CMU AND BANKING UNION: COMPLEMENTARY OR ANTAGONISTIC?

1. Complementarities between banks and capital markets

1.1. Complementary risk allocation and financing functions

A Central Bank official stated that banks and capital markets are inherently complementary and are necessary for every well-functioning financial system. They fulfil two separate but complementary functions[1]. This is first the case in terms of risk-sharing. The banking sector performs risk-sharing in an inter-temporal smoothing way, providing borrowers and depositors with borrowing and saving opportunities that compensate each other over time. Capital markets have a different risk-sharing function, ensuring diversification and cross-sectoral risk-sharing for investors. The USA has a very large share of cross-state risk-sharing coming from the financial sector. This is much lower across member states in the euro-area, where consumption benefits much less from cross-border payments, dividends and interest rate payments. Improving cross-border financial risk-sharing in the euro-area would also require much higher cross-border holdings of equity claims in particular.

Secondly there are complementarities in terms of financing illustrated by the 'Spare Tyre Theory, which is the idea that if circumstances change borrowers can switch between different funding sources. This is an underlying motivation for the objective of the Capital Markets Union (CMU) to diversify funding sources. Empirical observation in countries with very developed banking and capital markets shows that, in a case of recession, bank lending goes down and corporate bond issuance usually goes up in compensation, at least partly. This means that in such a situation the funding opportunities of firms and households can be smoothed, showing the inherent complementarity of these two funding sources.

An industry representative suggested that the capacity to manage relationships is a major specificity of banks, whereas capital markets are more a matter of product provision and transaction execution. These relationships make banks the natural intermediary between issuers of capital and investors or savers.

Another industry representative added that a long-term relationship is an important element when lending to private households and SMEs. The relationship is taken into account in the credit scoring process underlying bank lending. The companies with longstanding associations with banks usually enjoy lower costs for debt and equity issuance. The effects of traditional banking relations therefore go beyond the pure banking sphere. However it is increasingly challenging for banks to maintain a close relationship with their customers with the increasing digitalisation of the financial sector that drives changes in client expectations.

The different types of enterprises must also be considered when assessing the complementarity between bank and capital market financing. Large corporates already use multiple sources of financing including capital markets, whereas SMEs rely mostly on bank funding. The situation differs for innovative SMEs, who need specific instruments for funding their projects which are often more immaterial and they also need investors who have an appetite for growth but are ready to take more risks. There can also be complementarity between banks and capital markets in the area of sustainable finance.

A regulator believed there is complementarity between banks and capital markets both for large companies and for SMEs. Italy has a small market for mini-bonds, and research shows that the companies that issued mini-bonds subsequently got a reduction on their bank lending rates of approximately 40 bp. This is because after the issuance of bonds the financing structure of these companies begins to change and they become less dependent on banks, making banks then more prone to lend more at better rates. This can help SMEs who cannot or do not want to issue equity at a certain stage to start testing a diversification of their funding.

An industry representative stated that financing growth is about getting access to liquidity and making smart risk allocations. The connections between banks and capital markets are obvious and both play a role in providing liquidity and allocating risks. Some projects generate cash flows with some level of predictability but others do not and financing instruments need to be provided according to this. The most effective way for the Banking Union (BU) to serve growth is to ensure banks act as the interface between companies and individuals who do not have enough money and need resources, and investors or savers who want to allocate a surplus of resources in exchange for a yield.

An industry representative suggested that the broader perspective of what really drives liquidity should also be considered in this assessment of CMU and BU complementarities. At present the real macro source of liquidity to companies is quantitative easing (QE), which plays a major role in the huge growth of the private equity bubble in particular. Without the huge flows of liquidity coming from Central Banks, the multiples that private equity have been paying over the past two or three years (20-times EBITDA) would not be possible and there would not be so many deals with no real due diligence. If money was priced as it was in the past, this would lead to a very different environment. The big issue is not only how to get CMU and BU to work together, but CMU, BU and monetary policy.

1.2. The role of capital markets in helping develop the lending opportunities of banks

A Central Bank official explained that simple, transparent and standardised (STS) securitisation, as defined after the financial crisis, is a highly illustrative case of complementarity between banks and capital markets, although there remains work to be done in Europe to develop securitisation markets. MREL (minimum requirements for own funds and eligible securities) is another illustration of this complementarity. MREL instruments are important for reducing the risk of having 'too big to fail' banks and stabilising the overall prudential architecture of the European banking system. The better the market for those instruments functions in terms of pricing and risk assessment, the better they will work for the banks issuing them.

An industry representative described how in Europe over the last four years banks have been able to grow their balance sheets, with some constraints, at a cost that remained acceptable. But this cost has increased significantly now due to Basel rules, TLAC and MREL, meaning that the expansion of bank assets will be coming to an end in the coming years. However, over 66% of the financing of European households still comes from banks. If banks cannot grow their loan books further due to these new banking regulations, capital markets will have to step in and CMU developments, including those concerning securitisation will need accelerating. The question is not so much about complementarity, but how faster the CMU can move to mitigate the impacts of banking regulations that are already there.

Banks need to evolve from a "buy to hold" approach of loans to an "originate to distribute" one. Major components of this include having a deep investor base to buy securitized papers that banks originate, and the existence of a very liquid market to ensure sufficient price transparency when these products are distributed. Many stakeholders also believe that unless market participants like financial institutions and banks are able to hold these securitised assets at a relatively reasonable economic cost then that liquidity may not happen in the secondary market for these products. Being able to do this would be a positive application of the complementarity between banks and capital markets. Originating assets at market-clearing price (a price at which investors will buy) will impose strong discipline on banks. An often-heard criticism of banks at present is that they are originating assets at a return on equity which is too low. That explains why banking companies in Europe currently trade predominantly below book value.

Another industry representative added that non-performing loans (NPLs) are another area that could benefit from connecting the BU and the CMU. As banks sell their NPLs into the capital markets there is a redistribution of risk and consequently a stronger balance sheet that allows fulfilling objectives on both sides.

There has been significant progress in NPL reduction since the financial crisis. A large proportion of NPLs sold is distributed through junior mezzanine tranches to investors such as hedge funds mainly based in the US and UK. Early in the NPL story private equity investors made very low bids, but over time sophisticated securitisation investors have come into the market and pulled bids up, allowing a meeting of bid and offer in the market. There has also been pressure from regulators to clean up balance sheets. The lessons learned are that the supervisory and regulatory attitude on the banking side can impact flows towards the capital market side. As prudential reforms are implemented in the European banking sector measures that provide an incentive for banks to retain assets on their balance sheets should be avoided as they may hinder flows towards capital markets. This is important to consider when analysing how the BU and the CMU should evolve in the future.

A third industry representative agreed that pushing banks to clean up their balance sheets and sell their NPLs is positive, but care must be taken not to go too far. Measures that are well-intended may have unintended consequences. For banks, cleaning up balance sheets means selling loans together with the relationships with the corporates that borrowed the money. Behind these loans are companies and jobs, and selling loans at a low price to financial investors may not be the best solution for the future operations of the companies concerned.

A Central Bank official however pointed out that a wider European market is needed for NPL assets, instead of single country markets.

2. Enhancing the role of banks in the CMU

An official wondered whether the CMU and the BU could, to some extent, be merged to provide a better result. An industry representative responded that whether they should be merged is somewhat moot. The important point is that they are complementary and should be considered together.

An official noted that US banks are integral to many capital market activities, and wondered whether this should not be better recognised in the EU's CMU plan. An industry representative observed that, largely because of their complexity, capital markets have not taken off in Europe. They speak less to the man in the street and generate less political support than banks. The issue is less a matter of merging BU and CMU initiatives and more about understanding, and appropriately reflecting in the CMU, that banks are important actors in the success of this project.

In the USA the development of capital markets went hand-in-hand with the strengthening of the banking industry. The separation between broker dealers and commercial banks was progressively alleviated to give banks a broader role in lending and as capital market actors both for their own account and as intermediaries.

Although building the CMU is an appropriate objective, progress has thus far been limited. The CMU action plan needs reviewing and the priorities of the next Commission in this area defining, but it is equally important to make sure that there are the appropriate market players needed to develop capital market activities in the EU. Banks should be more comprehensively involved in the CMU process. Creating the CMU requires stronger banks, for which the BU is also needed. If a single capital market area is created in the eurozone without strong enough local actors to provide capital, then capital will come from the rest of the world and increase Europe's dependence on other regions.

A regulator agreed that banks are an integral part of the US capital market, particularly in activities such as securitisation and derivatives. They are the greatest investors, but also the greatest issuers in the market. In European markets, banks play a major role in equity and bond issuance. In many cases they are also directly or indirectly the main market makers, so there is perhaps a potential crowding out effect. Accompanying non-financial companies to the market can be a very profitable activity.

A Central Bank official noted the importance of being mindful of transition dynamics from bank financing to more capital markets. In the long-term the complementarities will benefit everybody, but the transition towards a model with more capital market market funding will require adjustments in the financial sector, which needs vigilant monitoring from a prudential perspective. Banks must also reformulate their business models as capital markets grow. Some banks will be able to maintain a strong position in local credit markets, but others will have to invest in the future opportunities offered in the capital markets and develop more fee-based business related to IPOs and other investment banking activities.

3. Hindrances to the development of capital markets in the EU

3.1. Regulatory obstacles to investment in and research on capital markets

An industry representative outlined that an effective capital market needs four elements: a sufficient number of issuers; liquidity; investors; and research. Europe is fine in the first area, but lacking in the other ones, which are strongly impacted by regulation and supervision. Fixing the weaknesses of MiFID II and Solvency II should be a key priority for the incoming Commission. The coverage of companies by research is strongly reducing following the implementation of MiFID II rules, particularly for SMEs. Measures are also needed to improve liquidity, which is driven by Solvency II and monetary policy. Capital comes from insurance companies, pension funds and retail investors, who must be incentivised to invest in stocks, but there are currently strong disincentives, notably due to Solvency II. Steps are being taken to tackle this problem, but it has taken too long for regulators to realise that the difference between the risk of a government bond and an equity does not necessitate such a difference in capital charges.

A further question is how to relaunch the IPO market. Any company at a certain stage decides between going public with an IPO and staying with private equity. Both have their pros and cons depending on the future prospects of the company and expected premia, but when the multiples offered by private equity are so high the rationale for going public weakens, hence the IPO market dries up, which further deteriorates liquidity.

A major problem in Europe however is the obsession with downside risk. Risk appetite is decreasing as the population on the continent ages. An important question is who in Europe is ready to take risks and how to increase risk appetite.

A regulator agreed that a recalibration is necessary to tackle the unintended consequences of some of the EU regulations. Improving the transparency of the cost of research, which is an objective of MiFID II, is a valid intention, but has had negative effects. It has gone too far because it has affected the economic incentives needed to support such activities. The cost of IPOs is higher in the US than in the EU, which means that revenues are available for intermediaries and it is possible to undercut the cost of research. However, the situation is different in the EU and we could end up having research only on big companies. Information provided through research is nevertheless essential to create interest in companies and attract investors. In Europe, companies that issue €10-20 million on the equity market do not have the liquidity to attract big asset managers and therefore need individual investors, such as high-net-worth individuals who require information to make their investment decisions. This issue needs to be addressed by the incoming Commission.

A second industry representative agreed with the first speaker that a recalibration of Solvency II is needed in particular. The first objective of the CMU was to develop capital markets in Europe to channel massive flows of outstanding savings to productive investments, diversify sources of financing to finance growth, and also to develop access to capital markets for investors. Amendments to Solvency II are needed for that to be possible.

Another issue, a third industry representative mentioned is reconciling the CMU objectives to develop investment in SMEs with investor protection regulations such as MiFID II. It is practically impossible to sell SME equity or mini-bonds to investors while complying with the investor protection and information rules imposed by MiFID II and the related processes. These constraints need reviewing if the objectives of the CMU in terms of investment are to be achieved.

3.2. Fragmentation and predictability of the capital market regulatory framework in the EU

An industry representative stated that fragmentation, which is omnipresent in the EU market and its supervision, hinders appropriate liquidity provision and risk allocation in Europe and is therefore a major obstacle to the CMU. If there is no single authority in charge of implementing regulations at the EU level, responsibility gets diluted. The only way to solve fragmentation is consolidation with an appropriate market model at the EU level. As an example, Euronext contributes to this by consolidating a certain number of markets in Europe (Portugal, France, Netherlands, Belgium, Ireland and the UK). That represents a liquidity pool of €3.9 trillion. A second dimension is a strong focus on SMEs which represent 1000 out of 1300 companies listed on these markets. Capital markets are particularly essential for tech companies, for whom debt financing is often less readily available.

A regulator suggested that a certain level of central supervision is needed in the EU notably for systemic and / or larger capital market institutions. It is too early to implement centralised supervision at EU level, but too late for only local supervision on capital markets.

Another industry representative explained that when banks look at allocating scarce capital they have to consider what returns they will achieve through different activities. Part of the success of capital markets in Europe depends on the ability to operate on a sufficient scale, which is the case in the US where scale is such that it is possible to operate economically and generate return in many market activities. For European banks, how to remove barriers and frictions within the EU and favour cross-border mergers is being discussed. Global banks operating in Europe have a further set of considerations. They look at their ability to operate in Europe with their existing model. Their objective is to achieve this with minimal adaptation and fragmentation for example regarding the amount of internal MREL needed. They also look at structural fragmentation with issues such as IPUs (intermediate parent undertakings) and measures on branching which may further increase costs. This combination of factors affects ROE calculations and ultimately determines the attractiveness of Europe for capital markets compared to other regions.

A Central Bank official added that another fragmentation issue in Europe, beyond that of the supply and demand of funding, concerns the size of average companies. Combining the existing capital market base of small companies into larger industrial clusters should be an objective. Europe does not want to imitate the USA and its Silicon Valley, but something of that type is needed. Existing examples such as German Mittelstand companies clustered in regions, and small companies in Northern Italy clustered around the stock market can be built on.

The second industry representative stressed that the predictability and reliability of the regulatory and supervisory system is another important factor for global firms. The way equivalence arrangements function at present and the possibility of a no deal Brexit could create a perception problem for the EU with a long-term bearing on its attractiveness as a location for capital markets and on capital allocation choices. This could hinder the aspiration to build a broader and more effective capital market in Europe.

1. This was illustrated notably in the work of two academics, Franklin Allen and Douglas Gale "Comparing financial systems" who argue that an optimal financial system relies on both financial markets and financial intermediaries such as banks.