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Closing the gaping hole in the capital market for EU start-ups – the role of pension funds

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Summary

Pension funds play a strategic role in our societies by providing protection and peace of mind to both consumers and businesses. As large long-term institutional investors, pension funds contribute significantly to the European economy's growth and the development of capital markets. At the same time, young, small, fast-growing and innovative companies are key to Europe's future economy and society, and a vital piece of the puzzle for achieving the EU's green and digital transition. Risk capital is necessary to finance the founding and growth of scale-ups and start-ups. However, Europe has a shortage of risk capital and this not only holds back the development of high-growth sectors but also the creation of a genuine Capital Markets Union (CMU).

Where do we stand?

Since 2015 and the launch of the CMU project, although investments made by European venture capital (VC) funds grew at a yearly average rate (16 %) similar to that in the US (17 %), the total invested amount in Europe at the end of 2023 (EUR 8.4 billion or 0.05 % of GDP) represented just 6 % of the amount invested by US VC funds (EUR 150 billion or 0.6 % of GDP). Consequently, in Europe, the average amount received by a VC-backed company is EUR 1.7 million, while a US company will get almost six times as much (EUR 10 million). The gap between the two markets is even more glaring when considering private equity (PE).

According to EIOPA data, at the end of 2023, EU pension funds' total assets stood at EUR 2.7 trillion, representing about 25 % of the EU's GDP. Most of these assets are allocated to

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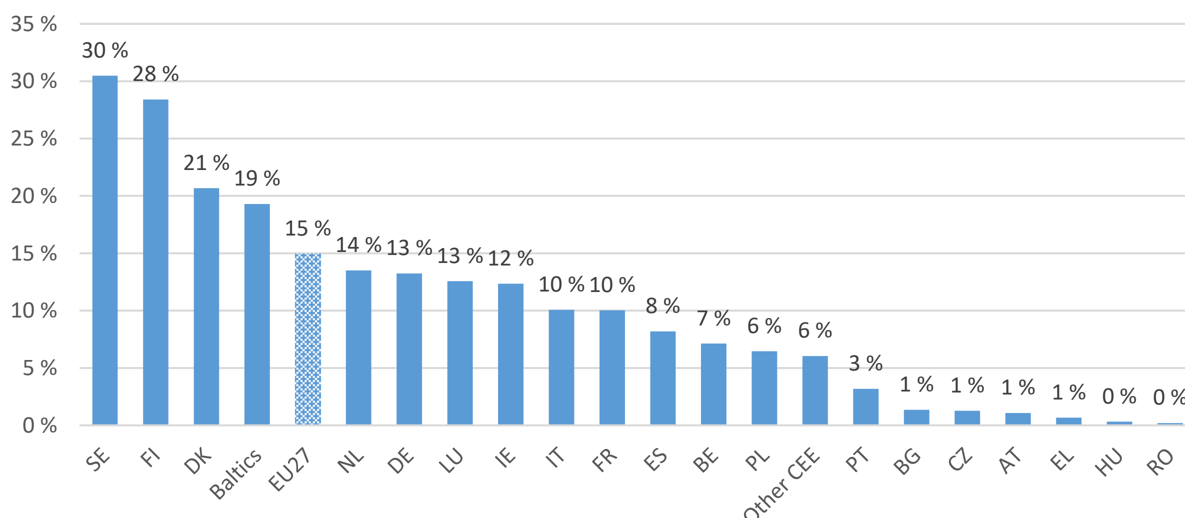
investment funds (38 %), government bonds (22 %), equity (18%) and corporate bonds (12 %). The largest shares of the pension funds' holdings within investment funds consist of equity funds (33 %), debt funds (26 %), real estate funds (14 %) and 'other' funds (13 %). Most PE funds, including VC funds, are classified as 'other' funds if they largely invest in unlisted companies (e.g. via loans or participation).

Despite their large amount of assets, pension funds' participation in the European start-up ecosystem is limited. In 2023, European pension funds committed EUR 6.5 billion (or 11 %) of new funds raised by PE funds and only EUR 0.6 billion (or 5 %) of new funds raised by VC funds. This represents 0.4 % and 0.02 % of pension funds' total assets. Even in the EU Member States where VC and PE fundraising by pension funds is the highest (see Figure 1)[1], comparing them with the US is still rather daunting – investments by US pension funds make up more than 50 % of PE/VC investments.

Figure 1. Pension funds' commitments on raised VC and PE funds (average 2007-2023)



Notes: The figure depicts pension funds' share of raised VC and PE funds (i.e. commitments). Funds raised are recorded in the country where the advisory team is based that is raising/managing the fund ('industry statistics'). VC stages include: seed, start-up and later stage venture. PE stages include: growth capital, turnaround/rescue, replacement capital and buyout. 'Baltics' include Estonia, Latvia and Lithuania. 'Other CEE' includes Croatia, Slovenia and Slovakia. Data do not include Cyprus and Malta. *Source*: Author's calculations based on data from InvesEurope.

What does regulation say?

EU regulation does not restrict pension funds from putting their assets into alternative investments. However, prudential rules (e.g. the prudent person principle) – concerned with policyholder protection and financial stability – have led to pension funds allocating a significant portion of participants' and policyholders' funds into fixed-income assets and less in long-term equity investments. Member States can discretely decide which precise investment rules they wish to impose on pension funds in their territories, unless justified on prudential grounds (see

[1] In 2023, Danish and Swedish pension funds each committed 24 % of the new VC funds raised. In terms of PE, commitments by Dutch and Swedish pension funds were 15 % and 24 % of the PE funds raised.

consideration 47 of the Institutions for Occupational Retirement Provision (IORPs II) Directive, as well as national quantitative portfolio restrictions applicable to pension funds).

As very long-term investors with low liquidity risks, pension funds can invest in both non-liquid assets – such as shares – and in other instruments that have a long-term economic profile that are not traded on regulated market, multilateral trading facilities or organised trading facilities within prudent limits. But IORP II's Article 19 requires that such assets must be predominantly invested on regulated markets. Investment in assets which are not traded on a regulated financial market must in any event be done to prudent levels.

In the US, where pension funds allocate a larger part of their portfolios to riskier and more illiquid investments, PE represents about 13 % of pension portfolio assets as of 2022. VC kick-started its significant growth trajectory in the 1970s following the adjustment of the Employee Retirement Income Security Act (ERISA) to allow pension funds to invest in alternative assets, along with a substantial reduction in capital gains taxes to encourage long-term investments and the creation of the National Venture Capital Association (NVCA) to provide a collective voice for the industry. All this, led to a surge in companies founded with VC backing and led pension funds to become the single most important source for PE/VC in the US.

What should be done?

The sheer scale of European pension funds means that even a small increase in their share of assets under management dedicated to PE/VC would transform the ecosystem. The pensions sector can – and should – play a stronger role in deepening and further integrating European capital markets. It can do this by reducing the existing financing gap for companies in their early stages of growth and development, as well as supporting higher-risk investments. Pension fund investment into PE/VC could be a very important source of long-term financing, not only ensuring the sustainable and continuous VC growth but they would also help to power the EU's twin transition.

However, channelling pension fund money to alternative investments is easier said than done, as these investments are generally riskier than a simple index fund. Moreover, and even though PEs and VCs' reputation leads to the expectation of high returns and access to unique investments, there are also drawbacks, including a lack of transparency and high fees. This is why many underperforming pension funds have recently faced criticism for their PE investments. They are also not agile institutions and they face many political and governance pressures. Thus, the role of governments in minimising risk is important as they can provide guarantees to pension funds when they invest in start-ups. One way to do this is for the government to bear some of the risk – for example, by entering into public-private partnerships.

Furthermore, the shift from Defined Benefits (DB) to Defined Contributions (DC) pension plans has impacted the demand for certain asset classes. This is because the two schemes have different investment horizons and risk tolerance (long-term and higher-risk assets versus more liquid assets), liquidity requirements (predictable long-term liabilities versus daily liquidity

requirements), fee sensitivity (less versus more sensitivity to fees and expenses), investment decision-making (made by professional managers versus, often, by individual participants), as well as regulatory and fiduciary considerations.

Moreover, Value for Money discussions, which aim to ensure that pension plan members receive the optimal benefits for their contributions, may significantly influence the asset allocation for both DB and DC plans. In the UK, DC pension schemes are subject to a cap on charges (currently at 0.75 % per annum for default arrangements). This cap limits the ability of DC plans to invest in high-fee asset classes like VC and PE, which typically charge higher management and performance fees. In the EU, only a few Member States have capped the fees that providers can charge their members (e.g. the Chez Republic, Hungary, Slovakia and Slovenia).

Pension funds should embrace risk by exploiting the trade-off between return and risk, and by sharing risk among participants. This mean that the EU's regulation of financial markets should not prevent pension funds from exploiting the risk premia on financial markets but rather should oblige funds to better communicate to individual participants the risks resulting from their investment policies and risk-sharing mechanisms. It is the investment perspective rather than the insurance perspective that should be dominant in the government supervision of pension funds. Supervising pension funds and the relevant EU regulations should not be modelled on insurance companies providing guarantees.

PE and VC bring diversification, a better risk/return profile, and provide a resilient asset class that is stable against macroeconomic shocks. They could also offer pension systems a way to overcome the declining public market returns of the last decade. The question is not whether pensions should invest in alternatives but rather on *how* they should do it.

Europe has a gaping hole in the capital market for start-ups and scale-ups – pension funds can certainly help to close it.

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