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Capital market working group of the FinanceEstonia cluster

DEVELOPMENT PROPOSALS FOR CAPITAL MARKETS

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Introduction

In this document, the situation in the Estonian capital markets is described and measures are proposed for rejuvenating it. The proposals were prepared by the capital markets working group established by MTÜ Finance Estonia, a non-profit association. Members of this working group are highly experienced capital market specialists covering the important institutions affecting the financial sector, including investment banks, pension and venture funds, Tallinn Stock Exchange, etc. The complete list of the working group members is provided in Appendix 1.

The capital markets working group has operated since 23 September 2011 with the purpose of devising measures for developing the Estonian capital market.

Among other things, the members of the capital markets working group also had meetings with the representatives of the following established capital markets players outside Estonia in order to prepare the proposals:

1. Varma, Finland
2. Solidium, Finland
3. Finanssialan Keskusliitto, Finland
4. AP2, Sweden
5. Danica Pension, Denmark
6. ATP Private Equity Partners, Denmark
7. Vækstfonden, Denmark

Moreover, respective literature on the relationship between capital market development and economic development has been explored and analysed and tens of unofficial meetings and several sessions of brainstormings have been hosted among the working group members.

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This document is structured as follows:

Capital markets

Capital markets can be broadly divided as follows:

1. Stock capital markets

   1.a. Regulated markets, i.e., markets where shares are traded in public exchanges

   Listed stock markets are probably the most noticeable - they comprise, among others, NASDAQ OMX (including Tallinn Stock Exchange), NYSE Euronext, LSE, Deutsche Bürse, etc. In 2010, the total share capitalisation of markets in public exchanges was approximately 55 trillion dollars (Source: IMF). Both financial institutions and private persons participate in these markets as investors.

   1.b. Alternative or unregulated stock markets

   Alternative stock markets are understood as unregulated markets, which mostly involve professional investors. First North, AIM in London, but also the so-called multilateral trading facilities (MTFs) e.g. Chi-X, BATS, Burgundy, Turquoise, etc.

2. Debt capital markets

   Debt capital markets constitute the largest part of international capital markets – 63% of world capital markets and as much as 81% of the Eurozone capital markets. (Source – IMF. Due to insufficient statistics, these capital markets do not include private capital markets, mostly meaning private equity and venture capital markets). [Please note that bank loans and other bilateral credit markets are not considered as debt capital markets.]

3. Private capital markets

   Private capital markets are where private equity and venture capital funds invest directly in companies.

The local capital market is essential for the economy

The local capital market functioning is important for the economy, as it diversifies the enterprises' financing sources. This, in turn, enables to raise the number of business projects that are launched, fund enterprises' capital investments and (international) expansion, and thus create jobs and increase the added value in the economy. Moreover, a functioning local capital market broadens the investors' options. As an indirect impact, a functioning capital market also has an important effect on the venture capital market since it creates a natural exit mechanism from previous risk investments. A weak local capital market leads to anomalies – loan products (commercial banks) dominate and although it is possible to list company securities in external markets, this kind of opportunity is only accessible to the largest enterprises in Estonia.

First and foremost, a functioning capital market is necessary for small and medium size enterprises (SMEs). Based on several examples, it could be claimed that SMEs are the main job generators and innovators in the economy. The SME sector enterprises of OECD countries constitute 2/3 of all jobs and over 50% of the added value in the economy. In the period 2002 - 2010, close to 23 million SMEs in the European Union created 85% of all new jobs. As a result of the recent regulative changes and financial crisis, the opportunities of raising capital have significantly worsened for the SME sector enterprises. According to a recent report by ESMA Securities and Markets Stakeholder Group, of the nearly 48,000 enterprises in Estonia, only 157 are large enterprises. It could thus be claimed that 99.9% of Estonian businesses are SMEs. Pursuant to the ESMA report, access to capital is limited for 2/3 of the SMEs in OECD. One of the best solutions would be to develop local capital markets and thereby increase the financing alternatives for SMEs.

Various studies support the importance of developing local capital markets, arriving at the following conclusions:

<u>Study No. 1: Augusto de la Torre, Sergio L. Schmukler – Emerging Capital Markets and Globalization. The Latin American Experience.</u>

The development of financial markets is one of the drivers of economic growth

"Since the beginning of the 1990s, a growing body of empirical work, including broad cross-country and panel studies, time series analyses, individual country case studies, and firm- and industry-level analyses, has provided evidence supporting the view that financial development is not just correlated with economic growth, it is actually one of its drivers." References of this part: Goldsmith (1969), King and Levine (1993b), Levine and Zervos (1998b) and Levine, Loayza, and Beck (2000).

<u>Study No. 2: Gugliemo Maria Caporale, Peter G.A. Howells, Alaa M. Soliman – Stock Market Development and Economic Growth: the Causal Linkage</u>

A well-functioning stock market fosters economic growth through enabling faster capital accumulation and a more precise resource allocation

p. 1: "The evidence obtained from a sample of seven countries suggests that a well-developed stock market can foster economic growth in the long run. It also provides support to theories according to which well-functioning stock markets can promote economic development by fuelling the engine of growth through faster capital accumulation, and by tuning it through better resource allocation."

Study No. 3: Laura Alfaro, Areendam Chanda, Sebnem Kalemli-Ozcan, Selin Sayek – FDI and Economic Growth: The Role of Local Financial Markets. November 2000

Countries with well-developed local capital markets gain significantly from FDI

p. 1: "[C]ountries with well-developed financial markets gain significantly from FDI."

p. 4: "Although most FDI by its very nature relies on capital from abroad, it is important to recognize that the spillovers for the host economy might crucially depend on the extent of the development of domestic financial markets. There are different ways in which financial markets matter. First, it is unlikely that spillovers are restricted to only costless improvements in the organization of the workforce. In particular, to take advantage of the new knowledge, local firms need to alter everyday activities and, more generally, reorganize their structure, buy new machines, and hire new managers and skilled labour. Although some local firms might be able to finance new requirements with internal financing, the greater the technological-knowledge gap between their current practices and new technologies, the greater the need for external finance. In most cases, external finance is restricted to domestic sources."

p. 6: "[I]t is not just easy availability of loans but also well-functioning stock markets that matter. Well-functioning stock markets, by increasing the spectrum of sources of finance for entrepreneurs, play an important role in creating linkages between domestic and foreign investors."

p. 6: "To summarize, one can conjecture that the extent of development of financial institutions may be a decisive factor in determining whether foreign firms operate in isolated enclaves with no links whatsoever with the domestic economy (beyond hiring labour). Or, whether they become the catalysts for technology transfers and other benefits that economists have long argued these firms should be."

Study No. 4: David Weild, Edward Kim: Market structure is causing the IPO crisis – and more. June 2010

The availability of capital increases the employment rate and innovation

p. 6: "When companies cannot raise capital effectively – or at all – they are deprived of their ability to acquire the assets and human resources they need to grow their businesses.

If we want to stop this vicious cycle of rising unemployment and its devastating impact on U.S. citizens, we must take steps now to revive our IPO[1] markets."

p. 17: "Impact of inaction. U.S. economic growth will be lower as returns languish without a functioning IPO market and investors allocate less money to venture capital as an asset class. […] Entrepreneurs take a beating – investors are already cutting back funding to entrepreneurs […] The incentive for Americans to leave well-paying jobs [in favour of establishing an enterprise] and risk everything will be less."

<u>Study No. 5: Bernard S. Black; Ronald J. Gilson – Does Venture Capital Require an Active Stock Market?</u>

Well-developed stock and bond markets are prerequisite to venture capital investments in start-ups

p. 2: "[V]enture capital can flourish especially – and perhaps *only*, if the venture capitalist can exit from a successful portfolio company through an initial public offering (IPO), which requires an active stock market. Understanding the link between the stock market and the venture capital market requires understanding the contractual arrangements between entrepreneurs and venture capital providers, especially the importance of exit by venture capitalists and the opportunity, present only if IPO exit is possible, for the venture capitalist and the entrepreneur to enter into an implicit contract over control, in which a successful entrepreneur can reacquire control from the venture capitalist by using an IPO as the means of exit."

p. 17: "[I]f the venture capital provider exits through sale of the portfolio company to another company, control passes to the acquirer, even if the entrepreneur remains in charge of day-to-day management. Thus, if an IPO exit is not available, the entrepreneur cannot be given the incentive of a call option on control exercisable in the event of success."

<u>Study No. 6: REPORT TO ESMA. Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding</u>

Capital markets are important for SMEs[2], who are in turn important employment promoters

p. 4: "The advantages to companies of using the capital markets translate to higher economic contribution and employment. The markets provide businesses with a high degree of diversification of potential investors, the access to additional equity capital and the higher public profile and brand recognition that a listing can provide a company with. This can also help to attract talented senior management."

[1] IPO – Initial Public Offering

[2] The study considers SMEs companies with less than 500 million euros of market value. This criterium would include most Estonian companies as SMEs.

p. 6: “In the early stages of their development, SMEs are typically dependent on equity financing. Initially capital may be provided by family, friends and eventually business angels. At a later stage, in order to professionalise and scale-up, growing and innovative companies will typically seek funding from venture capital and private equity funds. Once these funds have taken the SME onto its next level of development, they will look to the capital market and an Initial Public Offer (IPO) as one of their exit options.”

p. 8: “[I]t should not matter whether a company obtains its funding by equity or debt; the relationship between risk and reward should be equal. Nevertheless, it does matter for a wide variety of reasons. One reason is tax, because most jurisdictions allow interest on debt to be subtracted from the financial results of a company before taxation, whereas dividends are paid out of profits that have been taxed. This asymmetry may distort may distort the funding decisions of companies. Another reason is based on the fact that dividends are only payable from profits and retained earnings, whereas interest on debt must be served irrespectively of whether the company is profitable or not. For this very reason, start-ups which often have little or no profits in the first years are usually ill advised using debt as funding and should prefer to attract equity that is more patient in the sense that dividends are only payable once the company becomes profitable.”

The impact of local capital markets on the risks of the economic climate

A deeper, well-functioning local capital market reduces systematic risks as financing and thus risks are not only concentrated in banks, but are divided between more parties.

Supporting capital markets is also mentioned in the coalition agreement:

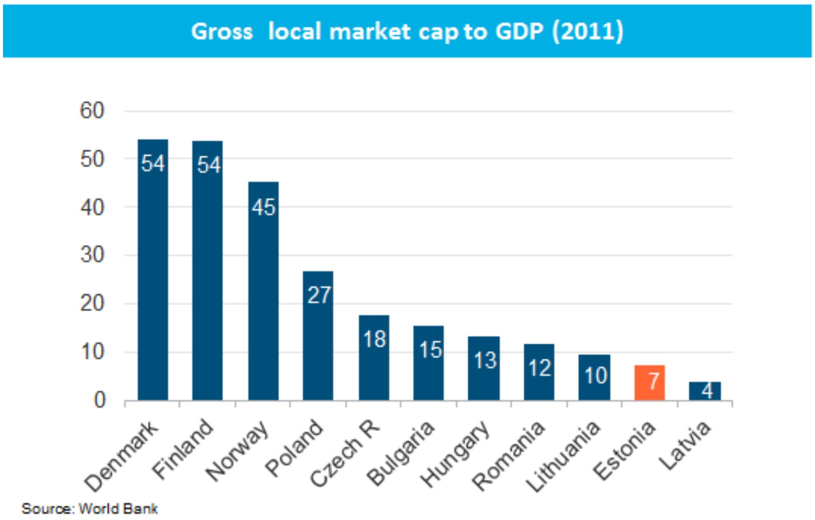
“We will simplify regulations so that, in essence, the stock exchange would function as an alternative source of funding good business ideas also for SMEs. The residents of Estonia must grow into an owners’ society also through being company owners.”

The Estonian capital market is fading

The Estonian capital market is very small as a share of total economic activity and has been in a downward trend during the last decade.

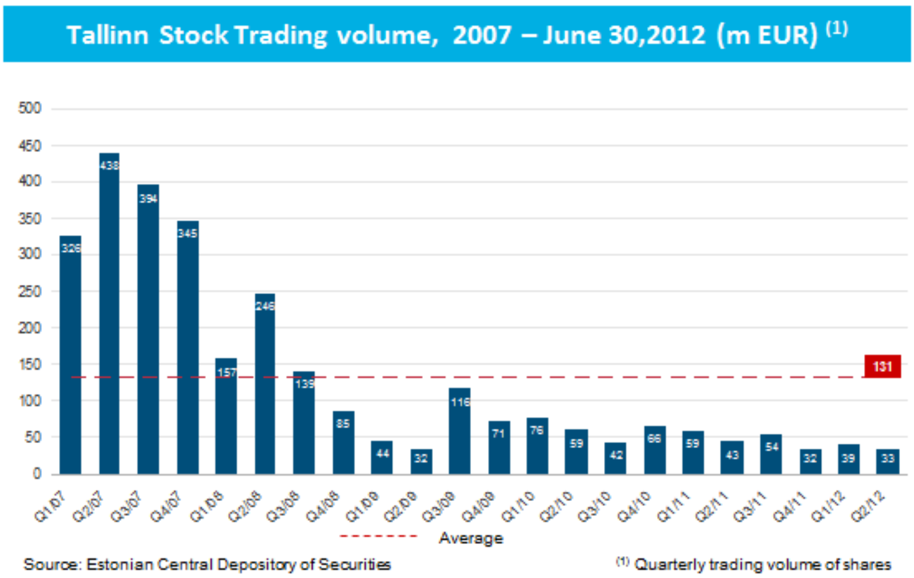
1. Stock exchange capitalisation (or the gross value of listed enterprises) has decreased threefold compared to 2007 even when considering the already low ratio of the Estonian stock exchange capitalisation to GDP throughout the whole period of independence.
2. Stock exchange volume has dropped more than 11 times compared to the 2007 average.
3. The ratios of stock exchange capitalisation and volume to GDP are very low in Estonia in reference to other comparable countries.
4. The bond market has stopped functioning.

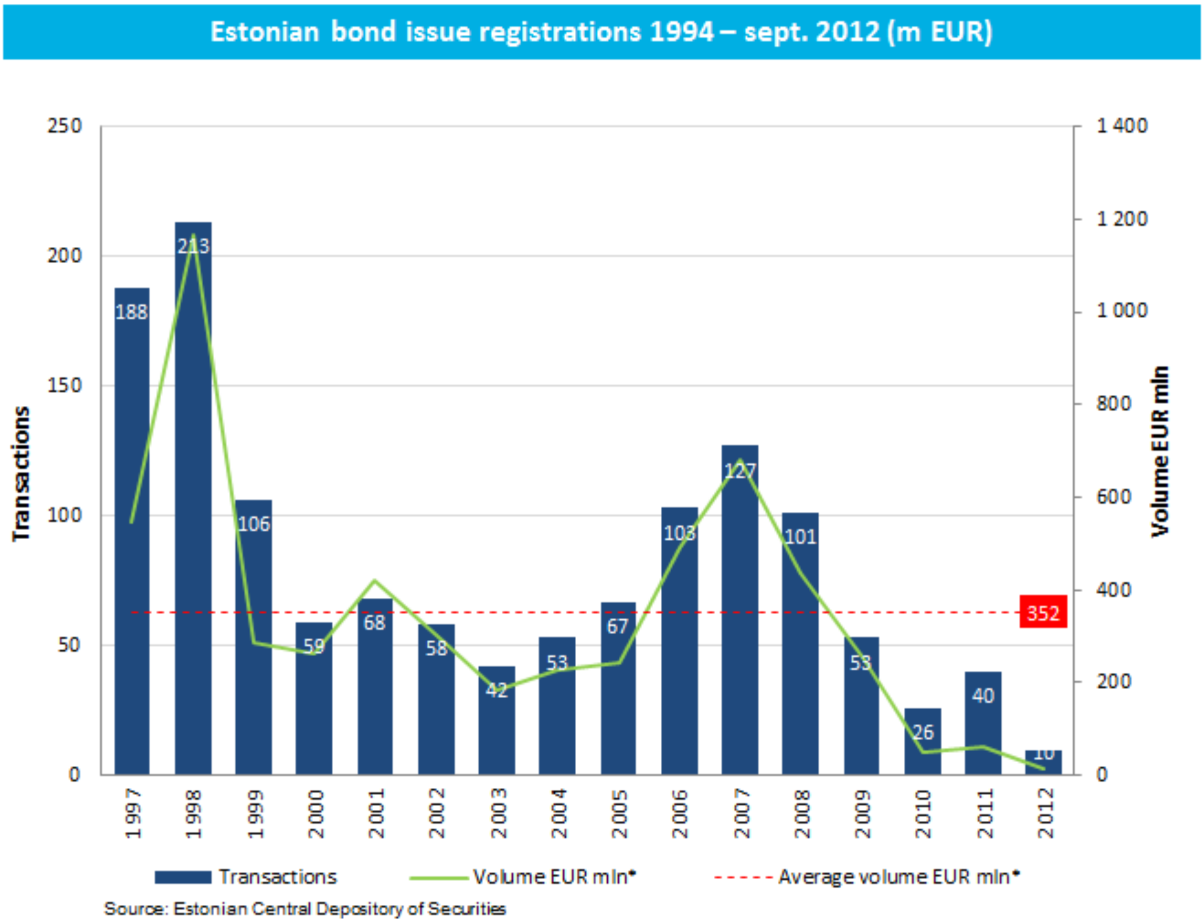
The ratio of stock exchange capitalisation to GDP, selected countries (2011)



Denmark, Finland, Norway, Poland, Czech Republic, Bulgaria, Hungary, Romania, Lithuania, Estonia, Latvia

Source: World Bank Database





Source: Estonian Central Register of Securities

Stock market volume % of GDP

OECD, EU, Estonia

Source: World Bank Database

Working group proposals

Globalisation and several other powerful external market trends significantly threaten the capital markets of small countries. The capital market working group of Finance Estonia has compiled several specific measures how to rejuvenate Estonian capital markets.

	Measures stimulating market development	***General measures / effects***
SUPPLY-SIDE MEASURES	Increasing offering of investment securities in various asset classes and creating new asset classes	Altering regulations in order to revive supply of investment products and enable new asset classes
		Direct state offering of instruments (state-owned company shares, bonds)
DEMAND-SIDE MEASURES	Increasing the number and interest of market players and abolishing restrictions so that all players could invest in Estonia	Altering regulations in order to revive demand and enable investments into new asset classes
		Active market involvement of local investors increases foreign capital's interest in the market

Several powerful measures need to be enacted simultaneously

In order to achieve the goal of significantly rejuvenating the local capital market, implementing only a few isolated and weak measures will not suffice, thus it is essential to coordinate powerful activities and carry out several measures.

We kindly ask to use this document as a specific set of measures. For the purpose of achieving the best possible effect, **the selected measures should be powerful, long-term and support both offer and demand.**

Not all of the following measures result in the direct inflow of capital for Estonian enterprises, state bonds or covered bonds, for instance. Nevertheless, these steps should significantly increase the activity of Estonian markets, attract the attention of foreign investors and thus make the capital raising easier for Estonian enterprises.

Ideas to improve the supply of investment products Short summary:

- Stock exchange listings of shares in government-owned enterprises
- Government bonds of Estonia
- Government owned company bonds issued to to the local market
- Establishing a municipal financing centre and financing it with bonds
- Establishing a covered bond market

Listing selected state enterprise shares in the stock exchange

Listing state enterprise shares, especially introducing larger enterprises to the market enables to rejuvenate stock markets significantly as these enterprise shares would not only attract all the local market players but also foreign investors.

NB! Our working group members do not recommend listing state enterprise shares in a stock exchange without thorough and calculated previous preparations. Thorough preparations would first and foremost include the following:

1. For example, several enterprises require restructuring in order to divide assets and the operator into separate bodies;
2. Most enterprises require reorganising the company management (or rearranging corporate governance). This would presuppose that the respective decisions of the company management would primarily reflect the interests of the enterprise and shareholders. Among other things, this would, for example, mean that the management and corporate board of the selected state enterprises would be chosen among the people who possess the necessary skills and experience for leading the specific enterprise and that the members of the selected management body would be notified that their first priority is to ensure the attainment of the goals important for the enterprise.

<u>The estimated direct effect of the measure:</u>

1. Broadens capital involvement opportunities for state enterprises.
2. Increases their competitiveness.
3. Orientation towards growth and efficiency.
4. Increases the options for all investors.
5. Increases market liquidity.
6. Depending on the issuer, there is a possibility of the emergence of a new Tallinn Stock Exchange ‘leading stock’. After Hansabank and Telekom delistings, Tallinn Stock Exchange has lacked a strong leading stock. Maintaining a leading stock that is attractive for international investors is accompanied by international investors’ interest in other local enterprises, which would be too costly to be invested in separately.
7. The larger and more attractive the company the government wants to list on the market, the greater the market effect would be.

8. Enables for more than 600,000 Estonian pension unit holders to become co-owners of high-quality state enterprises.
9. Increases the shareholding of Estonian residents in the stock market and thus enables to broaden people's saving alternatives.

<u>The estimated indirect effect: increased opportunities to involve capital for other enterprises and job creation</u>

92% of all jobs created by the companies listed in the U.S. stock exchange after 1970 have been created after the companies have gone public.[3] Stock exchanges help growth enterprises to develop and thus guarantee a degree of certainty which is necessary for creating jobs. The estimated effect of a strong leading stock on jobs is presumably manifold as, by supporting market establishment, listing a large enterprise will also enable listing other enterprises.

Issuing government bonds and retailing them in the Estonian market

Issuing government bonds in a way that would include a public offer in the local market is a very powerful step towards reviving the local bond market.

1. Defines a 'risk-free' rate of return.
    - Risk-free rates of return are used as a comparison to evaluate any Estonian financial assets; whereas, using formulas (like Capital Asset Pricing Model, for instance) for evaluating assets that are important for the financial sector also requires the inclusion of the risk-free rate of return. If the risk-free rate of return cannot be determined on the basis of the market (as there are no state bonds), the parties will employ predictions, which will most likely reduce the value of the potential financial assets.
2. Enables to invest long-term local savings, including the II pillar pension funds and savings of private persons into the highest quality domestic asset class.
    - Helps to relieve the shortage of suitable domestic instruments.
    - Increases saving alternatives for private persons, including investors with less investing know-how.
    - Helps to increase the transparency of local pension funds for those collecting savings.
3. Fulfils the preconditions for (re)forming other bond classes in Estonia, including various corporate bonds.
   Issuing government bonds on a regular basis supports the institutions trading with financial instruments allocating the organization's resources in order to enable trading with Estonian securities. After these systems have already been created within brokers and other financial institutions (or, rather recreated in case of many institutions), other Estonian investment assets would also benefit from it.

[3] National Venture Capital Association „Global Insight and Survey of Top 136 VC-Based Companies That Went Public 1970-2005"

Issuing local bonds by high-quality state enterprises

The bond market of Estonian enterprises has been an active and important alternative source of financing. In the period from 1995 to 2002, this bond market mainly relied on low-risk large enterprises. The investors' interest to buy similar bonds has remained the same.

In order to rejuvenate the local bond market, the government could motivate state enterprises to finance a part of their financial liabilities through local bond emissions. This could be achieved through a government provision or a specific legal act. There would be a demand for these bonds and regular issues would turn the bond market into a normal place for securing capital for Estonian enterprises; in turn, the bond class of Estonian enterprises would also become a standard in investing institutions. Today's problem is partly the fact that local enterprise bonds have been forgotten, thus it is an unusual instrument for both enterprises to finance and investors to invest in. That is why it is important to facilitate the re-launching of the market as it would not begin to function properly otherwise.

The government intervention as mentioned above must be carried out carefully as it ispossible to cause damage when choosing the wrong specific steps in this process. Enterprises themselves definitely do not wish for such an intervention in their management, although it could make sense for the same enterprises in the long term as it would enable the emergence of a convenient additional source of financing.

Reviving the local bond market of large enterprises will turn investing in Estonian enterprises' bonds into a natural activity again both for funds and private persons, and this could also enable completely private-owned enterprises to secure money from the bond market. We thus assume that the efficient implementation of this measure would foster the emergence of a reprocessing and self-managing system.

The estimated effect of the measure:

1. Increases the investors' options.
2. Increases market liquidity.
3. Would enable to re-launch the bond market of Estonian enterprises.
4. An alternative to bank deposits.
5. Diversifies the funding options of state enterprises.

Municipal fund

What we mean by a municipal fund is establishing a local government unit financing centre or centralising local government financing into one legal body. What is important is that all local government units, without exception, would finance themselves through this legal body. This is necessary because, when taking into account only voluntarily acceding local government units, we could suppose that the local government units that are able to finance themselves cheaply enough on their own would not join. This would, in turn, mean that only those local government units whose credit risks are higher and whose bonds would thus be less attractive for investors would join the Municipal fund. Also, the investors might presume a potential state warranty in case all local government units have joined the scheme without the state actually having to commit to it in writing.

It is advised to establish the Municipal fund as a company in which the local governments are shareholders in accordance with their budget size.

To support capital markets, it is recommended that the Municipal fund would finance itself only through local bonds. This approach would enable to create a very important tradable instrument in the Estonian market, which could presumably have a similar credit rating as that of the state.

Although this does not concern supporting capital markets, it would be reasonable to centralise several other activities related to the financial management of local government units to the Municipal fund, including predicting loan needs, monitoring and analysing loan portfolios, monitoring the financial activities of local government units and implementing preventive measures to avoid problems.

In order to analyse this measure more precisely, it should be explored how this scheme could be incorporated into the local government units' principle of autonomy.

The estimated effect of the measure:

1. A potentially large-scale bond market. On 30 September 2011, the debt load of local government units was over 560 million euros in total.
2. Enables to lower the price of money for smaller local government units.
3. Enables a better control over local government financing.

Covered bonds

Covered bonds are popular in Scandinavia, where they have been used for a long time. First and foremost, Estonia could benefit from bonds which would be issued by local banks with a specific home loan portfolio as a security and which would be considered bankruptcy-remote of the respective bank. In other words, bonds would not be issued by separate legal bodies – the so-called mortgage banks like in the case of Denmark – but by local commercial banks. Thus, the investor would have a double warranty with this bond – firstly, a specific housing loan portfolio and secondly, the issuing bank would also secure the bond. This would provide banks with a chance to involve important capital from the local market and lower financing costs. Considering that the housing loan balance was a bit more than 5.8 billion euros according to the Eesti Pank statistics (July 2012), issuing covered bonds could significantly revive the capital market.

Establishing a covered bond market requires some amendments in acts. For example, it is necessary that loans which are essentially collateral would be excluded from the bank's bankruptcy estate; also, conditions related to the collateral should be regulated, and a collateral register should probably also be created.

Estimated effect of the measure:

The volume of housing loans was about 6 billion euros in July 2012, so through covered bonds, a significant volume of instruments could accrue to the bond market and thus the reviving of the whole market becomes possible.

The impact of pension funds on capital markets

Pension funds are the single most important long-term source of local capital. Pension money plays a leading role in the formation of institutional capital almost everywhere in the world, often being the anchor investor in both capital market transactions as well as in funds based on various sectors or asset classes (like venture capital funds, real estate funds, share funds etc.)

In September 2012, the volume of Estonian pension funds was about 1.4 billion euros; however, very little has been reinvested in Estonia by today – less than 8% by estimations.[4] This is partly due to the shortage of suitable instruments. At the same time, pursuant to present day legislation, it is possible to transfer investment management entirely outside Estonia, which at least some Estonian pension fund managers have taken advantage of.

If we could ensure that investment decisions are made in Estonia, it could be assumed based on international experience that more investments would flow into Estonia. The place where investment decisions are made affects the choice of the investment destination, so it follows that home markets are preferred everywhere. Estonian pension fund managers are mostly Scandinavian enterprises and if some of them decide to centralise investment decision-making outside Estonia in order to reduce costs (because the rest of the investment activities of the respective financial institution are already located in Stockholm, for example), it would mean an automatic decrease in Estonian investments. The experience of the present day Estonian pension market also suggests that funds led from Estonia have significantly higher allocations to the home market than in case of funds led from the Nordic countries.

Most world markets have historically implemented foreign investment restrictions on their pension funds. One of the aims and outcomes of these restrictions has been to support the local economy. In the last 10 years, these restrictions have been reduced in the European Union countries in order to guarantee the free movement of capital, but despite liberalisation, pension money has a strong home bias (see below).

Relying on international studies and the meetings that the working group members held in Finland, Sweden and Denmark, it could be highlighted that regulating pension funds with the aim of rejuvenating the economy has been deemed important. Some quotes from the meetings:

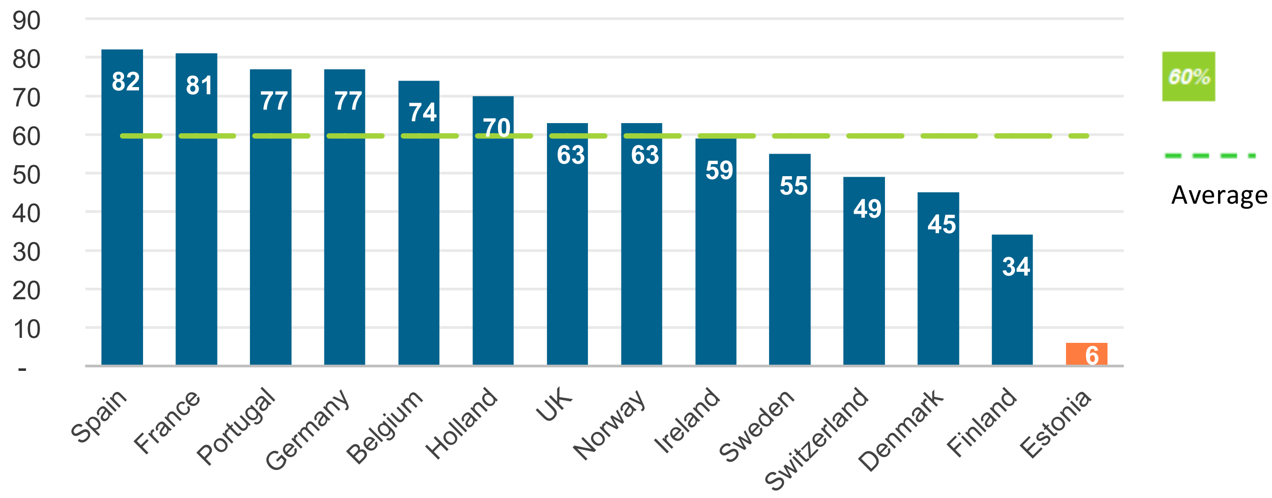
1. A local institutional base of investors has been the main reason behind the Swedish export-oriented economic success story (Niklas Johansson, AP2, Sweden).
2. If investment allocation decisions are made outside Estonia, they are made in favour of other markets (Niklas Johansson, AP2, Sweden).
3. If Varma (one of the largest managers of Finnish pension assets - FE) was to significantly reduce its allocation of Finnish assets, a strong public disapproval would ensue (Risto Murto, Varma, Finland).
4. It is important for the local economy that pension funds would invest in Finland (Risto Murto, Varma, Finland).

[4] Redgate analysis 31 October 2012

5. Investors always possess more information on home markets, which is a logical reason to prefer home markets (Kari Järvinen, Solidium, Finland).
6. Information on local market investments is more cheaply attainable (Jens Dalskov, Danica Pension, Denmark).

According to the experience of developed countries, the share of domestic investments in the total portfolio is around 60%. Estonia's objective in the near future should be to increase the share of local investments of pension funds to 20 - 30%, and even more in the longer term.

Strategic allocation of pension assets, share of home market, May 2011 (%)



Source: Asset Allocation Survey, Mercer, May 2011; Finnish Centre for Pensions, Estonian Pension Centre, SEB Enskilda

Other: excl. cash, Finland in 2010, only II pillar funds in case of Estonia; statistics on Estonian funds on 30 September 2011.

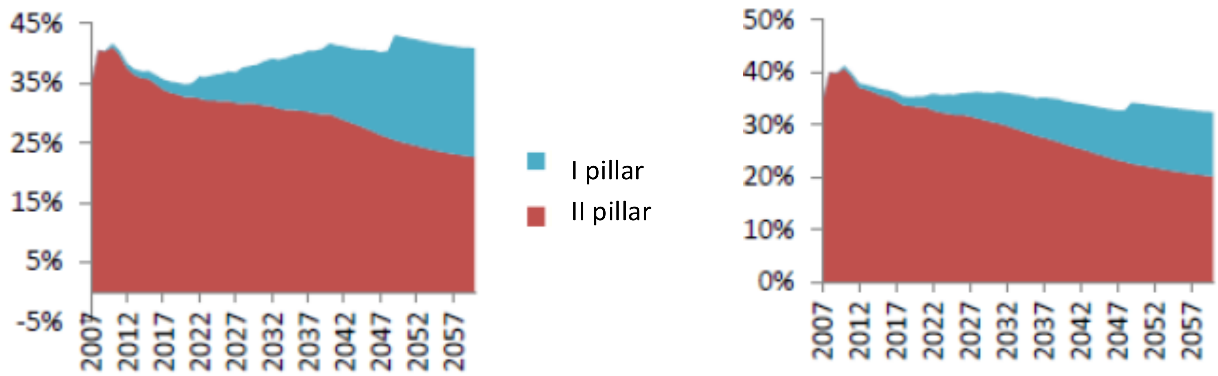
The high concentration of pension assets is justified as the real rate of return of pension assets is benchmarked against local inflation and money is collected on account of payments made by people working in the home market. When re-investing this in the home market, pension funds contribute to increasing the added value in the home market, which in turn facilitates economic growth and increases peoples' incomes and tax base. Moreover, in the long-term perspective, local assets should provide a rate of return which exceeds local inflation and this, for example, is what Tallinn Stock Exchange has managed to offer in its time of business.

In case of proposals related to funded pension, it has to be taken into account that state pension will still remain the most important for financing Estonian pensions – according to a study conducted by Praxis, state pension or the I pension pillar will constitute 55% of men's and 62% of women's pensions in 2060.

Graph 3.2.11. Average gross replacement rate of the pension insurance system for new old-age pensioners at the moment of retiring at the retirement pension age.

New pensioners, men

New pensioners, women



Note: the gross replacement rate has been calculated *vis-à-vis* the average revenue taxed with social tax.

Source: Social Budget Model by Praxis, calculations by authors

In order for a country to be able to pay I pillar pensions, economic growth which would enable sufficient tax revenues has to be ensured. Economic growth can be partly facilitated through redirecting the money collected in the II pillar to the Estonian economy.

Ideas to secure long-term demand of Estonian investment products Summary:

- More active involvement of pension money in the home market
- Tax incentives
- Obligation of direct investments
- Management fee linked to asset composition
- Obligation to analyze Estonian investment assets
- Prohibition of outsourcing investment decision-making
- Relaxing investment restrictions
- Diversifying the II pillar structure
- Estonia Fund

More active involvement of pension money in the home market

The sub-objective of many demand-side measures is to increase the Estonian investments of pension funds. Below, we have described several legal and strict measures which the government could consider to contribute to the partial direction of pension money to the Estonian economy.

Although the working group has contributed significant work-hours to come up with these suggestions the list is most likely not exhaustive.

In short, we recommend the government to consider a combination of various measures in order to involve all pension fund managers actively in the local capital market.

<u>The estimated effect of the measure:</u>

1. Involving pension money as Estonia's only long-term institutional capital more actively in the market also helps to increase the interest of private banks and retail investors and their trust for the local market.
2. An increased interest on the purchasing side will also increase activity on the offer side.
3. The increased activity of local market players will increase the interest of foreign investors in this market.

Tax incentives

Properly developed tax incentives may lower market barriers and increase the liquidity of the capital market. Estonia would contribute from differentiating income tax in relation to the dividends of enterprises which are listed in the Tallinn Stock Exchange (even if it would be limited to 3-5 years as of making the enterprise public).

Implementing income tax on bank deposits could also be considered, as it could promote investments in other bonds. At the same time, this measure would not be powerful enough to significantly contribute to the establishment of a long-term market.

The other side of the same measure would be to implement tax exemptions on interest revenue obtained from Estonian bonds.

Obligation of direct investments

Today's pension fund regulations favour indirect investments, meaning investments through a third party financial product (funds, ETFs, derivatives). Although this kind of investment activity is cost effective from the point of view of the fund manager, it has not been proved that the broader diversification of investments which is achieved through indirect products would compensate higher costs which the pension fund shareholder pays to the manager of indirect funds, or that it would ensure a higher rate of return for those saving money than in case of direct investments. A considerable problem with this portfolio is also its transparency and comprehensibility for pension savers. The state has created an opportunity for fund savers to change funds several times a year, but has not established a framework that would help savers to make informed decisions.

Third-party financial products usually have service fees in addition to the pension fund fees, so through these double fees, the shareholder could lose a substantial part of the depositors' savings.

In addition to this, the money invested in indirect products will not return to the Estonian economy, so we recommend an option to consider implementing an obligation for II pillar funds to hold a part of the share and interest product allocations as direct deposits (meaning not through funds, ETFs, derivatives).

The estimated effect of the measure:

1. Increases the options of some funds, primarily funds structured as fund of funds to invest in Estonia and thus increase the number of players in the capital market.
2. Decreases the share of passive investing.
3. Increases costs for fund managers.

Management fee linked to asset composition

The assets of Estonian pension funds are usually invested in other funds, though the costs for managing these assets are high - mostly between 1 - 2% (Pension Centre - Fund management fees as of 1 January 2011) in addition to the fees of those funds in which Estonian pension funds have invested (like ETFs and other funds).

It would be advisable for Estonian capital markets to motivate direct investments. For this purpose, setting a maximum limit for fund fees on indirect investments could be considered. In other words, the part of the monthly fee which corresponds to the share of indirect investments acquired in the fund in the corresponding month as an average should be limited with an agreed maximum rate.

It is important that the restriction would be implemented only to indirect investments with the purpose of motivating direct investments. If all fund fees are decided to be restricted, it will most likely not result in the desired outcome on capital markets.

In order for the measure of regulating fund fees to have an effect on the Estonian capital markets, it would be recommended to implement it along with the obligation of Estonian asset analysis described below.

The estimated effect of the measure:

1. The aim is to motivate pension funds to make direct investments which would, among other things, motivate funds to consider more local financial instruments (e.g., bonds, shares).

Obligation to analyze Estonian investment assets One potential measure for supporting local investments would be to consider adding to the regulations the obligation of analysing Estonian tradable assets. This would thus mean that, when necessary, pension funds would be obliged to present documented analyses on Estonian assets regardless of whether the analysis recommended to purchase or sell the asset under question.

This restriction could be combined with the prohibition of purchasing the analysis and investment decisions from outside.

The estimated effect of the measure:

This obligation would justify international structures which manage funds in Estonia to maintain Estonian teams, without which investment decisions towards Estonia would not occur.

Prohibition of outsourcing investment decision-making

Pursuant to present-day legislation, a pension fund manager is allowed to purchase the investment activity service from outside. After meeting several specialists, it has become clear that the place of investments is of utmost importance in relation to asset allocation:

1. If investment allocation decisions are made outside Estonia, they are made in favour of other markets (Niklas Johansson, AP2, Sweden).
2. Investors always possess more information on home markets, which is a logical reason for preferring home markets (Kari Järvinen, Solidium, Finland).
3. Information on local market investments is more cheaply attainable (Jens Dalskov, Danica Pension, Denmark).

According to this proposal, pension funds would be prohibited to outsource the service of investment decision-making.

The estimated effect of the measure:

1. Pension fund investments into the Estonian economy would increase.
2. Maintaining well-paid jobs by fund managers based in Tallinn.

Relaxing investment restrictions

In order to promote pension funds to make equity capital investments into Estonian issuers, the risk and liquidity profiles of pension funds and mandatory investment restrictions should be liberalised. Specific proposals include the following:

1. An opportunity to invest up to 20% in unlisted instruments, including company loans, real estate and venture capital funds, whereby separate restrictions could be implemented for bond and equity capital investments. For example, in case of bonds, listing is required pursuant to current legislation, but at the same time, in the prime time of Estonian enterprises' bond market in 1995 to 2002, almost all emissions were unlisted, which affirms that listing is not necessary for the investor and more likely hinders the market offer.
2. An opportunity to acquire up to 100% of a specific project/real estate SPV. This is necessary to enable funds to invest in real estate. Real estate is one of the most important asset classes among the investments of several Scandinavian pension funds.

The estimated effect of the measure:

1. To provide partially more freedom for investment funds to invest in Estonian assets, which are generally illiquid and demand substantial managing resources (which are limited).

Diversifying the II pillar structure

Managing a part of the II pillar by a state structure could be considered; its investment strategy's cornerstone would be to invest into the Estonian economy and entrepreneurship, but not exclusively.

Managing pension assets and the principles of paying for this service should reflect the respective principles of private managers.

A combination of private and state pension asset managers is widespread in Europe. Among others, state pension funds are employed in Sweden, Norway, and Finland.

The estimated effect of the measure:

1. Emergence of pension asset managers who are concentrated on the local market.
2. Increasing competition among today's asset managers.

Estonia Fund

With the aim of facilitating the establishment of investment funds directed towards Estonia, we recommend considering the creation of a fund of funds, which would invest in sub-funds, the assets of which would in turn either be the securities traded at Tallinn Stock Exchange or risk investments (private equity) in unlisted Estonian enterprises. The creation of a fund of funds would help to increase the attractiveness of establishing investment funds directed towards Estonia. The sub-funds would involve capital from other financers themselves and thus it could be assumed that it would contribute to creating a reproductive investment ecosystem.

We recommend the fund of funds structure instead of a conventional investment fund, as in case of a conventional investment fund, the project would have a short-term estimated effect, whereas in case of a fund of funds, the effect will presumably be recurrent and long-term.

The fund of funds would be capitalised directly with pension fund payments.

In addition, an idea employed in Denmark could also be used, where 75% of money was transferred to a (low credit risk) state institution through a loan, which directly lent the money to the respective fund (Danish Growth Fund in case of Denmark).

The estimated effect of the measure:

1. The creation of a fund of funds and directing important capital there could foster the establishment of a long-term ecosystem of local investments.
2. This scheme would not be non-recurrent but would enable to ensure long-term capital inflow to the market.
3. The fund of funds would not create a leverage effect as the funds which are being invested into are able to involve financing also from other sources.

Appendix 1a. Working group members

In alphabetical order:

Aare Tammemäe – Redgate Capital

Andrus Alber – Nasdaq OMX Tallinn

Ege Metsandi – ERGO Funds*

Erkki Raasuke – Ministry of Economic Affairs

Henrik Igasta – SEB Enskilda

Loit Linnupõld – Swedbank Investment Funds*

Peeter Saks – Baltcap

Priit Põldoja – Cofi

Reimo Hammerberg – Sorainen

Robert Kitt – Swedbank

Ülo Kallas - Colonna Capital

* The pension fund managers involved in the working group do not approve of all the proposals of this document concerning pension funds.

The statements of this document cannot be considered by default as the positions of the working group members' employers or administrative agencies.

Appendix 1b. References

1. Augusto de la Torre, Sergio L. Schmukler – Emerging Capital Markets and Globalization. The Latin American Experience.

   “Since the beginning of the 1990s, a growing body of empirical work, including broad cross-country and panel studies, time series analyses, individual country case studies, and firm- and industry-level analyses, has provided evidence supporting the view that financial development is not just correlated with economic growth, it is actually one of its drivers.” References of this part: Goldsmith (1969), King and Levine (1993b), Levine and Zervos (1998b) and Levine, Loayza, and Beck (2000).

2. Gugliemo Maria Caporale, Peter G.A. Howells, Alaa M. Soliman – Stock Market Development and Economic Growth: the Causal Linkage

   “The evidence obtained from a sample of seven countries suggests that a well-developed stock market can foster economic growth in the long run. It also provides support to theories according to which well-functioning stock markets can promote economic development by fuelling the engine of growth through faster capital accumulation, and by tuning it through better resource allocation.”

3. Laura Alfaro, Areendam Chanda, Sebnem Kalemli-Ozcan, Selin Sayek – FDI and Economic Growth: The Role of Local Financial Markets. November 2000

   p. 1: “countries with well-developed financial markets gain significantly from FDI.”

   p. 4: “Although most FDI by its very nature relies on capital from abroad, it is important to recognize that the spillovers for the host economy might crucially depend on the extent of the development of domestic financial markets. There are different ways in which financial markets matter. First, it is unlikely that spillovers are restricted to only costless improvements in the organization of the workforce. In particular, to take advantage of the new knowledge, local firms need to alter everyday activities and, more generally, reorganize their structure, buy new machines, and hire new managers and skilled labour. Although some local firms might be able to finance new requirements with internal financing, the greater the technological-knowledge gap between their current practices and new technologies, the greater the need for external finance. In most cases, external finance is restricted to domestic sources.”

4. Economic impact of AIM and the role of fiscal incentives. Grant Thornton. September 2010

   Value of fiscal incentives

   Fiscal incentives including Venture Capital Trusts (VCTs), the Enterprise Investment Scheme (EIS) and Business Property Relief (BPR) for Inheritance (IHT) Tax underpin the economic contribution of AIM, as they:

   - Address persistent market failures and barriers which restrict access to capital, such as asymmetric and imperfect information, illiquidity of assets and transaction costs.

- Encourage new investment in the primary market (i.e. new share issues) to address the 'equity gap' where SMEs and growth businesses can struggle to attract equity investment of up to £10 million.
- Improve liquidity in the secondary market (i.e. the trading of AIM shares) which supports investor appetite in the primary market, as increasing liquidity lowers the cost of capital, permitting greater levels of investment which in turn enhances productivity.
- Have a 'leverage effect' whereby amounts invested significantly exceed cost to the Exchequer (e.g. VCT ratio of funds raised to cost is 2.3).

The fiscal incentives act as a package of measures to address market failure in both the primary and secondary markets. Without a well-functioning secondary market, incentives to address the equity gap alone will be inefficient. The fiscal incentives have led to fund raised of over £4.6 billion over the past five years and are eligible to investors in 35% of AIM companies. Without such incentives, many AIM companies would suffer reduced investment or would not have been able to raise capital on AIM in the first place. In the absence of the incentives, liquidity would be lower, and delivery of the economic benefits would be put at risk.

5. David Weild, Edward Kim June 2010 Market structure is causing the IPO crisis – and more

6. Bernard S. Black; Ronald J. Gilson 1998 Does Venture Capital Require an Active Stock Market?

   The United States has both an active venture capital industry and well-developed stock markets. Japan and Germany have neither. We argue here that this is no accident – that venture capital can flourish especially – and perhaps only – if the venture capitalist can exit from a successful portfolio company through an initial public offering (IPO), which requires an active stock market. Understanding the link between the stock market and the venture capital market requires understanding the contractual arrangements between entrepreneurs and venture capital providers, especially the importance of exit by venture capitalists and the opportunity, present only if IPO exit is possible, for the venture capitalist and the entrepreneur to enter into an implicit contract over control form the venture capitalist by using an IPO as the means of exit."

7. ESMA Securities and Markets Stakeholder Group. Date: 12 October 2012. ESMA/2012/SMSG/59. REPORT TO ESMA. Securities and Markets Stakeholder Group – Report on Helping Small and Medium Sized Companies Access Funding

   p. 4: "The advantages to companies of using the capital markets translate to higher economic contribution and employment. The markets provide businesses with a high degree of diversification of potential investors, the access to additional equity capital and the higher public profile and brand recognition that a listing can provide a company with. This can also help to attract talented senior management."

   p. 5: "The 23 million EU SMEs are crucial for economic growth, job creation and exports. They currently account for two out of three jobs in the private sector and are responsible for more than half of the total value added by EU enterprises. In the period

2002 to 2010, they were responsible for 85% of the net new jobs in the EU. As dynamic enterprises, they are significant contributors to innovation and breakthrough technologies. For example, UK SMEs account for 40% of live patents and are twice as likely to be in high technology sectors as their Chinese rivals."

p. 6: "Even if in most countries as we have seen debt remains the predominant form of SME financing before companies are able to generate profits and a positive cash flow, it is difficult to obtain loan financing from banks. In the early stages of their development, SMEs are typically dependent on equity financing. Initially capital may be provided by family, friends and eventually business angels. At a later stage, in order to professionalise and scale-up, growing and innovative companies will typically seek funding from venture capital and private equity funds. Once these funds have taken the SME onto its next level of development, they will look to the capital market and an Initial Public Offer (IPO) as one of their exit options."

p. 8: "It should not matter whether a company obtains its funding by equity or debt; the relationship between risk and reward should be equal. Nevertheless, it does matter for a wide variety of reasons. One of the reasons is tax, because most jurisdictions allow interest on debt to be subtracted from the financial results of a company before taxation, whereas dividends are paid out of profits that have been taxed. This asymmetry may distort may distort the funding decisions of companies. Another reason is based on the fact that dividends are only payable from profits and retained earnings, whereas interest on debt must be served irrespectively of whether the company is profitable or not. For this very reason, start-ups which often have little or no profits in the first years are usually ill advised using debt as funding and should prefer to attract equity that is more patient in the sense that dividends are only payable once the company becomes profitable."