BOOK LAUNCH

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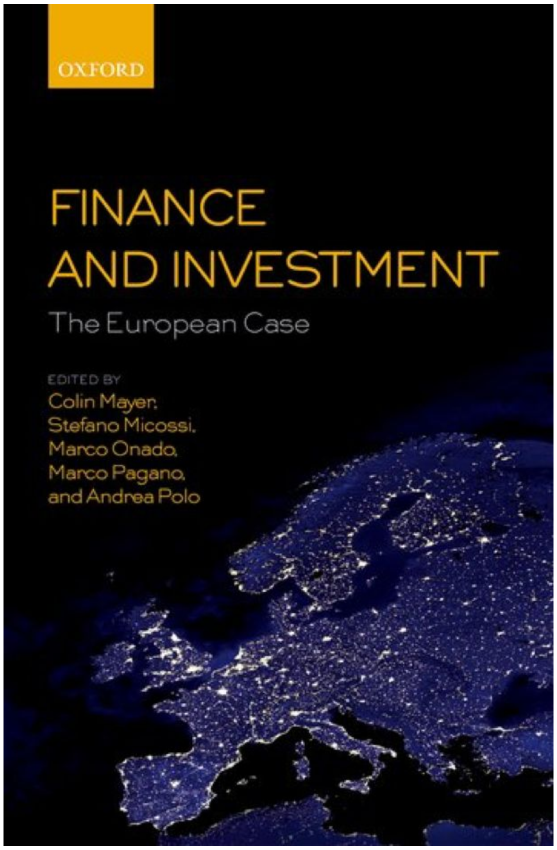
Finance and Investment: The European Case



The findings of a two-year research programme were presented in Brussels on 20 March 2018, calling for further reform of the financial and regulatory system in Europe. The research, which provides one of the most comprehensive and thorough analyses of any financial system undertaken to date, highlights the the need to modify prudential regulation of banks' sovereign exposures so as to eliminate the current regulatory preference for public over private debt, and instead encourage banks to hold a well-diversified sovereign debt portfolio.

The study considered the causes of the persistently low level of investment in Europe pointing out that Europe has experienced a "lost decade" following the Financial Crisis similar to that of Japan. This collapse in European Investment contrasts with the United States which recovered more rapidly as a result of more developed capital markets and the importance of equity as well as debt in the funding of the corporate sector.

The research also emphasises the 'double-edged sword' nature of debt and the risks inherent in excessive reliance on debt as a source of funding, observing that this reliance is substantially intensified by the corporate tax system. One feature of corporation tax around the world is 'interest tax-deductibility' – the provision by which companies can deduct their payments of interest against their earnings in computing their liabilities for corporate taxation. It makes the cost of debt finance substantially less than that of equity.

The study, produced by the Centre for Economic Policy Research (CEPR) by Professors Colin Mayer (Said Business School, Oxford University, ECGI and CEPR), Stefano Micossi (Assonime), Marco Onado (Università Bocconi), Marco Pagano (Università di Napoli Federico II, ECGI and CEPR) and Andrea Polo (Universitat Pompeu Fabra, Barcelona GSE and CEPR), concludes that 'we should correct the distortions imposed by taxation and regulation as a matter of urgency and recognise the importance that equity plays as the lifeblood of corporate sectors in loosening the noose of excessive corporate debt'.

Finance and investment: Europe's lost decade

The financial crisis of 2008 and the ensuing sovereign debt crises of 2010 to 2012 had devastating consequences for European economies, not least for corporate and public-sector investment. It fell sharply and remained depressed for the best part of a decade, in contrast to the US where there was a rapid recovery after the financial crisis (European Commission 2013). In many respects, the experience of Europe mirrored that of Japan in its lost decade after the banking crisis of the 1990s.

At the same time, the financial and sovereign crises provide remarkable 'natural experiments' of profound unanticipated shocks that afflicted economies, corporations, financial institutions, and public sectors. A two-year research programme[1] exploited these events to identify the impact of different contributory causes to the decline in European investment (Mayer et al. 2018).

The collapse in investment was particularly pronounced in some countries, such as Italy and Spain, in some sectors, such as construction, and in some companies, such as more capital-intensive ones. However, there is one especially important characteristic of the worst-affected companies – they were highly leveraged in having high ratios of debt to equity on their balance sheets. There were significantly greater declines in investment after both the financial crisis and the sovereign debt crises in companies that had above average levels of leverage before the crises.

But it was not just leverage that mattered; so did the type of leverage. The impact of debt was greater if it was of longer maturity. Companies with high levels of long-term debt cut investment prior to the crises more sharply in response to the crises than those with less or shorter-term debt.

This is very striking because one generally regards debt as an important source of funding and the availability of long-term debt finance as necessary for the funding of long-term capital investment. And so indeed they may be. However, what the financial and sovereign debt natural experiments illustrate is the double-edged nature of debt and especially long-term debt: ex ante, they promote

[1] The research programme entitled "Restarting European Long-Term Investment Finance" (RELTIF) was jointly organized by Assonime, the Federation of Italian Stock Exchanges, and the Centre for Economic Policy Research (CEPR). The objectives of the programme were described in an initial Green Paper available at https://reltif.cepr.org/sites/default/files/RELTIF_Green%20Paper.pdf

investment; ex post, they expose companies to shocks that not only threaten their solvency but also their subsequent investment and growth.

The reason for this is what is termed the ‘debt overhang’ problem. The existence of high levels of debt in companies in financial distress discourages the provision of further funding, as this would predominantly serve to bail out existing creditors rather than benefit shareholders or the new investors. The problem is particularly acute where the debt obligations are long term and cannot be rapidly extinguished. Debt is a millstone around borrowers’ necks; long-term debt is a noose.

The parallels between Europe’s and Japan’s lost decade are therefore very real. Both have debt overhang as their underlying cause and the consequences were also very similar. They gave rise to ‘zombie banks’, namely, banks whose financial conditions are so precarious that the collapse of their borrowers threatens their own solvency. As a consequence, instead of liquidating failing companies and imposing hard budget constraints on them, banks prop them up with further loans, and turn themselves into the ‘walking dead’.

The financial and sovereign debt crises allow natural experiments to be performed on banks and other financial institutions as well as companies. What this reveals is that it was banks in the ‘periphery’ rather than the ‘core’ euro countries and the less liquid, less capitalised and foreign rather than domestic banks that cut their lending the most in response to the crises.

However, there was one group of banks that were particularly adversely affected – the ones that had done what regulation encouraged them to do, namely, lend to the supposedly safe sovereign borrowers. In fact, those sovereigns turned out not to be so safe after the crisis struck, and the repricing of their debt dealt a blow to the balance sheets of the most exposed banks, forcing them to retrench on lending to their customers. Moreover, by threatening the solvency of banks the crisis forced governments in the affected countries to bail out their banks, thereby worsening their own predicament.

There was, in other words, a ‘diabolic loop’ by which failing countries provoked failing banks that exacerbated the failure of countries, and both adversely affected the funding and financial conditions of their corporate sectors. This highlights the need to modify prudential regulation of banks’ sovereign exposures so as to eliminate the current regulatory preference for public over private debt, and instead encourage banks to hold a well-diversified sovereign debt portfolio.

In face of the paralysis of the banking sector, one might expect the corporate sector itself to mitigate the adverse consequences by recycling funds from companies with surpluses to those with deficient financial resources. Small and medium-sized companies (SMEs) are particularly dependent on bank finance because in most cases they do not have access to the bond markets available to larger companies. Hence, they were particularly exposed to the cut in lending imposed by banks after the crises.

One might therefore have expected large companies to provide funding to SMEs in the form of trade credit, acting as quasi-banks in response to the crises. In fact, one observes exactly the opposite, namely, a pronounced increase in trade credit from SMEs to large companies. Far from acting as lenders of last resort to SMEs, large companies appear to have exploited their dominant positions by extracting funding from smaller companies.

The failures of the financial and corporate sectors in the wake of the financial and sovereign debt crises raise profound questions about the appropriateness of the policy responses to them, just as the Japanese crises cast a shadow over the policy responses there. Why were the effects so long and pronounced in both places but so much shorter and milder in the US?

Part of the answer lies in the different macroeconomic policy response across the Atlantic. An implication of the above analysis is that fiscal or monetary stimuli may not only address deficiencies in aggregate demand, but also problems of underinvestment arising from financial distress and debt overhang. The recent growth of both European and Japanese economies, as well as the faster recovery of the US may bear witness to that. However, the research also raises significant issues about the effects of public policies and regulation on the financial sector.

In particular, it emphasises the 'double-edged sword' nature of debt and the risks inherent in excessive reliance on debt as a source of funding. That reliance is substantially intensified by the corporate tax system. One feature of corporation tax around the world is 'interest tax-deductibility' – the provision by which companies can deduct their payments of interest against their earnings in computing their liabilities for corporate taxation. It makes the cost of debt finance substantially less than that of equity.

Its effects on the behaviour of companies are profound. It not only induces companies to have much higher levels of leverage than would otherwise be the case, but also undermines bank lending to the corporate sector. The way in which this occurs is illustrated by the few cases of where countries have experimented with levelling the playing field between their corporate tax treatment of debt and equity, most notably in Belgium and Italy. The response was a remarkable increase in lending by banks in the two countries as their capital adequacy and equity cushions improved. In other words, interest deductibility both artificially inflates companies' demand for debt and constrains banks' willingness to supply it.

It is extraordinary that on the one hand, capital requirements seek to improve the solvency and capital adequacy of banks and, on the other hand, corporate tax systems encourage exactly the opposite. This is made worse by the inherent distortions introduced by capital requirements. High 'risk weights' on corporate lending impose large capital requirements on banks and encourage banks to invest in (illusorily) 'safe' government bonds in preference to lending to parts of economies that are most dependent on them, namely SMEs.

Instead, we should recognise the importance of equity as well as debt in the funding of the corporate sector. Europe has begun to catch up with the US in the provision of venture capital finance for start-ups and early stage companies. However, it still lags markedly behind in the provision of later stage funding for the scaling up of companies to becoming ‘unicorns” (with valuations of more than $1 billion). This is in part a reflection of less developed capital markets in Europe than in the US. But it is also a consequence of regulatory policies regarding information disclosure, corporate governance, takeovers, and equity issuance that are designed to enhance investor protection, but in the process discourage equity investment and investor engagement in European firms. As in the case of bank regulation, in focusing on investor and systemic protection, equity market regulation has paid insufficient attention to their potential detrimental implications for the European corporate sector.

In summary, the programme has shed new light on the operation of economic and financial systems around the world and the causes of Europe’s ‘lost decade’. The insights come from the remarkable natural experiments that the financial and sovereign crises have provided. They point consistently to the importance of debt overhang as a contributory factor and the role of both tax and regulatory policy in exacerbating the problems. We should correct the distortions imposed by taxation and regulation as a matter of urgency and recognise the importance that equity plays as the lifeblood of corporate sectors in loosening the noose of excessive corporate debt.

References

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Mayer, C, S Micossi, M Onado, M Pagano and A Polo (eds) (2018), Finance and Investment: The European Case, Oxford: Oxford University Press.

The book, published by oxford University Press is currently available for purchase with online retailers.

The event was held in collaboration with the European Corporate Governance Institute (ECGI).

About the European Corporate Governance Institute (ECGI)

www.ecgi.global

The ECGI is an international scientific non-profit association which provides a forum for debate and dialogue focusing on major corporate governance issues and thereby promoting best practice. It is the home for all those with an interest in corporate governance offering membership categories for academics, practitioners, patrons and institutions.

Its primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, it can advise on the formulation of corporate governance policy and development of best practice. In seeking to achieve the aim of improving corporate governance, ECGI acts as a focal point for academics working on corporate governance in Europe and elsewhere, encouraging the interaction between the different disciplines, such as economics, law, finance and management.

About the Centre for Economic Policy Research

https://cepr.org/

The Centre for Economic Policy Research (CEPR) was founded in 1983 to advance the quality of economic policy-making within Europe and beyond, by fostering top quality, policy-relevant economic research, and disseminating it widely to decision-makers in the public and private sectors. Drawing together the expertise of its over 900 Research Fellows and Affiliates, CEPR initiates and coordinates research activities, and communicates the results quickly and effectively to decision makers around the world. CEPR organises approximately 80 meetings a year, and produces over 600 Discussion Papers, reports and books. The Centre is an independent, non-profit organization and takes no institutional policy positions.

About RELTIF

https://reltif.cepr.org/

RELTIF is a research project on corporate financing in Europe jointly developed by Assonime and the Centre for Economic Policy Research (CEPR) in London. It is designed to serve two purposes:

1. Advance the understanding of issues relating to the financing of corporations, especially European ones,

2. Provide evidence on the policy issues currently debated in Europe about the financing of corporations.

The project aim is to distil robust policy recommendations that can guide and influence the future path of reform, and the resulting changes in the structure of financial markets in the years to come.

The time horizon of the project is three years. Funding is provided by Emittenti Titoli.

About Assonime

http://www.assonime.it/

Assonime is the Association of Italian joint stock companies, constituting around 500 companies from a range of sectors including finance, public utilities and industry. Assonime was established in 1910 as a research centre by a distinguished group of industrialists and financiers. Its history is intertwined with that of the Italian economic system and, more recently, European integration. Both a company association and a think tank, Assonime's goal is the creation of a healthy macroeconomic and regulatory environment for business as a whole, without sectoral interests, and with a strong commitment to opening markets and promoting European integration.

Assonime is an Institutional Member of the European Corporate Governance Institute (ECGI).

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