their degree of supplied credit information, but also by the coverage of public and private credit registers. While Portugal and Belgium have public credit bureaus with coverage of nearly 100 percent, Sweden, Slovenia, Italy, Ireland, Croatia, United Kingdom, Germany and Lithuania have covered nearly 100 percent by means of private credit registers. However, there are member countries, like France, with coverage of under 50 percent. In Italy, the credit register coverage lies under 25 percent. There are several other countries with credit registry coverage of under 10 percent (figure 17).

Figure 17: Public and Private Credit Registry Coverage

Public or private credit bureau coverage reports the number of individuals or firms listed by a public or private credit bureau with current information on repayment, in percent of adult population



Source: World Bank

Beyond the availability and standardization of SME credit information, one has to find the optimal helpful amount of data per company which has to be supplied by the creditors. Investors need a core set of indicative information in order to make rational and elaborate choices. In contrast, a plethora of information could lead investors to lose their focus. On the capital demand side, moreover, SMEs might be overburdened with administrative cost arising from compiling the demanded documentations. Therefore, the EU should constrain the administrative burden for SMEs to publish credit information to a core set of indicative variables.

5. Conclusion and Outlook

The effectiveness of the CMU cannot be analysed in isolation, but it has to be seen in a broader context with its interconnections to monetary policy, macro-prudential financial market policy, sovereign and private debt sustainability as well as economic policy. The Commission's proposal on capital markets union needs therefore some enhancements:

Firstly, economic and political uncertainties hinder investment. In order to foster investment demand, a stable growth path has to be achieved. Actions should include the necessary supply-side reforms together with monetary policy ensuring price stability. The global financial crisis from 2008 and the Eurozone's banking and sovereign debt crisis produced a lot of uncertainties which hindered investment demand. Therefore, European supervisory agencies have to ensure financial market stability and thereby foster confidence in EU financial markets and financial institutions. Member states, moreover, have to promote investment-friendly economic policies and ensure sovereign debt sustainability.

Secondly, sovereign debt markets were not addressed in the Commission's proposal on CMU. Sovereign debt markets are, however, huge and systemically relevant, since disruptions in these markets can trigger a vicious circle of sovereign debt and banking crises. When sovereigns are highly indebted, sovereign debt markets are vulnerable to self-fulfilling expectations that have the potential to trigger sovereign insolvency. Distressed sovereign debt markets due to over-indebted sovereigns result in financial market fragmentation along national borders, like observed during the Eurozone banking and sovereign debt crisis. Since one aim of the CMU is to foster financial integration, it also has to prevent financial market fragmentation. For ensuring financial stability and capital market integration, the bank-sovereign-nexus has to be lowered. That makes a prudential regulation of banks' exposures to sovereign debt inevitable for CMU.

Thirdly, since the EU aims at mobilising savings from private households for long-term investment, financial literacy is a prerequisite for consumers to invest in products beyond savings accounts. The EU should foster financial literacy among its citizens. A high level of financial literacy enhances the financial decisions made by households, especially for old-age provisions. It is an important subject, because inefficient decisions can be costly to households' retirement savings plans. In order to avoid an overload of consumer protection leading to a high administrative burden for the supply side of financial products as well as for the demand side, a higher level of financial literacy helps households to make rational decisions in their best interest without overwhelming them with too much protection.

Financial literacy is, moreover, a way to regain the private households' confidence in financial products and financial institutions. Households not only have to understand how financial products work and what their risk-return-profile is, they also have to understand the fundamentals of financial regulation and financial supervision in order to gain confidence in the CMU. Since the fundamentals of financial regulation and financial supervision are complex fields, the EU should foster initiatives that aim at explaining the design of the financial system, financial products as well as the fundamentals of financial regulation and financial supervision to the broader public in simple language. These initiatives should be conducted similarly to those that explained the fundamentals of monetary policy, monetary union and the design of the European System of Central Banks in easy language to the broader public. Since the CMU is a broad and complex field, citizens need to understand its structure and implications in order to be confident to invest their savings in assets beyond savings accounts, e.g. longer term projects.

The EU should conduct research projects that aim at quantifying the degree of financial literacy among its member countries' citizens. The research should be carried out through household surveys and data should be analyzed for different member states and different population groups. Policy implications should be derived from these data. In countries where the data implies a low degree of financial literacy, the EU should conduct targeted initiatives that address different population groups in such a way that financial literacy cannot only be improved on average, but also in less educated population groups.

Fourthly, the capital markets union needs robust banks. The European Banking Union was a step in the right direction. The Banking Union, however, is only mandatory for the Eurozone member countries, while non-Eurozone member countries of the EU can join the Banking Union on a voluntary basis. Up to now, there is a fragmented system of bank supervision in the EU with a multiple of different supervisory agencies. There is the European Banking Authority (EBA) which is responsible for the whole EU but whose main tasks are the setting of standards and the performance of bank stress-tests. Then there is the European Systemic Risk Board whose main task is the macroprudential supervision of banks in the EU. The supervisory competencies of the banking union are located at the ECB which is responsible for either microprudential, as well as for macroprudential supervision of Eurozone banks.

Supervisory loop wholes exist between the banking union and the non-Eurozone member countries, where bank supervision is still a national competence. While bank

supervision is mostly centralized within the Eurozone, supervisory agencies in the other member countries have no European supervisory approach. Thus, there is still the risk that national supervisory agencies in non-Eurozone member countries conduct in a lax supervisory approach and foster national champions. Since this opens the door for regulatory arbitrage, the EU as a whole needs a unified approach to bank supervision. Since banks in a capital markets union are of high importance for SME finance, the EU needs a unified approach to bank supervision. The best way to achieve this goal is to enlarge the banking union such that it covers all EU banks.

Lastly, in the capital markets union securitization will play a crucial role, since it will provide corporate financing with additional options, e.g. the securitization of trade and leasing receivables, SME securitization, credit funds and debt certificates. The Commission and the ECB already highlighted the importance of high quality securitizations in Europe. Since securitizations are non-standardized products and therefore characterized by asymmetric information, liquid markets and high quality standards are necessary. To revive the market for securitizations the establishment of a certificate for high quality securitizations is necessary. The German True Sale International certification and its standards can guide the Commission with a blue print for European high quality securitizations and their certification, including a generally binding high quality definition of simple, transparent and comparable asset-backed securities transactions and their treatment in bank regulation.

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