Finance Watch
Making finance serve society

Speaking notes prepared for Christophe Nijdam, Secretary General of Finance Watch, ahead of his participation in a DG FISMA Public Hearing

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See also the Commission's event page and summary, and Finance Watch's CMU publications

1. What are the main barriers?

Identifying the main barriers across the EU and between member states to the more efficient flow of retail and institutional investment into capital markets?

a. Social and cultural issues, particularly around different social models and cultural attitudes towards savings and pensions provision

While attitudes toward savings and pension provision may be driven partly by social and cultural issues, they are also **driven to a large extent by other factors**, such as a difficult economic context, uncertainty about the future, distrust of the financial industry and distrust in governments' willingness to protect pensioners in the reform of pensions.

While there is a need to reform pensions, recent trends such as the shift from defined benefits to defined contributions that **transferred risk on a massive scale to pensioners** and the massive shortfalls of some pension funds did not contribute to fostering citizens' confidence.

Getting a public buy-in for the privatisation of pensions would require offering appropriate products simple, comparable, with limited fees and without excessive risk transfer to pensioners. It might also require rethinking more broadly the **political choice to make future pensioners bear the full cost** of this reform.

Lastly we must ensure that **transferring risk from banks to institutional investors like pension funds and actively promoting the growth of third pillar pensions does not create additional moral hazard**: if tomorrow a large pension fund runs into trouble, it is quite likely that there will be a political willingness to bail it out.

b. Trust issues: low levels of consumer trust in the capital markets and in the financial industry, and how can CMU help bridge the gap between 'finance' and the 'real economy'

The question is two-fold. Let me start with the second part: **how can CMU help bridge the gap between 'finance' and the 'real economy',** and - as it is the topic of this panel - more specifically how will shifting retail savings from banking deposits to capital markets benefit the real economy.
It is far from clear in our view how this would bring capital to a **more productive use to finance the real economy**:

a. First b**ank deposits DO already finance the real economy**, as they contribute to **the stable funding of banks** who provide loans.

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b. Reducing bank deposits would precisely EITHER lower banks' ability to provide lending OR **increase banks' reliance on wholesale funding**, making their **funding structures more fragile and unstable**, and in turn making it **more difficult and riskier for them to offer long term loans**.

c. Since retail deposits already finance the real economy, this would **not bring in additional capital** into the economy but **merely change the intermediation channel**, from banks to asset managers. It is therefore not clear how this would bring additional funding overall.

In addition, as **asset managers are key funders of banks**, shifting retail savings from banks to asset managers would merely mean increasing marginally the returns for investors at the price of **higher funding costs for banks and consequently more expensive loans for ultimate borrowers such as SMEs**. While this would benefit retail investors, it would not benefit companies.

It is just **basic math and common sense**: getting **funding from UCITS funds is more costly** for banks in many cases than funding from deposits, which impacts the price of loans offered. The flipside of the higher return for investors is thus a higher cost of borrowing for companies. It is not clear that such a **trade-off would be positive for growth and job creation**.

d. The argument that banks **use some of the deposits to finance proprietary trading** instead of lending to the real economy, and therefore that shifting savings to capital markets would finance more directly the real economy is also weak: it can and should be addressed easily through a real **bank structural reform**.

e. Shifting retail savings to capital markets would also **only be beneficial insofar as the investment style of asset managers is long term**. The short term horizon of most asset managers (1 year performance evaluation and bonus calculation) and their focus on liquid and tradable securities means that shifting savings to capital markets is likely to lead to **shorter term investing** compared to bank lending. This is not what EU companies need to grow.

f. Due to the growing institutionalisation of retail savings, direct investment on capital markets by retail investors is becoming more and more a **niche market**. Promoting it might thus have a very limited impact.

g. A larger involvement of retail savings into capital markets is likely to increase the political incentive to have a "**Greenspan put**", i.e. to take action to prevent capital market downturns, which is a form of **moral hazard**.

h. There is already **too much private capital** looking for investment opportunities with EU Assets under Management close to €16,000 bn 2 years ago[1], therefore no obvious need to channel more funds towards capital markets.

➔ CMU is therefore unlikely to increase the flow of capital into the economy.
It would merely change the financing channel, at the cost of additional instability in bank funding structures and related less stable lending to companies.
It would also lead to higher funding costs for ultimate borrowers and possibly create additional moral hazard.

[1] FT Adviser, Hughes, E. A., Half of managers have had no inflows for three years, 2 October 2013

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c. How do we ensure that that end users' interests are at the forefront of capital markets union?

1. **If by end users we mean borrowers**, as discussed earlier CMU may lead to **more financing but a more unstable and more expensive** financing in many cases, therefore we would argue that their interests are not at the forefront of CMU.

Putting borrowers interests at the forefront would entail promoting in priority short intermediation chains that offer less procyclical and more stable lending at an affordable cost for the borrower, such as **the traditional retail funded banking model**.

2. **If by end users we mean retail investors**, the potential **benefits for retail investors** of shifting retail savings from bank deposits into capital markets **are mixed and overstated in our view**:

a. CMU may indeed bring **lower fees and more comparability** that would benefit retail investors.

b. It may also bring more **diversity and choice** to retail investors, although by itself it remains to be seen whether it is a positive development. There is indeed no lack of choice in the current product offer. What is missing instead is rather the **ability for retail investors to navigate the plethora of products on offer that are not always suitable**.

c. The main argument is that shifting retail savings to capital markets would **increase returns for retail investors**.

First it is important to remember that there is **no free lunch**, and any yield pick-up above the so called "risk free" rate comes at the price of **additional risk**. A fact that retail investors may miss, leading to **increased misselling**.

Any investment in **low risk securities would not offer a significantly higher return** than bank term deposits, only higher risk investments may bring meaningfully higher returns.

d. Additionally, asset managers are **risk channelers, not risk takers** like banks. This means that retail investors would be **more exposed to market risks**.

e. Along the same lines, assets invested in capital markets are not protected by **deposit guarantee schemes**.

f. Lastly, we should be aware that the **yield promises of new asset classes such as infrastructure are unlikely to materialise** given the excess amount of capital chasing few assets, likely to lead quickly to unreasonable yield compression.

➔ **Putting end users' interests at the forefront of the Capital Markets Union would require promoting in priority simple stable financing channels with short intermediation chains, if by end-users we mean ultimate borrowers.**

If we mean retail investors, putting their interests at the forefront would require first ensuring they receive an appropriate level of protection for the additional misselling risks that CMU might create.

It would also crucially require ensuring that investors understand that additional returns come at the cost of additional risks, something that they systematically don't understand especially in a context of low interest rates.

2. How to encourage more institutional investment in a wider range of assets classes?

How to attract more institutional investors into capital markets and in particular into a wider range of asset classes, such as infrastructure and venture capital.

a. How should we address the information problems for investors wanting to invest in infrastructure or non-listed assets?

Large institutional investors have the in-house expertise required and are already active in this area with growing assets under management earmarked for these assets.

Small and medium size institutional investors wanting to invest in infrastructure or non-listed assets can do so through specialist funds that have the appropriate expertise or indirectly by investing in banks, as banks are the best experts in project finance.

3. How to encourage wider retail investor participation in capital markets?

How to attract more retail investment into capital markets, with a particular emphasis on converting a savings culture in Europe into more of an investment culture:

a. What about better financial guidance / education for retail investors?

Better education for retail investors, as well as for financial advisors would certainly be beneficial. As behavioural economics taught us however, the **impact is likely to be limited due to retail investors' bounded rationality.**

The **purpose of financial education** should also **not be to promote retail investors' participation in capital markets**, **but rather to teach them basic concepts** such as risk and reward, so that they understand that more return means more risk and then can make an informed decision about whether to engage more directly in capital markets.
Education cannot be neutral and unbiased while serving a politically motivated market push objective.

b. How to ensure the appropriate balance between consumer protection and higher levels of investment, particularly when it comes to cross-border investment?

In the current context of high distrust of the financial system, we believe that there is **no-trade off between consumer protection and high levels of investment**, but on the contrary that **both go hand in hand**. Only high levels of consumer protection will restore confidence and contribute to higher levels of investment.
As an example, the commercial success of the UCITS framework is evidence that investors value a sound and tight framework and that soundness and commercial success go hand in hand.

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Just as the **alleged balance or trade-off between financial stability and sustainable growth** is a misleading conceptual approach, we believe that the **alleged balance between consumer protection and levels of investment is misguided**.

4. If I ruled the world…

Imagine that you have absolute power to change just one thing in capital markets in Europe today. What would it be and why?

I would **shrink the size of shadow banking** to make it stable.

Why?

1. The financial system's procyclicality (and comparatively higher procyclicality of non-bank lending) require for some entities to be able to act in a countercyclical manner for the financial system to be stable,
2. Public safety nets play that role for banks,
3. The crisis has shown that private backstops for shadow banking did not work,
4. We must therefore choose between either extending direct and explicit access to public safety nets to shadow banking or shrinking the size of shadow banking to a level where private backstops can work,
5. It is not desirable to extend public backstops as it would increase moral hazard, and would at the very least require a regulatory level playing field that isn't there,
6. Consequently a stable financial system would require shrinking the size of shadow banking,
7. Yet the EC is proposing to INCREASE the size of shadow banking without any consideration for countercyclical backstops. This will lead to an unstable financial system, more vulnerable to future crises. This is not the kind of stable system and stable lending needed to help EU companies grow.

The post-crisis regulatory environment: to what extent is CMU aligned with other current and proposed reforms (eg. FTT)

Unlike most post-crisis regulatory initiatives that aimed at improving financial stability from a micro prudential angle, CMU is in our view solely focused on creating short term growth and improving the competitiveness of the financial industry, at the possible cost of additional financial instability.

Indeed the argument that CMU will make our financial system more resilient by diversifying the sources of funding is flawed: capital market financing is first strongly linked to banks as they perform many essential functions, which nullifies the alleged diversification benefits. In addition non-bank lending is a much more collateral intensive activity which will lead to a more procyclical and interconnected financial system, more vulnerable to systemic crises.

In this respect CMU is not at all aligned with past proposed reforms such as the FTT or CRD IV. It is on the contrary strongly aligned with other recent initiatives such as TTIP or better regulation whose purpose, just as that of CMU is not financial stability but rather short term growth at any cost, being the social contract or financial stability.

Once again we should remember that the alleged trade-off between growth and financial stability is a flawed and biased intellectual construct, as given the huge cost of crises financial stability is a prerequisite for growth. The current and understandable obsession with growth and jobs should not blind us into accepting any price for alleged growth promises that might fail to materialise.

Anecdotally CMU shares another common point with TTIP and better regulation, which is a regrettable lack of consultation of civil society, where stakeholder groups and public hearings give so little space to civil society organisations that they risk becoming more a PR and ticking box exercise than a true balanced consultation with the real stakeholders.

What can the investment industry do to rebuild trust with consumers, perhaps by reducing complexity and increasing transparency?

In the current context of high distrust of the financial system, we believe that there is **no-trade off between consumer protection and competitiveness**, but on the contrary that **both go hand in hand**. Only high levels of consumer protection will restore confidence and contribute to higher levels of investment.
As an example, the commercial success of the UCITS framework is evidence that investors value a sound and tight framework and that soundness and commercial success go hand in hand.

Increasing transparency is a useful but insufficient step: behavioural economics taught us that investors can rely more on other factors such as the intuitu personae nature of the relationship with an advisor than on factual information.

Reducing complexity would be a very welcome additional step, since in most cases complexity does not provide any benefits to the investor but is only a way to embed more margins for the sale side.
In this respect we regret that PRIIPs final compromise left the comprehension alert as a recital, since it is acknowledged that flawed product design is a cause of mis-selling.
More importantly we strongly hope that the European Commission's desire to revive simple securitisation will live up to its name and that qualifying securitisation will be truly simple, without any asset transformation or credit enhancement but merely basic pooling and risk transfer.
Failure to do so would once again attract investors that do not understand what they purchase but are lured by attractive ratings. It would also once more create enormous additional complexity that does not deserve a softer prudential treatment, model uncertainty and conflicts of interests among other issues.