Richard J. Gnodde

Chief Executive Officer, Goldman Sachs International

In conversation with Richard Gnodde

David Wright

David Wright introduced Richard Gnodde and thanked him for being at Eurofi.

Richard J. Gnodde

Richard Gnodde stated that he would focus his remarks on the role that capital markets can and should play to support Europe's recovery. When he last spoke at a Eurofi event, three years ago in Tallinn, he shared his perspectives on the importance of developing capital markets in Europe. Much still needs to be done, and it is more pressing now than ever. Europe has set out an ambitious roadmap for its future: a world-leading green deal, a comprehensive digital strategy, and the landmark COVID-19 recovery package. Harnessing capital markets and the financing that they can bring alongside a healthy banking system is the only way that these ambitions can be turned into reality.

The last six months have seen an unprecedented economic shock. This was smoothed by central bank support, the action of many healthy banks across the world, including Europe, and remarkably resilient capital markets. Despite volatility being at all-time highs and unprecedented volume levels, the markets coped extremely well; there are fresh highs in the S&P 500, and European equity markets are significantly up from the March lows.

Looking at the European investment-grade index as a barometer, it is now at pre-COVID levels. The index started the year at 44 basis points, peaked at 138 basis points in mid-March and is now trading back at around 50 basis points. Sovereigns and corporates have strengthened their liquidity and capital positions by accessing the global debt and equity markets in very significant scale.

Looking at the primary volumes, investment-grade corporate supply in the euro is up 35% relative to the same period last year, standing at €330 billion to date. This is an important figure because if all of this capital had to come from the banking sector it would have required an incremental €18 billion of bank capital to support these loans; capital markets, working alongside banks, can be highly effective. US dollar issuance has been even stronger, with corporate volumes up 78% relative to the same period last year, and well through $1 trillion in aggregate. Sovereign supply in euros is also 75% higher, and equity volumes also stand at record levels.

Acknowledgment is needed of central bank support, which has been absolutely critical, particularly at the beginning of the crisis, in maintaining functioning markets. The post-crisis regulatory framework held up well and, as a result, the financial sector has been able to be part of the solution to support the recovery. This is a great example of the different components working together, allowing much to be done to help drive the broader economy.

Looking forward, there are two key trends, digitalisation and decarbonisation. Organisations that have been able to leverage technology effectively through the crisis have clearly fared better. For some, this has been achieved by continuing to engage in commerce through digital channels, and others have used technology to drive efficiencies through their businesses. It is very clear that the pandemic will have a lasting impact on consumer behaviour and business models broadly across the economy, including the financial sector.

The need for scale in the financial sector has never been more important, with smaller firms struggling to find the right balance between driving returns and managing costs. Investment in technology is key to having long-term, sustainable business models, but according to PwC, 30% of global financial CFOs are considering cutting IT investment as a result of COVID-19. There is encouragement for the Commission's digital strategy. This is clearly an important initiative that can deliver real innovation, security and resilience, and put Europe on a stronger competitive footing.

Deep modernisation is another megatrend; acknowledgement of President von der Leyen's leadership is needed, with her ambitious green deal, putting Europe at the forefront of the global fight against climate change. Davos showed the focus and energy on the green agenda, and COVID-19 has strengthened the resolve of all stakeholders to tackle this challenge. This is going to be important because the scale of the challenge is very significant. At the height of COVID-19 in the second quarter, when many countries were in full lockdown, daily global CO_2 emissions were down 17% compared to 2019. However, that puts the challenge in context. To meet the two-degree scenario Europe will require a reduction in CO_2 emissions of about 6% every single year over the next 30 years.

Goldman Sachs recognises that, but also sees a very significant opportunity. The market is also seeing this opportunity. Looking at recent equity performance, high-scoring environmental, social and governance (ESG) stocks have outperformed the broader market by an average 5.5% this year, so cost of capital is coming down for companies in this space. Goldman Sachs research, branded Carbonomics, estimates that the decarbonisation of the energy industry alone will require €13.5 trillion of global infrastructure investments by 2030. In doing so, this can create 20 million jobs. This is going to be one of the big political challenges, with scope to achieve two things at the same time: decarbonisation and creating jobs. This can clearly be a key driver of the economic recovery going forward.

There is an abundance of large, low-carbon investment opportunities in the power-generation industry and mobility, and the list goes on. As Europe embarks on the path to become the world's first climate-neutral continent by 2050 it will be vital to have the right regulatory framework in place. An expansion of carbon emissions pricing could provide a dynamic, technology-agnostic incentive to find the most financially efficient solution to climate change. A global approach to this is clearly the best solution.

Putting this together, economic recovery, digitalisation and decarbonisation all need financing. The financing needs of Europe have never been more significant. The green deal would necessitate €7 trillion of cumulative investment between now and 2050. With government balance sheets already stretched, bank balances are clearly not large enough. Based on rough estimates, an additional €1 trillion of bank capital will be needed to finance the green deal between here and the end of the period. It is very clear that a significant part of the financing needs to come from the capital markets. They need to be fit for purpose. Without them, economic recovery will be shallower, longer and harder than it needs to be, and many terrific opportunities will be left on the table.

The good news is that there are a number of developments which will reinforce each other as the industry goes forward, and will provide impetus for the necessary transformation which lies ahead. First, under the recovery plan, the Commission will tap the market over the next few years to the tune of €850 billion, creating a significant long-term, risk-free, AAA-rated debt security for institutional investors and European bank-balance sheets, as well as meaningful boost for European capital markets.

There is a need for scale in the banking sector. The US clearly has it; this is less prevalent in Europe. However, recent developments give some cause for optimism. Intesa Sanpaolo's takeover of UBI created Italy's largest bank. Earlier this month, CaixaBank and Bankia confirmed merger discussions, with the potential to create the largest domestic bank in Spain. Goldman Sachs' research team in Europe covers 55 banks, which are the largest listed institutions and national champions. At the end of Q2 2020, however, 12 of these 55 banks were loss-making. Another 20% make a return below 3% in terms of return on equity, so 40% are clearly yielding very little. Banks are clearly not yet strong enough to sustain a recovery. The banking union needs to be completed and has the scope to create the conditions for a stronger, more efficient sector that is able to support European corporates across the EU and globally.

This brings the discussion back to the CMU. It is necessary for the recovery to be fast paced; the CMU can play a significant role in that, providing an alternative avenue for corporates raising capital and funding at affordable rates. Deeper capital markets would allow for efficient placement of large amounts of debt being issued at an EU level. Of course, more vibrant securitisation markets would enable banks to become stronger and allow them, on a forward basis, to fund the economy. With Brexit, there will inevitably be a rebalancing of market-based financing between the UK and Europe, and a lot of capability and expertise will be located inside the EU. This rebalancing process still has some way to go, which means that European corporates and sovereigns should have access to the true breadth and depth of the UK capital markets for some period of time, without the necessary regulatory hurdles being put in their way. Currently everybody in Europe can access markets in the US, and the same is hoped for in giving them access to the UK.

Developing Europe's capital markets is not just about size, and the ambition should not be solely about replicating what exists elsewhere. It is incumbent on everyone to work together and develop capital markets that cater for what European investors want. Investor flows in the ESG product have grown exponentially over the past five years, up nearly 2,500% between 2014 and 2019. More recently, ESG funds have, year to date, received €63 billion of net inflows only, with broad equity funds having experienced net outflows over the same period of €100 billion, so it is clear where the money is going.

It is time to show innovation and creativity, and time to share ideas on products that are or could be of interest to investors. There is clearly a demand for green key performance indicator bonds to raise capital for projects that benefit the environment and respond to investors' desire to invest sustainably: or COVID 19 bonds to raise funds whose proceeds can be used directly to finance COVID-19-related activities, where there is a lot to be done; for longer-maturity bonds for institutional investors with longer-dated liabilities such as insurance and pension companies; and for developing a framework for retail investors who are keen to invest in ESG funds.

It is not just a question of capital markets helping support the COVID-19 recovery; it is absolutely essential to make step changes to provide the scale of funding needed by sovereigns and corporates, not only to help them navigate the immediate challenges but to achieve Europe's longer-term ambition of a green and digital economy. Embracing capital markets can achieve this.

David Wright

David Wright asked Richard Gnodde how he sees Brexit affecting capital market developments in Europe, and whether he sees severe damage on both sides if there is a breakdown.

Richard J. Gnodde

The critical point is to avoid fragmentation in markets, as fragmented markets lose liquidity and their ability to provide support and access to the investors in the real economy. The good news is that there will be more capability, capital and skills located inside the EU starting on 1 January 2020. That journey has already started and will continue for some period of time. Embracing that skillset and that capital and working with it to really drive the development of these markets, provides a terrific opportunity. One of the long-term benefits of Brexit might be that across the EU 27 capital markets are embraced in a way that has not been before. The hope is that EU 27 corporates, sovereigns, agencies, retail and regulatory bodies embrace, support and try to put in place strategies that can drive growth in this space.

David Wright

David Wright asked Richard Gnodde if he considers Europe to be focusing on the right things, and whether there is enough political force changing things.

Richard J. Gnodde

Richard Gnodde responded that, on paper and in some discussions, the right things are being focused on and talked about, such as building the securitisation capability, building equity markets and developing pension schemes and insolvency regimes. There is a long list of topics that need to be tackled. The right things are on the table, but there needs to be a sense of urgency; great benefits can happen if that takes place.

If Europe has strong and efficient capital markets, then it can get to a place where it has strong banks that can play their role in the economy. The need for financing is very significant but the benefits are even more significant, such as job creation, transformation of the economy, benefits to savers and ways that people can manage their pensions. The opportunities have never been greater but there is a sense of urgency; a positive and enthusiastic approach will pay dividends.

David Wright

David Wright is of the view that, of the key points of the High-Level Forum work on CMU, which the Commission is preparing an action plan on for the end of October, the exact same point was made. The EU will simply not be able to fulfil its objectives, whether they be sustainable development, social issues or dynamic SMEs, without the capital markets being developed and integrated in Europe. ■