SCOPE

Capital Markets Union: building an EU MidCap Bond market should be a priority

Keith Mullin | August 2024

Achieving financial sovereignty and safeguarding economic security and resilience are vital against the backdrop of today's unsettled political and geopolitical landscapes. European Union policymakers remain steadfast in their conviction that mobilising and deploying bank and institutional capital and retail savings across the EU through banking and capital markets union (CMU) will help achieve those aims.

At the heart of CMU lies a firm belief that only frictionless markets will ensure that sufficient capital is allocated to priorities such as dealing with climate change, social and environmental sustainability and digitalisation while sustaining growth.

Creating a single market for both banking and capital markets will remain a policy imperative of the new Commission in support of long-held assertions that fragmented markets deprive citizens and businesses of the deep, competitive, efficient and reliable sources of funding and investment that a single capital market can offer, including facilitating capital markets access to issuers in EU member states currently have no such access. Policymakers also want to create a viable alternative to bank lending while embedding securitisation at the CMU core to increase bank capital velocity to support continued bank lending to the real economy.

Beneath the aims of CMU, some attractive high-level benefits are held out:

- More funding choices for businesses at lower cost;
- Giving SMEs the financing they need;
- Supporting economic recovery and creating jobs;
- New opportunities for savers and investors;
- A more inclusive and resilient economy;
- Helping deliver the Green Deal and digital agenda;
- Reinforcing global competitiveness and autonomy.

Yet progress in CMU has been arduous since the project was launched in 2015 and has iterated several times. A major challenge of CMU, just like the still-unresolved European Deposit Insurance Scheme in the Banking Union, is that it remains a fractious political topic at member-state level.

The fact that the Eurogroup of euro area finance ministers started again in 2023 to work towards a renewed strategic initiative to reach agreement on key CMU priorities speaks volumes about the difficulties the project has encountered in the securing support of all EU member states. So while CMU will remain a priority, the idea of enhanced co-operation between a sub-set of member states has also gathered pace. Case in point here: the French-German CMU roadmap of 2023. Progress here will be determined by policy direction in both countries following the results of 2024 European Parliament and French elections.

Notwithstanding ongoing political negotiations, some important CMU workstreams have continued, including simplifying listing rules to encourage companies to list on EU stock exchanges via a Listing Act; making the EU clearing landscape more attractive and resilient; and introducing a European Single Access Point (ESAP) for public information about companies and investment products. Directives and regulations have also been amended or reviewed: the Regulation on European Long-Term Investment Funds (ELTIF); the European Markets Infrastructure Regulation (EMIR); the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Regulation (MiFIR).

A major drawback to cross-border investing in the EU is the lack of harmonised tax, insolvency and restructuring laws. Steps are now in process to harmonise insolvency laws, while the May 2024 Council agreement on new procedures for double taxation relief will also offer significant benefits to CMU.

The aim of the so-called FASTER initiative (Faster And Safer Tax Excess Relief) is to boost cross-border investment and fight tax abuse by making EU withholding tax procedures safer, faster and more efficient for investors, tax authorities and financial intermediaries via a common EU digital tax residence certificate. The new procedures will save investors EUR 5.17bn a year according to John Berrigan, Director-General, Financial Stability, Financial Services and CMU at the Commission.

Fragmentation has led to what policymakers refer to as capital markets 'parochialisation' whereby each jurisdiction is still subject to its own legal peculiarities. According to the European Commission's Euro Area Report 2024, 78% of equity and 49% of debt held by investors are issued in the same Member State.

Building a MidCap Bond Market – creating the right focus

Top of the agenda as the new Commission looks to build on these workstreams to operationalise aspects of a single capital market should be creating a bespoke EU-wide debt market for midcap companies, providing them with more funding choices that ideally help them minimise capital costs. But it is vital to define the issuer universe that is most likely to make use of such a market.

One issue here is there is no single definition of 'midcap' or Small and Medium-Sized Enterprise (SME) in the EU. Germany's Federal Ministry for Economic Affairs and Energy defines SMEs as companies employing fewer than 500 people.

Eurostat also uses number of employees but with different cut-offs: micro and small enterprises up to 49 people, medium-sized up to 249 people, and large 250+. Using Eurostat's definition, 99.8% of the 31.7m non-financial EU corporates in 2022 were microcaps and SMEs.

Figure 1: EU enterprise breakdown by size and turnover (2022)

Number of employees	No. of enterprises	Segment turnover (EUR trn)	Average turnover by enterprise (EUR m)
0-9	30,119,467	6.34	0.21
10-19	1,039,039	2.42	2.33
20-49	539,915	3.48	6.45
50-249	246,577	6.81	27.63
>250	**52,704**	**19.17**	**363.78**

Source: Eurostat, Scope Ratings

The broad base of issuers that could reasonably make use of a Midcap Bond Market sits within the 0.2% or roughly 53,000 companies that Eurostat classifies as large. But even more precise targeting is required as Eurostat's large enterprise universe includes the EU's largest companies that already have diversified access to competitively-priced capital as well as companies in the lowest quartile with modest funding needs that will continue to rely on banks as core finance providers.

EUR 100m-EUR 1bn in turnover is the sweet spot

A bespoke EU midcap bond market can best serve the needs of companies in terms of funding need that sit between EU-domiciled multinationals and large national champions, and the mass of micro, small and medium-sized companies. The upper-middle section of Eurostat's large-company grouping is likely to have funding requirements big and regular enough to benefit from an alternative while offering investors issuance frequency and size.

Overlaying turnover on headcount offers a more useful approach to specifying a group of likely midcap bond issuers, as turnover correlates more closely with funding needs. German state lender KfW defines SMEs as companies with turnover of up to EUR 500m, while banks typically use EUR 100m in turnover as the starting point to pitch more sophisticated funding instruments and services such as syndicated loans. In the context of building an EU midcap bond market, companies turning over between EUR 100m and EUR 500m and potentially up to EUR 1bn form a workable nucleus around which a bespoke market architecture can be built and instruments designed.

An EU MidCap Bond label

An EU framework culminating in the assignment of a formal EU MidCap Bond label would give issuers, investors, intermediaries and service providers the confidence that labelled issues meet minimum standards. A label would also slot in neatly alongside other labelled products such as European Green Bonds (EuGBs); European Covered Bonds; Simple, Transparent and Standardised (STS) securitisation; European Long-Term Investment Funds (ELTIFs); and Pan-European Personal Pensions (PEPPs).

An EU MidCap Bond label will provide comfort to investors that issuers have met robust disclosure and investor protection rules, obviating a requirement for EU MidCap Bonds to be listed or admitted for trading on regulated EU exchanges or multilateral trading facilities.

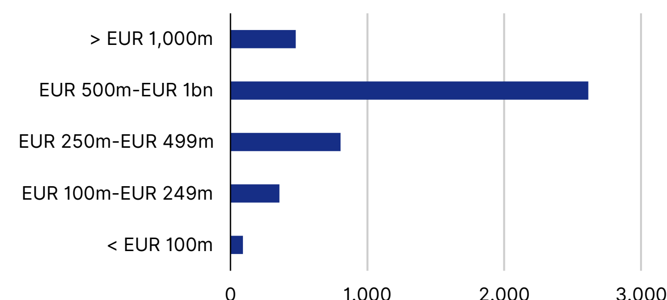
As an aside, robust disclosure and investor protection rules will also help EU MidCap Bonds avoid the fate of Germany's *Mittelstandsanleihen* SME bond market, which attracted too many weak issuers that used the market as a last-resort funding channel, which culminated in high default rates.

In an increasingly digitalised capital market, the standardisation a labelled market would achieve around eligibility, documentation design, definition of terms and other issuance parameters would make issuance ideal to be transposed into digitalised formats.

As a starting point to for optimal market features, regulators should consider the most suitable aspects of existing European markets (private debt, private placement and domestic SME debt markets) including Schuldschein (Germany), Minibonds (Italy), MARF (Spain), Euro Private Placements (France) and others, and review the ideas laid out in the International Capital Markets Association's Pan-European Corporate Private Placement Market Guide, published in support of CMU as far back as February 2015.

A cross-border EU Midcap Bond market intermediating issue sizes between EUR 25m and EUR 125m would fill a major gap in the EU's financing toolkit since the corporate segment of the Eurobond market caters to multinationals issuing frequently and in large size.

Figure 2: Corporate bonds by transaction size: 2014-2024*
EU corporate issuers issuing in EUR



*Jan 1 2014 to Jun 27 2024.
Figures on the x axis refer to number of debt tranches
Source: Bond Radar, Scope Ratings

The chart shows how EU corporate bonds have broken down over a 10-year period. Over 60% of bonds sold by EU corporates in euros in the Eurobond market have been in the EUR 500m-EUR 1bn size range.

The market is dominated by a small group of large companies and large global investors that demand size and liquidity materially above the capital needs of most midcap issuers. Issuance is dominated by frequent issuers, many raising over EUR 10bn over the period, some significantly so.

Supporting benefits

A number of in-process initiatives will benefit an EU Midcap Bond market, including the consolidated tape being ushered in by the MiFIR review; the introduction of the ESAP; and the European Crowdfunding Service Providers for Business Regulation.

The aim of the consolidated tape is to improve trading transparency and price discovery, reduce fragmentation and limit liquidity and execution risk by creating aggregated real-time/close-to-real-time price and volume data feeds from hundreds of venues across the EU. The European Securities and Markets Authority (ESMA) is scheduled to submit final draft technical standards to the Commission by 29 December 2024.

The crowdfunding regulation has harmonised rules across the EU. Authorised platforms operate under the regulatory umbrella of ESMA. Crowdfunding could develop into a supplementary funding channel for debt issues at the lower end of the size spectrum.

Home bias

Partially supplanting the domestic and bank-led orientation of capital provision in the EU, even for the companies that have financing needs big and frequent enough to justify a search for alternatives, is where the rubber of CMU can reasonably hit the road with EU MidCap Bonds, even if familiarity with local companies will tend always lead to better funding terms from banks and institutional investors, while retail savers will tend to gravitate to investment opportunities close to home.

Home-country bias will never fully melt away but if, in the real world of capital-raising and investing, market users can see tangible benefits from using an EU-wide solution, it may help them surmount a bias that militates against the aims of CMU.

The degree of success of a non-bank channel will also depend on how much of a problem accessing finance is. Demand for capital ebbs and flows with economic, monetary and business cycles. For example, the results of the European Commission's 2022/23 SME Performance Review, which ranked a range of topics by importance on a scale of 1 (low) to 10 (high), did not demonstrate specific concerns about access to finance by EU companies.

Across the EU-27, access to finance scored a low 4.2 in terms of importance and individual country scores ranged from 3.1 to 6.1. In the current monetary cycle, the issue has been a lack of demand for finance rather than inability to source it.

Bank-originated assets vital for EU SME ABS

On market choice, there is a reason banks will continue to fund most EU corporates: they are best placed to do so and have a wide range of tried-and-tested products to service funding and other corporate client requirements. This tends to be overlooked by reports that blithely lament the fact that EU corporate debt remains heavily bank-driven. Standard commercial-banking products are just a good match for the needs of microcaps and small companies.

Some corporate clients also benefit from relationship banking arrangements and can garner reasonable debt pricing by offering ancillary business to their relationship banks, allocating a share of the fees they pay out. And the bank market is a private market offering clients confidentiality, sparing them the disclosure requirements demanded by bond investors or listing venues.

In many respects, the lack of a discernible shift in the provenance of EU corporate funding can be attributed to the high level of comfort most European companies have with banks as their core funding providers. Banks have deep expertise in pricing credit, built on access to the credit behaviour and credit histories of clients.

Of course, it is never an issue of either/or. Even multinationals that have open access to the bond market and other capital markets maintain core bank facilities.

But large pools of bank-originated receivables are vital if the EU is to develop a vibrant securitisation market, including SME ABS. Policymakers have embedded securitisation as a centrepiece of the single capital market as a mean to accelerate bank capital velocity and ultimately increase the total level of funds available to lend to SMEs.

Some observers doubt even that CMU can properly take off without a securitisation market, which could become one of the most important cross-border investment channels.

Even with the STS designation introduced in the 2017 Securitisation Regulation, activity has not lived up to expectations, however. That is, to some extent at least, because insurers are excluded from participating directly in the market. This is under discussion and could be subject to a regulatory framework update, as regulatory capital requirements are reviewed.

Interestingly, though, this year could be the busiest since before the pandemic as banks shift assets to structure balance sheets to best meet the final demands of Basel III. An active SME ABS market sitting alongside a labelled EU MidCap Bond Market would provide tremendous opportunities to investors and to issuers, while providing banks with the benefits of capital optimisation.

The UK government plans to look into securitising portfolios of SME debt receivables created under the state-run British Business Bank's ENABLE guarantee programme in order to support lending by challenger banks and small business lenders. If that happens, it could provide a useful blueprint for Brussels.

In fact, developing EU capital markets in greater partnership with the UK could be an interesting proposition. The government's pre-election document Financing Growth: Labour's Plan for Financial Services, which laid out six priorities for the UK financial services sector, talked of building a more collaborative relationship with the EU ("A future Labour government will adopt a more pragmatic and co-operative approach to working with the EU in areas where it is mutually beneficial"). Capital markets is one area where huge mutual benefits could accrue.

Enter direct lending

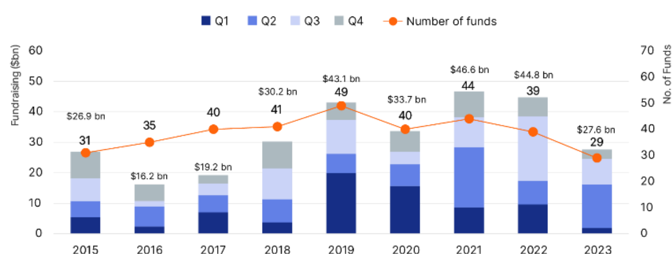
If mobilising large pools of institutional non-bank capital offering an alternative to mid-market companies regardless of where they are in the EU is a core goal of CMU, the emergence of direct lending in Europe is a big step forward. That the underlying drivers of the accelerated growth in private credit cannot be ascribed to any political or regulatory efforts to achieve CMU is incidental.

Private credit growth was driven by stringent capital, leverage and liquidity requirements in the re-regulatory aftermath of the global financial crisis that forced banks to deleverage and de-risk. To drive up individual client profitability, banks also started putting in place return hurdles for their corporate clients, exiting some of those that fell below internal rating floors or which failed to provide durable hurdle returns.

In less than a decade, private credit has emerged as a force in Europe. Since 2015, European direct lending funds have raised USD 288bn equivalent, 40% of which between 2021 and 2023 according to Deloitte's Spring 2024 Private Debt Deal Tracker. Those datapoints include the UK, the largest European market but large EU economies are also experiencing growth in this segment.

One reason for the precipitous growth in direct lending is that unlike securitisation , insurers can participate in this market. If the case for securitisation changes, this will also accelerate the securitisation market.

Figure 3: European direct lending fundraising
Volumes in USD bn (LHS). Number of funds (RHS)



Source: Deloitte (using Preqin data)

The core targets of direct lenders are mid-market companies, although within that client segment, the strategy has evolved as an M&A and private-equity play: two-thirds of last year's transactions were M&A-related and 84% were linked to LBOs and private-equity-sponsored assets, according to Deloitte.

Also, much of the current supply of EU direct lending is US-originated but as a European market develops, it could become an important source of capital driving directly to the goals of CMU.

From a client selection perspective, private lenders have targeted a higher-risk client demographic, one that banks don't want to or can't lend to any longer, because the funds have targeted a higher-return profile than what is available from standard stand-alone bank lending.

That has changed to some extent in the higher rate environment but it will likely shift back in line with the monetary cycle. Funds are also more willing to lend to growth companies on an Annual Recurring Revenue (ARR) basis where EBITDA is not available or not meaningful. ARR-based financing has developed away from the banks as a credit fund play.

The interplay between banks and private credit will obviously depend on how the asset class develops. Concerns have been raised about lack of transparency around default and delinquency in private credit, the fact that the asset class is illiquid, and that higher-for-longer rates will more adversely impact the lending universe of direct lenders, which is more highly leveraged and of typically lower credit quality than standard midcap bank lending.

Concerns have been expressed too about the extent of bank-direct lender inter-connectedness as banks have been providing financing facilities to private credit funds in increasing volumes, including facilities collateralised by fund capital calls on LPs or underlying fund receivables. Recent updates to the AIFMD, though, have tightened the rules governing the activities of loan-originating funds "to alleviate risks to financial stability to ensure and ensure an appropriate level of investor protection," in the words of the EU Council. There is also a case to be made for deeper engagement in this market by credit rating agencies.

No need to mirror the US

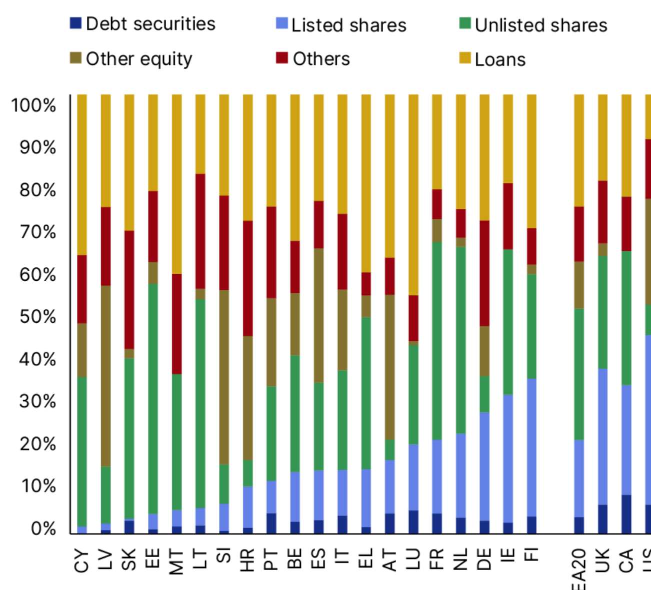
EU policymakers continue to look to the US market and hold up the US funding model as the blueprint for what they would like to see in the EU i.e. non-bank capital providing 60% of corporate funding and banks 40%, the reverse of the EU status quo.

The Commission accepts that the lower proportion of market-based funding in the euro area compared to the UK, US or Canada is due to the bloc's high share of small companies and family-owned businesses that are financed predominantly through loans. Its 2024 Euro Area Report noted that loan liabilities in the euro area represented 229% of GDP in 2021, debt securities 169% and listed shares 82%. By contrast, in the US, loans represented 156% of GDP, debt securities 223%, and listed shares 254%.

The notion of creating a mirror image of the US in the EU is unrealistic. The banking and capital markets cultures, conventions, market practices, regulatory frameworks and market architectures that have led to the current funding mix in the US have developed over decades. Underpinning US capital markets are deep and broad pools of retail and institutional capital that act as symbiotic off-take channels for bank-originated mortgages (facilitated by the Government Sponsored Enterprise model) and other receivables.

Non-bank capital has also emerged over decades as a first-line provider of investment-grade and sub-investment-grade debt funding, while the loan market in the US has developed along much more heavily institutional lines than in the EU. With an altogether different history and financing culture, whatever happens in the EU needs to be a 'Made in Brussels' solution that plays to prevailing structural and cultural factors.

Figure 4: Non-financial corporates share of liabilities:
Euro area vs US, UK, Canada



Source: European Commission 2024 Euro Area Report (Eurostat and OECD data).

APPENDIX: snapshot of selected domestically-anchored EU debt markets

➢ Germany's **Schuldschein** (SSD) market is a mature, fully-functioning market. Schuldscheine are unlisted debt products distributed to investors via underwriting syndicates. Legally, SSD are loan contracts written under the German Civil Code. They can be secured or unsecured and be issued by one or multiple obligors. One of the product's key benefits is simple, standardised, short documentation.

SSD can accommodate modest issue sizes for midcap companies but this is not an SME-only market. In fact, the 10 largest deals of 2023 were mega-transactions that raised an aggregate EUR 7.35bn. Large companies routinely tap the SSD market to diversify their funding and to capture spread arbitrages that arise between the bond, SSD and term loan markets. The SSD market is limited in that there were only 105 transactions last year.

➢ **Euro Private Placements** (Euro PP), a French initiative, are medium or long-term transactions sold by listed or unlisted companies to a limited number of institutional investors based on deal-specific negotiated documentation, generally via an arranger. Negotiated documentation sets Euro PP apart from public offerings. Euro PPs can be structured as note issues or loans.

Euro PP market data is hard to come by but the indications are that this market has struggled to take off in terms of SME volumes and number of issuers. Deals subject to public announcements in 2023 numbered no more than a couple of dozen to raise EUR 1.2bn, according to law firm CMS Francis Lefebvre's March 2024 *Observatoires des Euro PP*. Also, Euro PP issue volumes were flattered by a small number of large placements by non-SME French and Belgian issuers.

➢ Spain's **Alternative Fixed-Income Market** (Mercado Alternativo de Renta Fija, or MARF), an MTF run by Spanish stock exchange operator Bolsa y Mercados Españoles, was launched over 10 years ago as a channel for small and medium-sized companies to raise finance using simple listing requirements and procedures and low costs. MARF offers a range of products from very short-dated commercial paper to long-dated corporate bonds to project bonds and securitisation. Spanish government agencies ICO and COFIDES provide financing to companies as investors in the MARF primary market, while Spain's export credit agency CESCE uses MARF to offer credit insurance to some issues.

Since launch, however, MARF has seen an average of just 15 new issuers each year and over its 10-year-plus lifetime has provided debt financing to just 150 companies (predominantly Spanish but also including a small number of international, mainly Portuguese, issuers), although a lot more have made use of its receivables-backed secured financing programmes.

Listings in 2023 amounted to EUR 15.35bn, 97% of which was in the form of revolving short-dated commercial paper programmes. In the first half of 2024, EUR 8.02bn in CP programmes were listed, alongside just EUR 65m bonds, EUR 109m in receivable-backed financing, and EUR 110m in preferred shares.

➢ The underlying framework for Italy's **Minibond** market could offer a good basis for an upscaled EU midcap corporate bond market. The Minibond market was created under *Decreto Sviluppo* of 2012, as amended. Minibonds are medium-term (typically five to seven-year) mainly unsecured bonds sold by Italian SMEs to institutional and qualified investors. They can be listed or unlisted. Minibond rules and guidelines lay down specifications about issuers, issue sizes (guided to sub-EUR 50m but issuance is typically much smaller) and information disclosure (new issues must be accompanied by a mini-prospectus). Some 28% of Minibonds in 2023 were rated.

The Minibond market also allows for basket bonds, where several smaller issuers can issue a joint bond and receive a pro rata share of proceeds. Since April 2023, banks and other eligible financial companies also benefit under certain conditions from a public guarantee on their minibond portfolios from a fund managed by Mediocredito Centrale on behalf of the Ministry of Economic Development.

Politecnico di Milano School of Management's (PoliMi) latest Minibond report noted that 26% of Minibond investments in 2023 came from foreign banks and funds while 6.5% of Minibonds are listed on Austrian, Luxembourg and Irish exchanges. Some 72% Minibonds issued to-date are unlisted while 21% are listed on Euronext Access Milan (the former ExtraMOT PRO). Activity suffered in 2023 from a spike in coupons driven by higher policy rates. The average fixed-rate Minibond coupon rose 200bp year-over-year to 7.17% in 2023, which pushed down the number of issues from 288 in 2022 to 184 last year, according to PoliMi.

Which shows that even with workable frameworks, debt issuance in any market will always depend on issuers being able to lock in capital that offers them the best economics. Still, even as activity waned, 123 of last year's Minibond borrowers were debut issuers, showing the market still had some appeal.

➢ ICMA's Pan-European Corporate Private Placement Market Guide built on the Charter for Euro Private Placements, published in 2014 by the Euro PP Working Group, backed by the Banque de France and French financial trade bodies. ICMA laid out best-practice standards to develop a private-placement market to provide medium and long-term senior debt to medium-sized companies. The ambition – unmet to-date – was to create a pan-European PP market to rival the well-established US private placement market.

Author

Keith Mullin

Scope Group

Phone: +44 (0)7826 517226

Email: k.mullin@scopegroup.com

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Scope SE & Co. KGaA

Lennéstraße 5
D-10785 Berlin
info@scopegroup.com

Contact Details
scopegroup.com/contact
Phone: +49 30 27891-0

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