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SAFE Finance Blog

Boosting Investment in Start-ups and Social Enterprises

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Günter Franke: Regulation should encourage co-lending by banks



Access to financial resources is one of the biggest hurdles for young companies in the European Union. In contrast to the US, venture capital markets in Europe are still underdeveloped. According to the European Commission, an extra 90 billion euros would have been available between 2009 and 2014 for financing European companies if venture capital markets had been as developed as in the US. In order to change that, representatives of the European Council and the European Parliament now agreed on amending the rules that govern venture capital funds (Regulation 345/2013). Similarly, rules that govern funds investing in social entrepreneurial activities (Regulation 246/2013) have been amended. By relaxing regulatory

burdens, venture capital and social activities shall be promoted.

The proposed amendments will make European venture capital funds (Euveca) and European social entrepreneurship funds (Eusef) available to fund managers of all sizes and expand the range of companies that the funds can invest in. To protect investors, both regulations require investors in these funds to be professional and invest at least 100.000 euros. In addition, the regulations impose various rules on fund managers including transparency rules. The stimulation of financing entrepreneurial activities without intermediation by banks should give a push to the European Capital Market Union.

To my view, the proposed amendments are useful by protecting investors and motivating such investments. As investing in young firms is very risky, intermediaries such as venture capital funds are important not only to protect investors, but also to help and monitor the managers of young firms. These intermediaries follow a shareholder value approach, meaning that they try their best to maximize the market value of the young firms.

Quite differently, investors in social enterprises follow a stakeholder approach, putting a higher weight on beneficiaries of social activities and a lower weight on shareholder value. The stakeholder approach is likely to lower the risk-adjusted return on assets of such enterprises. This approach makes it harder for investors to assess whether the managers of social enterprises do a good job or whether they spend little effort or even waste money. For fund managers and investors it may be very difficult to detect inefficiencies because managers can always claim that their social activities are quite costly. To overcome this difficulty, strong transparency rules are needed. But so far reliable quantitative measures of social benefits are rare, which gives these managers much leeway.

The problem is similar with so-called sustainable investments. A recent investigation by Union Investment (<https://unternehmen.union-investment.de/startseite-unternehmen/pressteservice/pressemitteilungen/alle-pressemitteilungen/2017/Nachhaltige-Kapitalanlage-gewinnt-weiter-an-Bedeutung.html>) shows that transparency is a big issue here, too. Interestingly, among the investors primarily large companies and banks complain about transparency problems, more than churches and foundations. That may be explained by less managerial competence on the side of churches and foundations and, perhaps, by less interest in profitability.

The lack of transparency could be mitigated if banks serve as co-investors. Banks have a special expertise in analysing the debt bearing capacity of a firm in relation to its profitability and monitor its activities since they have access to more firm data and they are experts in restructuring distressed loans. Hence, less experienced lenders and equity providers for social enterprises could benefit from synergy effects when having banks as co-investors. As a consequence, the regulation of social enterprise funds should encourage co-lending by banks so as to promote effective management procedures and, thereby, strengthen the European Capital Market Union.

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More on this topic: Günter Franke/ Jan Pieter Krahn: SME Funding Without Banks? On the Interplay of Banks and Markets, SAFE Working Paper No. 44. (<http://safe-frankfurt.de/de/policy-center/publikationen/detailsview/publicationname/sme-funding-without-banks-on-the-interplay-of-banks-and-markets.html>)

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