



Finance Watch

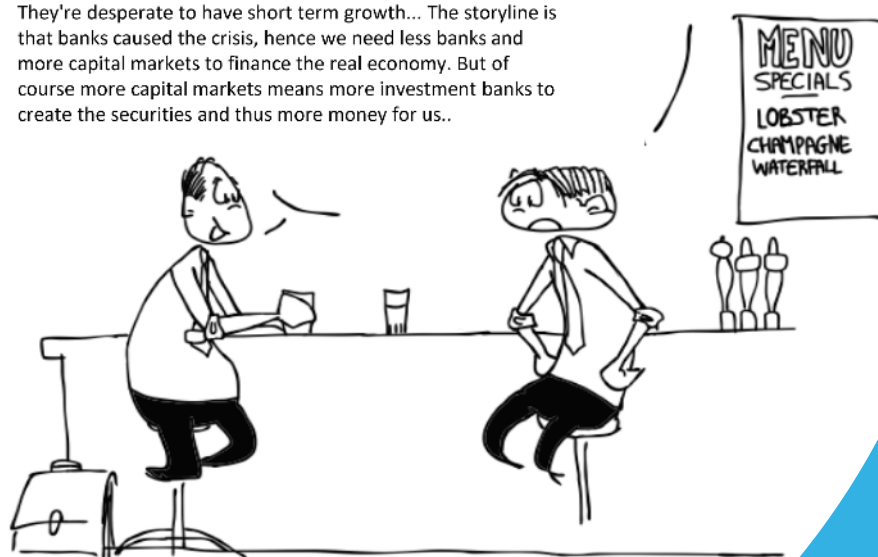
Making finance serve society


Capital Markets Union in 5 questions

How likely is the European Commission initiative to address the lack of sustainable growth and job creation and to reduce the risk of future crises and related costs to citizens?

Really? Did they already forget about the crisis?

They're desperate to have short term growth... The storyline is that banks caused the crisis, hence we need less banks and more capital markets to finance the real economy. But of course more capital markets means more investment banks to create the securities and thus more money for us..





*We cannot solve our problems
with the same thinking we
used when we created them.*

Albert Einstein

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Finance Watch has received funding from the European Union to implement its work programme. There is no implied endorsement by the EU or the European Commission of Finance Watch's work, which remains the sole responsibility of Finance Watch.



More than seven years after the financial crisis and the subdued period of growth that followed, the European Commission is committed to putting the European economy back on its feet. In March 2013, it published a preliminary report on the long term financing of the European economy.

This report was part of a wider set of initiatives aimed at restoring sustainable growth and job creation in Europe. Projects such as "Europe 2020", "Connecting Europe", "Innovation Union" and the "2030 Climate and Energy Package" have identified a number of priorities to achieve this objective. These initiatives aim among other things at fostering education, research & development, financing the green transition, developing transport infrastructure and networks and boosting small and medium enterprise (SME) growth.

While these other initiatives focus on which investments are needed, the long term financing initiative complements them and focuses on how these initiatives are to be financed, whether by banks or capital markets, crowdfunding, with public investments or private ones etc. Two particular areas are put forward: infrastructure and SME financing.

A large number of proposals in the long term financing initiative have now been rebranded Capital Markets Union. The European Commission published a preliminary report highlighting its early priorities for Capital Markets Union in February 2015 and opened a consultation with stakeholders about some of these priorities.

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1. What is the Capital Markets Union?

The Capital Markets Union aims at developing capital market financing in Europe

The Capital Markets Union is a patchwork of initiatives aimed at developing non-bank lending¹ (so-called "shadow banking") and capital market financing² in Europe, with a particular focus on infrastructure and SME financing.

It aims to increase the role of institutional investors such as pension funds and insurers and the involvement of retail investors (households) in financing the real economy, and at the same time to reduce the role of traditional banks.

It also aims to use capital markets as a way of pursuing European integration, by removing national barriers and harmonising rules on the free movement of capital. The crisis showed that foreign banks and investors retreated within their national borders in times of stress. This left companies and households that relied on foreign banks and investors with a much reduced access to funding when they needed to renew their loans. The idea is thus that by making capital markets more harmonised in Europe, households and companies would have access to a wider range of investors and so better and more similar access to finance, no matter which Member State they are located in.

The Commission identified five early priorities:

- 1. Review the documentation that companies need to publish before raising money in capital markets:** as the information required can be very burdensome, the objective is to simplify the information needed, making it easier and cheaper for companies to access capital markets.
- 2. Develop standardised quantitative methodologies to assess the creditworthiness of SMEs:** The objective is to make it easier for non-experts and non-bank lenders such as insurance companies and asset managers to get the information they need to lend to SMEs.
- 3. Revive high quality securitisation:** securitisation is the practice of pooling together and repackaging a number of loans granted by a bank and issuing tradable debt securities (such as bonds) sold to investors. The investors buy the securities and are repaid as the underlying loans are reimbursed (see diagram below).

This technique was at the heart of the financial crisis, as it enabled banks to transform bad quality subprime loans into AAA rated securities³.

The European Commission now wants to define via a number of criteria a "good" securitisation that would be simple and transparent. This good securitisation could then benefit from a much softer regulatory treatment – i.e. investors would need to have less capital to absorb potential losses – to make it more attractive for investors to buy it again.

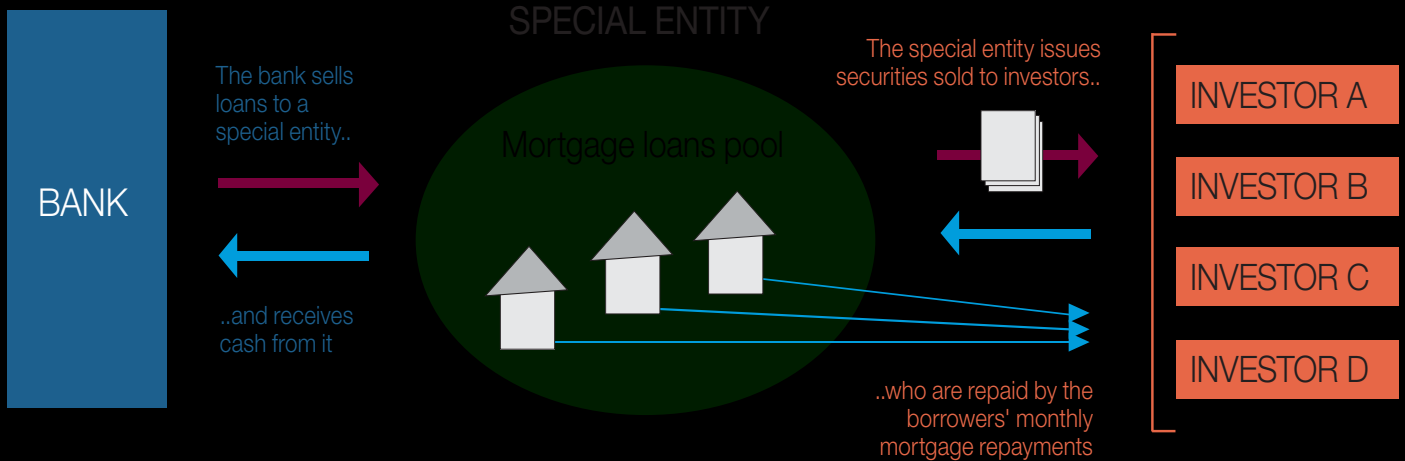
The five priorities of the European Commission

1 Non-bank lending is lending provided by investors or financial institutions other than banks, such as hedge funds, pension funds, insurance companies etc.

2 Capital market financing is borrowing or raising money from investors via the issuance of bonds, shares or other financial instruments.

3 This can be done through a number of mechanisms such as purchasing insurance or issuing less securities than the value of the underlying loans etc. to reduce the risk and improve the rating of the securities issued.

As the securitisation process (repackaging, designing the new securities to be issued and providing guarantees) is done by investment banks, **reviving securitisation will implicitly promote investment banking activities relative to traditional relationship banking in Europe.**



One of the objectives is to harmonize the legal framework and diversify the supply of funding for the real economy

4. **Promote the development of European Long Term Investment Funds:** this new type of fund aims to attract insurance companies and pension funds to invest in privatised infrastructure and companies over a longer time horizon.
5. **Develop European private placement markets:** Private placement is where a company raises funds directly from a small group of investors rather than on a stock exchange. The Commission's objective is to harmonize the legal framework to reduce national differences, such as in insolvency laws and documentation rules, which currently act as barriers.

2. Why the need for it?

The European Commission's initiative is based on a number of assumptions, some of which are a source of discussion. It is important to understand them, because incorrect assumptions can lead to inadequate policy responses to the issues at hand:

Claim 1: The lack of growth and job creation comes from a lack of credit supply, therefore we need to boost the supply of credit and capital markets.

FW view: There is a wide consensus⁴ on the fact that the lack of growth comes for a large part from a lack of aggregate consumer demand, itself linked to structural factors such as the rise of inequalities over the past decades. Yet the political response is focused on supplying more cheap credit to the economy and does not address this issue. As European households are already heavily indebted and worried about the future, it seems unlikely that lowering interest rates further will encourage them to take on a second mortgage or more consumer credit so that they can consume more. Alternatively it has been argued that a more progressive tax system favouring work and income over wealth and inheritance would increase the purchasing power of the low and middle classes and truly boost consumption and growth⁵.

Claim 2: The European economy is too reliant on banks especially compared to the US, whereas bank lending will decline due to regulation and the need to deleverage.

FW view: We note the strong desire to transform the European model towards a US funding model where capital markets play a bigger role. It has been amply demonstrated⁶ however that the structure of a financial system – whether it is bank based or capital market based – is secondary from a growth perspective. In this respect the growth differential between the EU and the US is not directly linked to the development of their respective capital markets.

We therefore do not see a compelling need to change the European model and promote capital market financing.

On the claim that bank lending will decline, we note that European banks' loans to households and non-financial corporations (the real economy) represent roughly only 30% of their activities⁷. It follows that banks may choose to allocate their capital to more profitable activities than lending, but by themselves new regulation and deleveraging do not automatically imply a reduction in bank lending. Banks that need to deleverage can indeed choose to reduce other activities or increase their capital instead. On the claim that tighter bank regulation will lead to an automatic reduction in lending, we note on the contrary that better capitalised banks can lend more, not less.

Finance Watch does not oppose bank lending and capital market financing and recognises that both have a role to play. It is important however to promote in priority the most

4 The Davos forum and the OECD acknowledge it among others.

5 See Joseph Stiglitz' *"The Price of Inequality"* (2013), Thomas Piketty's *"Capital in the Twenty-First Century"* (2014) and the article from the Foundation for European Progressive Studies *"The recovery needs wage growth"* (online available at: <http://www.queries-feps.eu/the-recovery-needs-wage-growth/>).

6 IMF, *"Market Phoenixes and Banking Ducks – Are Recoveries Faster in Market-Based Financial Systems?"* (2011) and Ross Levine's article *"Bank-Based or Market-Based Financial Systems: Which is Better?"* (2002)

7 European Commission, *"Final report of the High-level Expert Group on reforming the structure of the EU banking sector"* (Liikanen Report), 2 October 2012

Addressing the lack of demand should be part of the policies aimed at promoting growth

Bank lending to non-financial corporations and households does not have to decline

Traditional relationship banking proved more robust and more focused on lending to the real economy

useful channels and models. In this respect, **the crisis has shown that traditional relationship banking proved more robust and more focused on lending to the real economy than large universal and investment banks.** Yet by promoting a revival of securitisation the European Commission is implicitly promoting the latter model that required in some cases huge bail-outs. We believe on the contrary that traditional relationship and local banking should be promoted in priority.

Lastly, we believe that the promotion of some capital market activities is aimed at boosting the profitability of European financial institutions in order to increase their competitiveness. While this may be a legitimate objective, it is not put forward in the current narrative.

Claim 3: There is an overall shortage of credit supply to SMEs in Europe and securitisation can help.

FW view: Data from the European Central Bank shows that SME's lack of access to finance differs strongly between Member States: SMEs struggle to get funding in southern countries like Italy, Portugal, Spain or Greece, but not in countries like Germany. SMEs' lack of access to finance is therefore not an overall shortage of credit supply but linked to local contexts and banking sectors.

In addition, assessing the creditworthiness of an SME requires not only reading its financial statements, but also crucially integrating qualitative elements such as knowing the local economic context and competition and meeting its management. A bank with a local branch is very well placed to get this information, an investor is not. As these qualitative elements cannot be adequately integrated into quantitative credit scoring methodologies, it questions the idea that investors can perform the necessary due diligence to lend to SMEs.

The global and lasting relationship between a bank and an SME also make bank lending more stable over time: a bank will be more willing to support its client during difficult times as the history of the relationship gives it confidence that the SME will get through it.

Lastly, Finance Watch argues together with other stakeholders that the securitisation of SME loans will be too complex and too expensive to work without subsidies, due to the need to remunerate a number of intermediaries and to offer an attractive return to investors. It therefore questions the idea that securitisation can be a sustainable financing alternative for SMEs.

For all these reasons Finance Watch believes that traditional relationship banking should remain the main source of financing for SMEs and should be promoted, unlike what is being proposed currently.

In this context it is important to note that banks like Northern Rock or some Spanish cajas that experienced difficulties during the crisis were not pure traditional banks. Instead they relied on wholesale⁸ funding and some were involved in securitisation.

We also acknowledge that banks need to be strengthened and incentivised to play their role in some countries where they have become too risk adverse. This started to be addressed through asset quality reviews⁹ from the European Central Bank that pushed banks to get rid of their bad assets and free up capital to make new loans.

Securitisation of SME loans will be too complex and too expensive to work without subsidies

⁸ Very short term lending between financial institutions.

⁹ The European Central Bank analysed the investments and loans of 130 European banks to assess the risk that they would fail in a crisis scenario. Those who failed the test have been required to take action.

Claim 4: There is a significant lack of investment in infrastructure in Europe. As governments cannot increase their deficits, public investment is not an option, therefore we need to increase private capital investments in infrastructure through public private partnerships.

FW view: We agree that there is currently too much private capital that could be better channelled to financing the economy on the one hand and that governments' budgets give them a limited margin of manoeuvre on the other.

Public-private partnerships are long-term contracts between a public sector entity and a private sector entity, where the private firm builds and operates an asset such as a highway, a railway or some other public infrastructure and is paid either an annual rent from the public entity or through user fees (e.g. toll roads).

Public private partnerships do not provide additional resources and shift the cost to future generations

The privatisation of quasi-public goods such as infrastructure raises a number of concerns. It is very attractive to politicians as it can enable them to show lower deficit figures: as an example instead of showing the full cost, say €1 billion expense in a bridge, public accounting in many cases will only show the annual rent that the public entity is paying, say €80 million. However **public private partnerships shift the cost of investments to future generations and have a poor track record in terms of value for money for taxpayers with citizens ending up paying more in many documented cases.**

Lastly, privatising infrastructure might exclude citizens who can't afford it from using privatised infrastructures.

Claim 5: We need to increase retail savings in Europe and channel them away from bank deposits and towards capital markets.

FW view: We are not convinced that additional retail savings should be incentivised for the purpose of reviving growth. Not only are European savings ratios relatively high and stable, but there is also already plenty of private financial capital looking for investment opportunities, with total assets under management in the European asset management industry close to €16,000 billion last year and financial capital globally expected to rise 50% from \$600trn to \$900trn by 2020.

More consumption, not more savings would boost growth and job creation

Additionally what is needed right now for the purpose of growth and job creation is more consumption, not more savings. Encouraging complementary savings may therefore have more to do with the pension privatisation agenda than with promoting growth. The European Commission is indeed working to develop private pension funds in all Member States, which will require citizens to save more for retirement.

We also query the Commission's suggestion that retail savings currently in bank deposits need to be "unlocked" and channelled to a more productive use in capital markets: **retail deposits do finance the real economy and contribute to a stable banking system; pushing individual savings into capital markets might create additional risks for retail investors.**

Lastly, we should also note that transferring risk from banks to pension funds as is currently promoted might 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.

Claim 6: Developing European capital markets will advance European integration.

FW view: Making the European Union more robust would require implementing a fiscal union (e.g. same tax system in all Member States), rather than pursuing an integration via capital markets.

Implementing a fiscal union rather than a Capital Markets Union would make the European Union more robust

Harmonising the rules to create more European and unified capital markets would indeed increase cross borders investments in good times. However as we cannot yet create truly pan-European pools of SME loans for example, due to the differences in national bankruptcy laws and definitions of what is an SME, investment products such as securitisations of SME loans will likely be based on national pools of loans. It is therefore likely that investors will differentiate quickly in times of crisis between securitisations based on SME loans of a troubled Member State and on SME loans of, say, Germany, just as they did during the crisis between the sovereign debt of Greece and Germany. An integration via capital markets might therefore not be as stable as would be desirable.

Implementing a fiscal union would arguably require a strong political will to overcome the reluctance of Member States to give up additional sovereignty (as individual countries would no longer set their own tax rates).

Yet much sovereignty is currently in the process of being given up through a potential transatlantic trade agreement¹⁰ (TTIP) or via the privatisation of quasi-public goods such as infrastructure.

Lastly, the claim that we need to increase market liquidity, that is the ease and speed with which money can be exchanged is debatable: it is a well-known fact that liquidity is highly dependent on investors' greed and fear and can decline very quickly in times of stress. It is also well-known that financial markets are manic-depressive and can overreact irrationally from time to time. In this respect a more sustainable alternative would be to truly promote patient investors such as insurance companies investing in illiquid assets for the long term.

In this respect the further involvement of long term institutional investors should only be promoted to the extent that they truly invest long term this time, unlike what they did pre-crisis.

Claim 7: Much prudential regulation has been put in place since the crisis, we are now done with stability concerns and should focus on growth.

FW view: While much regulation has been put in place after the crisis, most of it is focused on making individual banks more robust but very little has been done to make the financial system as a whole more robust and stable. This is indeed very different: making the system more robust requires, among other things, ensuring that financial institutions do not run into trouble at the same time. If one medium-sized bank runs into trouble, this is not a threat to the financial system, as other banks can buy the troubled bank and ensure a continuity of services. If however most banks experience troubles simultaneously as happened during the crisis, governments need to intervene to bail them out with taxpayers' money.

Preventing this from happening again would require, for example, **ensuring that banks do not all invest in the same things and limiting the web of contracts between institutions to reduce the risk of domino effects. As long as this is not done, we have not fully addressed the risk of future crises**, which is a pre-requirement for sustainable growth.

¹⁰ See Finance Watch, "Understanding Finance #2: Financial services in TTIP?" (2014) (online available at: <http://www.finance-watch.org/hot-topics/understanding-finance/926-understanding-finance-2>)

3. Why should I be interested as a citizen and taxpayer?

Promoting the development of capital markets in Europe might create an even more volatile financial system that is more vulnerable to domino effects.

The suggestion that enough has been done in terms of financial regulation and that the European Commission should now focus on boosting short term growth is dangerous: as long as systemic risks have not been comprehensively addressed we haven't truly reduced the risk of future crises and related costs on the economy and citizens' lives¹¹.

Transferring risks from banks to non-bank entities such as pension funds does not make the system less risky and might create additional moral hazard if pension funds run into trouble and have to be bailed out with taxpayer money in the future.

Focussing the policy response on increasing the supply of credit without addressing the lack of consumer demand, linked to the rise in inequalities among other factors, is unlikely to generate significant growth and job creation. As a recent report¹² put it "*policies that help to limit or reverse inequality may not only make societies less unfair, but also wealthier.*"

Lastly, privatising the funding of infrastructure might lead in some cases to excluding poorer citizens from accessing essential services. It might also increase the ultimate cost of infrastructure investments for taxpayers while shifting the burden to future generations.

Promoting capital markets might create a financial system more vulnerable to domino effects

Reviving simple securitisation requires a tighter definition than what is currently proposed to make it truly simple

Systemic risks should be comprehensively addressed

4. What are Finance Watch's key points?

1. **The promotion of public private partnerships** requires, at the very least, complete transparency about contracts and a periodic review of their value for money by competent authorities, in order to avoid creating "economic rent" situations.
2. **The future definition of "good" securitisation** should be robust enough to learn the lessons from the past: among other things banks should be more incentivised to securitise only good loans and not the worst ones, investors should have more information about the loans and the structures should be truly simple for investors to understand what they invest in. In this respect the recent definition proposals go in the right direction but are not tight enough to deserve a softer prudential treatment (i.e. to allow investors to have less capital to absorb potential losses).
3. By promoting securitisation, that is the issuance of tradable debt securities guaranteed by future repayments of loans, we will also **increase the risk of a domino effect** in our system: the securities issued are indeed often used as a guarantee by financial institutions to obtain short term lending.

As an example imagine that bank A makes 100 mortgage loans. It then issues 10 year securities guaranteed by these 100 loans and sells them to investor B. The investor

11 See Finance Watch note, "*Too-big-to-fail in the EU*" (2014) (online available at: <http://www.finance-watch.org/our-work/publications/912-tbtf-note-fw>)

12 OECD, "*Trends in Income Inequality and its Impact on Economic Growth*" (2014).

B who purchased these securities will then lend these securities to bank C over two weeks in order to fund part of its purchase. Bank C will then lend these same securities to investor D over one week to obtain funding etc.

The web of contracts created increases the risk of contagion if one entity in the chain fails or cannot renew its short term borrowing and is consequently forced to sell some assets.

This issue needs to be addressed by limiting the number of times a security can be re-used or by incentivising banks to obtain longer term funding, among other measures.

Traditional relationship banking should be promoted

4. **We should also promote traditional relationship and local banking** as this model proved more stable and more focused on lending to the real economy. Amongst other measures we should change the regulation that currently favours large banks over small banks by requiring more capital for the latter.

5. What happens next?

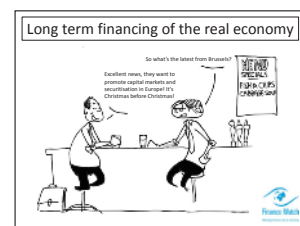
The European Commission is currently consulting on the proposed framework and on some of the priorities such as the future definition of "good" securitisation.

It aims at implementing a future capital markets union by 2019. While this may seem far away, the important decisions are being taken now and deserve a democratic debate given their impact on European citizens' lives for the decades to come.

For more detailed information or to get involved please go to Finance Watch website <http://www.finance-watch.org/>



Finance Watch report
"A missed opportunity to revive "boring" finance?"



Finance Watch cartoon
"Long term financing of the real economy"

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org



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