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EU Capital Markets Push Raises Cross-Border Investing Hopes

By **Tom Zanki**

Law360, New York (March 05, 2015, 2:58 PM ET) -- The European Union's push for unified capital markets can potentially unleash cross-border investment and revive moribund economies, but only if the body can overcome the resistance of a fragmented continent often loyally attached to local jurisdictions, experts say.

The cautiously optimistic reaction follows the European Commission's recent Green Paper on Capital Markets Union, a broad outline that seeks to unlock frozen capital by removing barriers to finance. The plan aims especially to benefit small to medium businesses, whose options are generally limited to traditional banking channels instead of tapping public markets.

Attorneys of firms with large capital markets practices in Europe say the proposal's odds of success, and the push for a single market in general, boil down to whether businesses in the EU's 28 member states are willing to venture beyond local banks for things like debt financing and raising equity.

"The aim is laudable," said Sean Geraghty, a London-based partner at Dechert LLP. "Whether you can get European corporates to embrace capital markets in the manner set out in the green paper and rely less heavily on banks is going to be a big leap."

A central theme of the plan is enabling wider funding sources for capital-starved companies. Experts say about 70 percent of European business funding is raised from bank loans compared with about 30 percent from capital markets, whereas in the U.S., that ratio is reversed.

The green paper proposals now contain broad strokes, but the commission is seeking detailed feedback from a cross-section of European governments, businesses and citizens over a three-month consultation ending May 13. The EU said it wants to develop an action plan by summer that would set a timeline for enacting building blocks by 2019.

The body has also submitted related proposals to simplify company prospectuses, hoping to reduce costly administrative hurdles that deter businesses from going public by easing disclosure requirements, as well as plans to improve transparency of the securitization process.

"There is a great opportunity to get involved in the debate now and shape its outcome," K&L Gates partner Sean P. Donovan-Smith said.

The backdrop for the capital markets union push is the sluggish economic growth plaguing Europe.

With much of the continent deemed in recession or growing slowly, the European Central Bank in January unveiled its own version of **quantitative easing**, injecting at least €1.1 trillion ($1.21 trillion) to stimulate lending and investment through massive bond purchases designed to keep interest rates low, similar to Federal Reserve policy in the U.S.

The ECB has committed to buying about €60 billion of bonds a month, a macro-initiative that comes while the EU seeks capital market reforms. The green paper also hopes wider access to capital will encourage infrastructure investment seen as key to reviving European economies.

“The crisis has fully exposed the shortcomings of not having a fully functioning capital market union where economic agents — particularly small and medium-sized companies — can have a realistic option of procuring funding away from traditional banking channels,” said Jose Garcia-Zarate, a senior fund analyst who studies European capital markets for researcher Morningstar Inc. “I think it’s fair to say that this has hampered the economic recovery.”

The EU stresses the need to diversify funding for startups to include nonbank sources, noting that the U.S. market for venture capital is five times as large as the EU's. The commission says that if European venture capital markets were as developed as U.S. counterparts, European companies could have tapped an extra €90 billion of funding between 2008 and 2013, potentially striking more than 4,000 venture capital deals.

“This reliance on banks makes the European economy more vulnerable when bank lending tightens,” Jonathan Hill, EU commissioner for financial stability, said Feb. 18 when unveiling the plan. “We all saw this happen, and we saw banks and investors retreat to their home markets. Our capital markets remain fragmented, largely along national lines. This is what we need to fix.”

Observers say the EU plan in many ways seeks to emulate more-robust American capital markets, seen as more seamless and accessible, easily uniting the worlds inhabited by Silicon Valley entrepreneurs, Manhattan financiers and foreign investors.

The EC notes that U.S. public stock markets are almost twice the size of European stock markets when measured in terms of stock market capitalization, while U.S. corporate debt securities markets are three times the size of Europe’s.

“U.S markets, really from the '70s onward, became very well-integrated, both through legislation and SEC rule-making,” Donovan-Smith said. “The EU is definitely 30 years behind in this regard.”

But the push will have to overcome institutional and cultural resistance. Garcia-Zarate described Europe as a collection of national markets “each working quasi-independently and with differing rules, differing tax regimes and differing insolvency laws.”

“This is easy to say but difficult to do, kind of squaring the circle, as it would entail getting all countries to agree to a common framework, while still respecting national sensitivities,” Garcia-Zarate said.

The EU has supported more-unified capital markets for years, though momentum stalled around 2008, Donovan-Smith said, as the financial crisis confirmed a deep-rooted skepticism of securitization across the continent. But experts see signs of gradual change.

Donovan-Smith noted the continent's streamlining of financial services, beginning in the late 1990s with the EU's Financial Services Action Plan, which took about a decade to implement.

"Historically, up until 2007, European markets operated with very much a vertical-silo mentality with respect to capital markets," Donovan-Smith said. "But the vertical silos are slowly starting to break down. There's a realization that if we are going to have a modern market system, we need efficient market and clearing systems."

A whole array of legal issues also have to be ironed out. Geraghty noted that a genuine capital markets union will have to address matters like shareholder rights, investor protection and insolvency laws, Geraghty said.

"The aim is very noble — putting the ideas into practice may be a challenge;" Geraghty said. "The EU doesn't have a great track record of putting in place new procedures without increasing the supervisory and regulatory burden."

The debate is sure to be closely followed as various stakeholders weigh in during the coming months.

"For all its shortcomings, the EU has a knack for confounding critics," Garcia-Zarate said. "So we'll see what happens with this one."

--Additional reporting by Stephanie-Russell Kraft. Editing by John Quinn and Edrienne Su.