How can banks contribute more to the CMU?

1. The complementarities between bank financing and capital market financing

1.1 The roles of banks and capital markets and areas of synergy in financing

An official outlined the synergies between banks and capital markets. Banks can be enablers of more liquid and deeper capital markets by acting as issuers of securities, as intermediaries for issuance, as intermediaries for institutional and retail investors and in some cases as investors. Banks are well positioned to help companies diversify their sources of financing and to contribute to channelling the unprecedented levels of savings created by the pandemic. These synergies should be taken advantage of particularly for the financing of start-ups and scale-ups, which lack equity financing. 2021 has been a record year for initial public offerings (IPO) in Europe and many new unicorns have emerged, but capital market financing needs to be more widely promoted from a public policy perspective. In addition to the role as intermediaries previously mentioned, banks can also play a more direct role in the financing of scale-ups, as investors or as promoters of venture capital funds investing in such companies.

An official explained that banks contribute to efficient capital allocation and risk diversification. In terms of capital allocation, banks help to connect investors and issuers. On the investor side, they can play a key role in particular in terms of encouraging savers to invest in capital market instruments in Europe, which does not have the same broker dealer and financial advisor ecosystem as the US. On the issuer side, banks can provide support notably through advisory work for small and medium sized enterprises (SMEs); market making; direct investment, which the new Capital Requirements Regulation (CRR) proposal facilitates using lower risk weights; and creating growth funds.

The official agreed that supporting the growth of scale ups is a particular challenge in Europe, because at a certain stage of their development, many of these companies turn to funding provided by non-EU investors and then get listed in the US, which may have consequences in terms of management control and growth potential for Europe further down the line. Countries such as Canada or the UK have created common bank funds to support scale-ups, which is an option that should be further considered in the EU. The development of a broader range of issuers in the EU, with more start-ups and scale-ups to invest in, would also provide investors with greater diversification. Moreover, a further integration of the EU banking sector with the implementation of the Banking Union could help to support issuers and investors across borders, contributing to a better allocation of capital across the Union.

An industry speaker added that banks raise their own funds both from deposits and the capital markets, issuing their own securities. They tend to raise funds in their own domestic market but should endeavour to attract more funding from other EU countries, although managing 27 different sets of legal rules is challenging.

1.2 Leveraging the complementarities between banks and capital markets to relaunch growth post-Covid

A Central Bank official noted that complementarities have developed between bank based and market based financing in Europe. In the wake of the 2008 financial crisis, the growth of capital market funding has reduced the EU's over reliance on bank funding, which was procyclical. Conversely, during the COVID 19 crisis, the banking sector countercyclically substituted the thinner market funding provided by capital markets and provided additional liquidity to the corporate and sovereign bond market. Going forward there are major opportunities for banks to further contribute to the growth of capital markets in the EU.

An official agreed that the response to the Covid crisis was different to the response to the financial crisis. The banking sector contributed in a significant way to all three stages of the response to the Covid crisis. Taking the example of Spain, banks in the first stage of the Covid crisis, granted more than €135 billion in publicly guaranteed loans to meet firms' liquidity needs. This helped SMEs in particular to cushion the fall in revenue that they experienced at the outset of the crisis. In the second and current stage of the crisis, the banking sector is a key tool used by the public authorities to ensure that credit flows correctly and that financing conditions are stable. In the third stage towards which the European economy is evolving, with public stimulus moving towards more targeted actions, it will be essential to drive excess savings from the pandemic into completing the twin green and digital transitions. Banks can play a key role in this perspective as intermediaries and also with their capacity to conduct risk and viability assessments. They can also encourage retail investors to engage in capital markets by familiarising them with these instruments.

Another official stressed the importance of capital market financing going forward and of the Capital Markets Union (CMU). The Russia Ukraine conflict will increase expectations of inflation, and decrease expectations of growth in Europe, potentially creating further economic damage and increasing the leverage of the corporate sector.

An industry speaker emphasised that Europe is in a novel historical moment: Covid has led to record saving rates among the retail population, even though interest rates are at zero. Economies being switched off also meant that the revenues, turnover and profits of most enterprises went down, which resulted in an erosion of equity. Alongside this, awareness of the need to fight the consequences of climate change rose significantly. As a consequence, banks are sitting on a huge pool of liquidity which needs to be put at work to support the economic transformation that is needed in Europe. Banks will need to create products and platforms, as intermediaries rather than direct investors, to make this cash available to the economy. Deepening the integration of the European financial sector and capital markets with a consistent implementation of regulations such as MiFID II should be a key objective in this perspective in order to facilitate the distribution of capital market products across the EU.

1.3 The role and potential of securitisation

An industry representative suggested that securitisation is an example of how banks can contribute to the development of capital markets and how the transition from relying entirely on bank lending to introducing more direct institutional investment in the market can be facilitated. The Simple, Transparent, and Standardised (STS) securitisation legislation was one of the first actions implemented in the CMU initiative, establishing standardised issuance rules and features that enable investors to compare one transaction to another. STS securitisations, which have become the benchmark across Europe, allow banks to alleviate their balance sheets in order to raise their lending capacity and may also contribute to the development of capital markets, by transforming lending portfolios into securities that can be issued to institutional investors. SME loan securitisation programmes which are put in place in Spain and Portugal on a yearly basis for example allow institutional investors to get exposure to the lending portfolios of banks. As they become more familiar with SME risk, these investors may consider taking direct exposure to SME investment. The same mechanisms are used in a variety of loan markets such as residential mortgage, auto-loans and consumer credit.

An official agreed that securitisation could work on both sides by ensuring that risk is unloaded from banks and developing a bigger capital market. This type of cross fertilisation between banks and capital markets should be further encouraged.

Another official considered that securitisation has very promising potential in creating space on banks' balance sheets, which is necessary in a competitive banking market. There might be too much emphasis however being placed on securitisation as a way to develop capital markets. The official queried the potential of SME securitisation in particular, because it can be quite hard to bundle SME loans. While STS provides securitisation standards, the underlying SME loans are not easy to standardise. Where banks could help SMEs to go to the market would be handling the issuance part.

The industry representative acknowledged that SMEs are not the largest asset class, although regular programmes exist in countries like Spain and Portugal and projects are being put together in other countries. One key challenge is the fact that SMEs are heterogenous. This is where securitisation can pave the way to further capital market financing, because banks can assemble a diverse pool of different types of SMEs, rather than having investors make bets on individual SMEs.

2. Obstacles to the CMU and to the role of banks in capital markets

An official considered that the Commission's CMU action plan covers many important issues for the development of capital markets in the EU, but it also faces two key challenges. First, its implementation is taking a long time, because underlying issues such as Banking Union and the fragmentation of securities rules are genuinely difficult to tackle, even though the CMU action plan is not addressing in depth the most difficult issues in terms of harmonisation (i.e. related to insolvency, taxation and withholding tax regimes). Because Europe is bank based, a considerable proportion of intermediation takes place through banks, both conventional intermediation such as loans and also capital market intermediation supported by banks. Without Banking Union, there will be no integrated CMU. In addition, capital market rules such as MiFID are not sufficiently consistent across the EU, because they have been implemented differently. Achieving CMU will be impossible if these issues are not addressed properly.

The official explained that the second issue is around the importance of cross-border banking activities for the CMU action plan. If Banking Union remains unfinished and cross border banking flows continue to be limited, banks will be unable to catalyse sufficiently the development of the CMU. This is not about issues such as the European Deposit Insurance Scheme (EDIS), which are very difficult to tackle. Even for simpler topics such as home host issues, the ring fencing of liquidity or resolution, progress is insufficient, which means that Europe is still not treated as a single jurisdiction by the Basel Committee. If banks cannot seamlessly perform the issuance and distribution of securities on a pan European scale, it will be impossible to overcome the national barriers to capital and achieve the single market aims of the CMU. Taking the securitisation example previously mentioned, it is very difficult at present to bundle securitized loans from different EU countries together because of their underlying nature. It would be easier to achieve this if there was a sufficient level of cross border banking. This would allow the creation of larger pools of assets with similar characteristics and could appeal to more institutional investors.

A second official agreed that tackling the obstacles to a more integrated banking market in Europe, such as ring-fencing issues, is needed for fostering greater cross border activity. However this cannot and will not happen single handedly, because countries in Europe have understandable risk considerations and want protection. This is why these issues have to be addressed in the context of a wider package including subjects such as EDIS, taking into consideration the interests of the different stakeholders concerned, in order to make progress on the Banking Union. A third official agreed that a holistic and pragmatic approach is needed on Banking Union to get everybody on board and make the project sustainable.

A Central Bank official agreed that the main issues on which progress is needed have been identified in the CMU, but there are challenges around implementation. An industry representative concurred with the previous point on securitisation. It is indeed difficult to pool securitised portfolios across borders, because there are different regimes for the underlying loans, different regulators, and different sets of practices. The CMU plan is the right way forward, but there is now a need for execution. For example the promise of the STS securitisation legislation has not been fulfilled. There has been moderate progress in terms of issuance, but not the step change that was envisioned.

The industry representative highlighted several obstacles that need to be tackled regarding securitisation. First, legislative activities are too siloed. In the attempt to harmonise securitisation legislation, it was forgotten that using a best in class benchmark type securitisation should be recognised in the liquidity ratio, because a separate working group was handling this aspect of the legislation. There is a similar issue on the capital requirement side which makes it very difficult to incentivise this type of activity within banks The speaker was however hopeful that the 'silo mentality' could be addressed in the same that it has been possible to produce a common and well accepted legislation on securitisation. Secondly, improving transparency remains a challenging task. Some efforts have been made in the market, for example with the European DataWarehouse securitisation repository, established by a certain number of banks, where loan level detail is made available to all investors. ESMA also included in the new legislation a template aiming to harmonise information related to securitisations, which is a good idea, but the template does not work at present in several areas. Changes should be made for transparency to become a reality in the European securitisation market.

3. Possible actions to further develop EU capital markets and related role of banks

3.1 Better managing the supply and demand for capital

An industry speaker agreed with previous speakers that the CMU proposals contain most actions that are needed for developing capital market financing in the EU. However, to define the appropriate course of action it is essential first to define the problem and then, without any preconceived ideology, discuss the solution. The problem that needs to be addressed most urgently in Europe is unlocking the potential of retail investors to contribute to the growth of an economy that is lagging behind other competing jurisdictions. The scattered regulatory environment around MiFID and some consumer protection rules are unnecessarily impeding the demand of retail investors. There are also issues on the supply side and the power of the combination of supply and demand also needs considering in the CMU initiative. On the supply side, there are issues with the European Long term Investment Fund Regulation (ELTIF) for example, such as the minimum investment threshold for retail investors and a lack of flexibility in the rules applying to portfolio composition. Removing these different barriers will be a long-term project, but should help to unlock the growth potential there is in the European economy. If retail clients are put in the right position, they will take informed decisions.

The industry speaker emphasised the importance of improving financial literacy in particular, noting that there are several ways to drive this. This topic is moving slowly in national financial education curricula, but it can be addressed via private public partnerships or private initiatives. In Slovakia for example, curricula are being developed by the speaker's bank in partnership with schools, in which financial literacy is not a particular discipline but features in many subjects covered e.g. languages, mathematics, history or geography. As a second example, a digital museum for financial literacy has been created in Vienna, which is visited by more than 35,000 pupils per year who learn how money works, how a budget works, how the global economy works and about the role of central banks.

An official was very supportive of initiatives on financial literacy, observing however that this is not sufficient to create a vibrant capital market such as the US. In the US individual savers invest in different ways through banks, brokers or pension funds; however, this does not mean they fully comprehend what underlies the assets in their savings pool.

Another official agreed that turning retail savers into investors is a major objective. This notably means having attractive companies in Europe to invest in, but there is also a challenge for banks here, which continue to sell loan products to those companies in great quantities, when there should also be an objective to move towards more diversified financing and less leverage.

A third official stressed that digital literacy also contributes to financial literacy in today's world and although it is important to set up financial and digital literacy programmes in schools for the future, it is also essential to ensure that the less digitally literate customers and SME owners are not left behind in the rapid drive to digitisation.

An industry representative also suggested that securitisation could play a role in transitioning investors to the capital markets, by making them more familiar with taking risk.

3.2 Supporting the financing of SMEs

An official considered that the main objective that the CMU project is seeking to achieve is providing companies with a more even cost of capital across the EU, especially for SMEs. At present, SMEs are penalized and banks could do more to improve the situation. Banks should endeavour to graduate SMEs to market finance, whether it is traded equity or debt finance. One of the CMU proposals suggests that banks should support the companies which they cannot finance in finding alternative sources of finance, but this seems odd because it is harder to take a firm to the market if a bank is not willing to lend to it.

Another official described how the Spanish authorities were supporting the development of capital market financing through changes in the Spanish regulatory framework. Recently, new regulations were introduced on promoting the constitution and growth of companies and on removing barriers for start ups. This includes measures to promote crowd funding services, to adapt the Spanish legal framework to European legislation, to improve the venture capital and private equity legal framework, and to improve the requirements for the marketing of those products to retail investors in line with ELTIF.