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Can Europe move from bank financing to financial market financing for its businesses?

It is often argued that financing European businesses on the financial markets would be more efficient than bank financing, which is largely dominant today, particularly because bank financing is not well suited to financing innovation.

But moving from bank financing of companies to financing on the financial markets (shares, corporate bonds) would be very difficult in Europe because it would require a change in institutions:

- The labour market, since market financing is generally associated with weak employment protection;
- Pension systems, since market financing requires the existence of large pension funds.

A more fruitful approach would be to modify European insurance regulations to allow them to hold more private equity, since private equity funds have a long-term horizon, like banksand unlike investors in listed shares. This would make it possible to preserve the labour market institutions and pension systems that already exist in Europe.

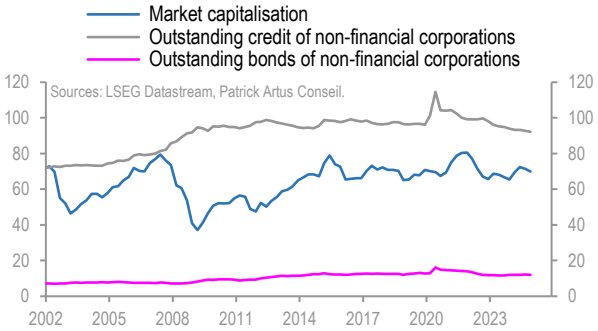
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Bank or market financing for European companies?

It is often argued (for example, in the Draghi report) that **European companies would benefit from a switch from bank financing to financial market financing (Chart 1)**, particularly because bank financing is not well suited to financing innovation or start-ups (with a high probability of failure, but also the possibility of high profitability).

Chart 1
Euro zone: Market capitalisation, outstanding bonds and credit (as % of nominal GDP)



But here we are defending the following thesis: moving from bank financing of companies to market financing of companies would be very difficult in Europe for institutional reasons.

European institutions are not well suited to financing companies on the financial markets

The first institution that is not well suited to the transition to market-based corporate finance in Europe is the labour market as a whole.

Corporate financing on the financial markets can come to a halt, as shown by the sharp variations in stock market indices and credit spreads (when stock market indices fall and credit spreads widen significantly, the financial markets are in fact virtually closed), **Charts 2a/b**.

Chart 2A
Euro zone: Stock market indices (01.01.2002 = 100)

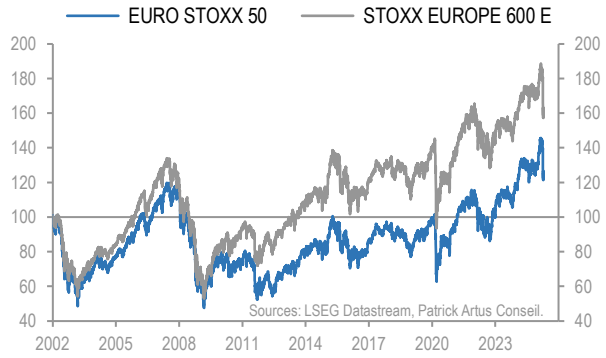
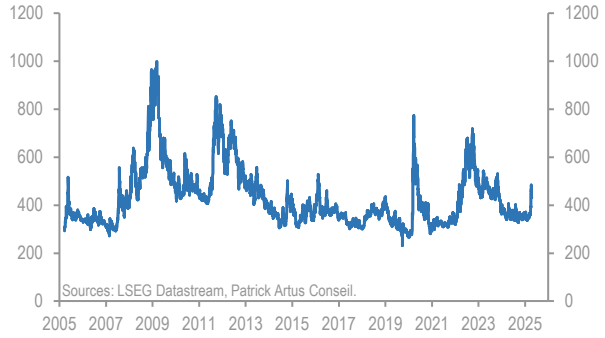


Chart 2B
Euro zone: High yield credit spread



Financing on the financial markets therefore requires companies to be able to adjust their cost base very quickly. **It is therefore incompatible with strong employment protection, whereas Europe differs from the United States in the high level of employment protection it offers (Table 1)**.

Table 1: Strictness of employment protection* (2019)

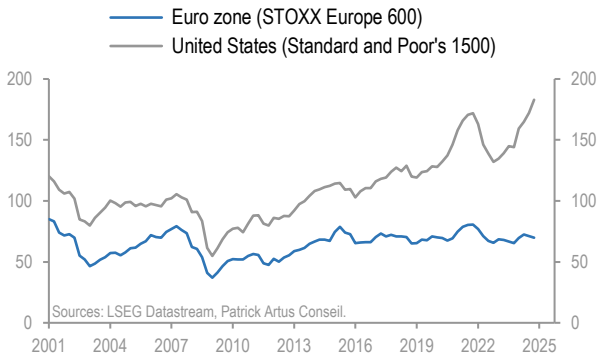
Strictness of employment protection	France	Germany	Spain	Italy	United States
Individual and collective dismissals (regular contracts)	2.68	2.33	2.43	2.86	1.31
Collective dismissals	3.25	2.61	2.43	3.19	1.33
Individual dismissals (regular contracts)	2.45	2.22	2.43	2.72	1.30
Temporary contracts	2.58	1.67	2.47	2.82	0.27

Source: OECD
(*) Scale from 0 to 6, with values increasing with the degree of stringency of regulation

A second institutional reason that would make it very difficult to switch to financial market financing of European companies is the **very small size of pension funds in Europe** (their aggregate size across the European Union is 22% of GDP, compared with 155% of GDP in the United States).

There would be a shortage of savings invested in equities to develop significant financing of companies on the financial markets in Europe. The small size of pension funds contributes to the low level of market capitalisation in Europe (Chart 3).

Chart 3
Market capitalisation (as % of nominal GDP)



Summary: there is a more fruitful way to develop the financing of risky investments in Europe

There is a broad consensus on the inadequacy of risky investment in Europe. However, we do not believe that the move from bank financing to company financing on the financial markets is a fruitful one, given the unsuitability of the labour market (strong employment protection) and pension systems (essentially pay-as-you-go) for financing on the financial markets.

In our view, it would be more fruitful to relax the EIOPA (European Insurance and Occupational Pensions Authority) solvency capital regime and allow European insurers to hold more private equity by reducing the equity capital they require to invest in private equity (currently 49% of the amount of these investments).

Private equity investors, like banks, have a long-term horizon, whereas most investors in listed shares have a short-term horizon. This change would make it possible to develop European venture capital (funds raised in venture capital reached Euro 22 Bn in 2023 in Europe compared with USD 250 Bn in the United States), and therefore the sums available to finance risky investments, without having to modify the institutions themselves.

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