FINANCING THE EUROPE OF TOMORROW

How to unlock Europe's latent growth potential

A vision for European policy makers, banks and markets in a changing world

EBF
European Banking Federation

INTRODUCTION

To meet Europe's investment needs over the coming decades, something must change. Europe's investment gap is estimated at about €700 bn per year, of which €180 bn per year is the climate gap. Simply put, we need more sources of private sector financing going into the economy, longer term investments to accommodate the ageing population[1], as well a greater availability of risk capital to finance innovation.

European banks, in their role as intermediaries between the savers / investors and the companies, have a leading role in financing the Europe of tomorrow. Companies rely on banks for 70% of their total external financing. In addition to corporates of all sizes, banks finance the needs of private individuals and households throughout their life-cycle (acquiring a home or a second residence, financing the children's higher education or pension needs, etc.) and supporting the development or planning structuring of their estate. Post-crisis reforms have paid off and banks are now able to pass on more funding to companies and households – such loans standing at their highest level since 2013, with SME access to bank lending improving every year.

Banks' business is rigorously regulated and supervised and is subject to strict (regulatory and non-regulatory) standards of conduct. To be able to continue fulfilling their role successfully, banks need an efficient regulatory and policy environment that ensures a level playing field and growth-enabling conditions both at European and national levels. European banks are more committed than ever to the EU's projects of the Banking Union and the Capital Markets Union,[2] within a fully-integrated Financial Union to overcome the considerable economic and political challenges of our times. With the hope of contributing to a better understanding of the challenges and opportunities faced by Europe in financing economic growth, this paper lays out a vision for a fully integrated Financial Union (1) and the role of banks (2), followed by recommendations for: enabling banks to provide more financing to corporates and households (3); building and integrating capital markets (4); bringing more investors into the market (5); ensuring fair competition (6); and achieving sustainability (7). The analysis and detailed recommendations are preceded by an Executive Summary.

1 Observations extracted from the 2018 Ageing Report of the European Commission: https://ec.europa.eu/info/sites/info/files/economy-finance/ip065_en.pdf
2 Please see Vitor Constancio, Synergies between Banking Union and Capital Markets Union: https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170519_1.en.html

EXECUTIVE SUMMARY: FINANCING THE EUROPE OF TOMORROW

Our Vision: An integrated, single European financial sector that fuels dynamic, sustainable and strong economic growth

With most of the post-crisis reforms fully embedded in the system, it is now time for Europe to focus on the **true measure of a financial sector**: its ability to finance cutting-edge jobs, stable family businesses, fast-growing innovative small businesses, research on cures for diseases, well-paying pensions, affordable mortgages, efficient solar panels, job-creating exports, and much more.

Without sacrificing safety and stability, the financial sector must be able to finance dynamic, sustainable and strong growth. To get there, the European Banking and Capital Markets Union must work at different levels of access: **local, regional and pan-European**, in a seamless and fully integrated way. Companies and savers from any corner of Europe must be able to tap the Union without hurdles.

Role of banks

Within this vision, **banks** play an essential role. Banking generates prosperity and opportunities for all. Banks are a core element of **corporate and household finance** in Europe. For both corporates and households, what makes their relationship with their bank unique is the bank's focus on **stable customer-bank relations (relationship-oriented) rather than individual transactions (deal-oriented).** Beyond providing lending, banks also act as intermediaries, advisers and providers of both capital and risk management expertise for capital markets. Far from being mutually exclusive, ´market-based financing´ and ´banking finance´ work together to meet the needs of companies and investors. A critical ingredient of this success is the heterogeneity of the European banking sector, consisting of banks of different sizes, allowing for breadth and depth.

Europe needs more capital markets, but not less banking

Europe needs more capital markets, but not less banking. Each type of financing has its unique features which benefit the economy. Building one should not distract from the importance of the other. This is not only because capital market financing starts from a lower share in Europe than in some other economies. It is also because bank financing is the cornerstone of economic activity and forms the basis of access to other kinds of finance. Therefore, instead of 'reducing dependency to banks', Europe should focus on promoting the diversity of funding for different needs.

To ensure that bank lending continues playing its role in meeting economic actors' needs, we need: (1) prudential regulation that does not hinder banks' lending capacity; (2) other forms of regulation that does not inhibit companies' access to banks' basic services; (3) a mix of public and blended financing that is focused, anti-cyclical and complementary to private funding; and (4) a genuine possibility to provide retail cross-border services across the EU.

Strengthening European capital markets with coordinated action

Strengthening and integrating capital markets in Europe will be beneficial for the economy, in particular through the provision of risk capital and diversification of funding sources. Banks meet diverse needs of their clients through capital markets, and they are also users of capital markets when they trade in the money markets or issue equity and debt financial instruments. The more efficient the capital market, the more efficient the banking system.

Intermediary and underwriting services in Europe are demonstrably efficient and affordable for companies. Yet, European capital markets remain small and underdeveloped compared to the size of the economy, and risk capital is not a sufficiently available source of financing for companies. Investors too suffer from a lack of capital markets investment opportunities. To ensure that European capital markets become deeper and more integrated, we suggest: (1) creating a Europe-wide discussion (e.g. through a "Wise Person Committee") to define the fundamental, structural obstacles that stand in the way of an integrated Capital Markets Union; (2) identifying and adapting, where possible, best practices from the regions that have more developed capital markets; (3) developing and/or rebuilding local ecosystems through regulatory and non-regulatory solutions; (4) developing private equity markets and alternative ways of financing to function as a complement to traditional capital markets; (5) developing a well-functioning pan-European securitisation market; and (6) ensuring that regulation does not unduly limit banks' capacity to finance the economy in terms of funds available or the activities that can be offered; and (7) building an equity culture in Europe supported by better opportunities for investing in capital markets.

Bringing the investors in through investor protection and financial education

A developed financial system relies on active savers and investors, willing and able to provide funding. While investor protection is quintessential, so is the availability of a spectrum of investment opportunities that are attractive, transparent, and easily accessible. To get there, we need: (1) active investors able to invest cross-border without undue obstacles; (2) retail investors who have greater choice and control; and (3) public and private initiatives (such as the EBF-spearheaded Financial Education Platform) which target financial education.

Fair competition is better – inside and outside Europe

The EU needs banks that face fair competition, both domestically and internationally. Only fair competition will ensure that the end-users – households, companies and investors – will benefit from access to the best possible services on the best possible terms. To retain the EU's attractiveness as a place for doing business, the EU needs banks and capital markets that face fair domestic and global competition. To get there, we distinguish among three dimensions of fair competition: (1) the digital field, where same rules should apply for the same services and the same risks for all players; (2) the international setting, where European banks must face fair competition vis-à-vis their global competitors (third country institutions); and (3) the attractiveness of Europe as a place to do business, which requires that the EU's capital markets remain competitive and open to foreign investors while retaining the EU's sovereignty and safeguarding the interests of its Single Market.

European banks will help Europe deliver on sustainability

European banks are fully committed to mitigating the risks and seizing the opportunities of a low-carbon and climate-resilient future. They have launched many individual initiatives in recent years to promote and consolidate sustainable investment and impact banking – and cooperate in global fora as well as within the European Banking Federation. EBF members support public and private initiatives that accelerate the required sustainable advancements in all spheres to achieve the Sustainable Development Goals, improve the sustainability of our planet, and ensure a vibrant and viable world for future generations. For optimal impact, policies must be holistic and lay out a stable, cooperative framework between the public and private sectors.

In this context, European banks support the European Commission's Action Plan on Sustainable Finance to achieve the Paris climate targets and will align themselves with these plans to deliver on these goals. Beyond the execution of the Action Plan, we additionally recommend to: (1) review the capital requirements to promote and include sustainable finance while ensuring financial stability; (2) embed climate change and sustainability in the EU decision-making process; and (3) streamline rules affecting public investments.

A VISION FOR EUROPE

European banks have a **simple vision:**
A European financial system that meets the needs of European companies, investors and savers. European companies, investors and savers – wherever they are, whatever their size and type – must have access to the financing they need in order to thrive in a competitive world.

While this vision sounds obvious, Europe's policymakers and financial sector have devoted the last decade to a different vision: A financial sector that does not create liabilities, excessive risks or losses for taxpayers and users. After the worst financial crisis across the world in a generation which threatened economic growth itself, restoring the conditions for **safety, stability and investor protection** – understandably – took priority over the efficiency or productivity of the financial sector.

During the ten years since the financial crisis, Europe has undergone many changes and reforms which have built up the safety and resilience of the financial sector and allowed the economy to get back on track. Growth is stable, while unemployment is at its lowest since 2008. [3]

Still, this picture is tainted by different challenges which put European economic and political well-being at risk. In particular, creating the conditions for dynamic, sustainable, inclusive economic growth in Europe has never been more important. As the provider of long- and short-term funding and of critical infrastructures for transactions and as the assessor of risk and value, the financial sector has a unique responsibility for creating these conditions.

This is the only way to realise the EU's ambitions of **economic growth, sustainability and cohesion**, and to reinforce its competitive edge in a global environment. In our vision, both the Banking Union and the Capital Markets Union will only be successful if they provide fair opportunities to companies, individuals and investors across the EU. This means that the Banking and Capital Markets Union must work at different levels of access: **local, regional and pan-European**, in a seamless and fully integrated way, simultaneously taking into account diverse cultural, economic and legal frameworks and the need to preserve the capacity to innovate. Finance must be able to do its job in the face of the severe challenges that our societies are confronted with.

3 Valdis Dombrovskis, Speech, 'The Transatlantic Economy Ten Years After the Crisis: Macro-Financial Scenarios and Policy Responses' http://europa.eu/rapid/press-release_SPEECH-18-3510_en.htm

Role of Banks

Financing corporates and households

Banks are a core element of **corporate and household finance** in Europe. For both corporates and households, what makes their relationship with their bank unique is the bank's focus on **stable customer-bank relations (relationship-oriented) rather than individual transactions (deal-oriented).** This is a key element of bank financing that distinguishes it from capital markets or alternative ways of financing. Banks typically have close and long-term business relations with their corporate and private clients, regardless of their size. This enables them to carry out informed risk analysis and cooperate with customers throughout the company and/or personal life-cycle and beyond economic cycles. The bank acts as a go-between and offers support and back-up in the form of bespoke solutions for all appropriate and diversified funding needs. It performs an essential intermediation role, matching financing needs with growth objectives.

Bank lending can serve a range of corporate needs, from working capital to long-term investment. In addition to loans, banks offer their customers a wide **range of modern financial services**, especially payments[4], export financing, risk management (e.g. of interest rate or FX risk) or in accessing the capital markets by arranging private placements or the issuance of public financial instruments. **Globally operating universal banks are important partners for internationally active companies** that need a full range of products and services in different countries. European structural and investment funds (from the EU or EIB, for example) are delivered most efficiently through the banking system, benefiting from the expertise, tools and the proximity of banks, also helping to leverage private finance especially for those **SMEs** with a short credit history, lack of collateral or a risk profile which to some extent keeps them out of traditional financing.

4 The Single European Payments Area covers more than 520 million people in the 28 EU Member States and six non-EU countries.

Against this general background**, trends from the last ten years confirm that the European banking sector is constantly continuing to improve its services to corporates and households.** Banks are the most important source of funding for companies: according to the latest EIB Investment Survey (EIBIS), "**bank loans account for the highest share of external finance (56%)"**[5] of companies in all different sectors, be they large companies, or SMEs. This data is consistent with last year's data. If we take into account other forms of bank lending, the amount of bank financing as part of **the total amount of external financing for companies amounts to almost 70%**.[6]

Given the dominance of bank financing in corporate funding, banks are well aware of their importance to the well-being of corporates and to that of the economy in general. Over the last decade, bank lending was sometimes constrained by **lower supply** due to the Non-Performing Loans' (NPLs) problem, as well as **lower demand** from the real sector due to the economic crisis. Yet, even in difficult times, banks have continued to provide support to the economy.

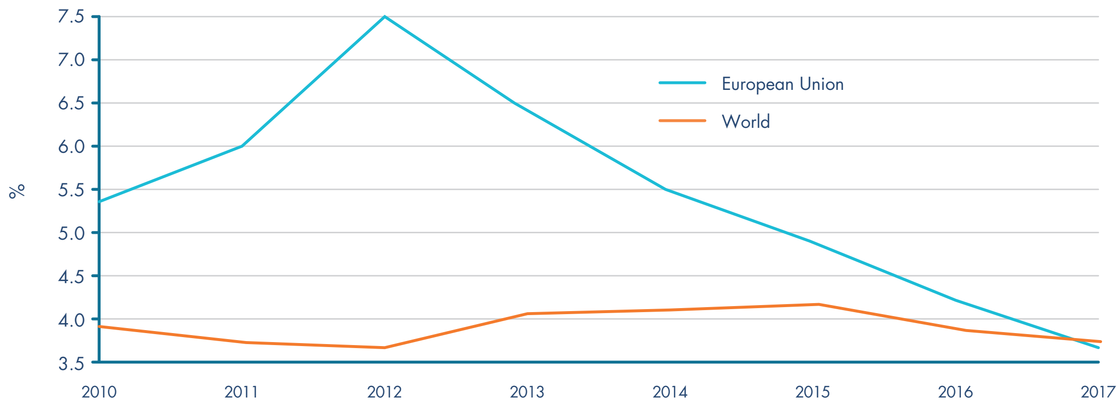
Moreover, since the crisis, European banks have steadily **built their capital positions** and **strengthened their balance sheets**. The recapitalisation effort of the European banks following the 2008 crisis has made the European banking sector more resilient and robust. In almost all countries, we see a steady recovery since 2013/2014. [7] Banks have made great strides in resolving and reducing NPLs from 7.5% in 2015 to 5.5% in 2017 in the euro area, a decrease of about €200bn.[8] However, and most importantly, since the end of 2014, the underlying macroeconomic recovery has allowed the increase in new lending volumes.[9]

The global financial crisis has seen a strong uptake in non-performing loans in banks' balance sheets, leaving policymakers worldwide concerned by this challenge. This trend has been exacerbated for some countries by the Euro Area crisis, particularly in Southern Europe, resulting in an EU-wide peak NPL ratio of 7.5% in 2012.

5 EIBIS 2017 p.19: http://www.eib.org/attachments/efs/eibis_2017_european_union_en.pdf
6 EIBIS 2017 p.19: http://www.eib.org/attachments/efs/eibis_2017_european_union_en.pdf
7 EU Real GDP growth rate, Eurostat data.
8 Lautenschlager, S. (2017), *"The European banking sector - the big challenges"* 20 November 2017, IIF European Chief Risk Officer Forum, Frankfurt, via http://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp171120.en.html
9 New lending to NFC and Households, ECB data.

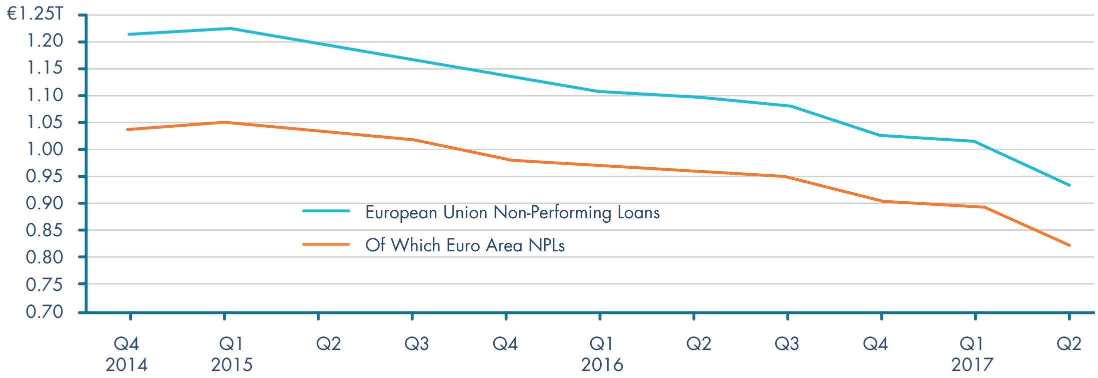
However, NPL ratio trajectories point to a significant decline across the European Union and Euro Area which can be attributed to enhanced loan selling activities of banks in recent years. **In fact, as of 2017, the ratio for the EU stood just below the world average of 3.74%, at 3.7%, which suggests that NPLs are no longer a specific European problem.**

NPLs to gross loans (Year-end, %)



Source: EBF, based on World Bank and IMF Data.

European NPLs declining



Source: Bloomberg based on ECB data.

On the whole, NPL stocks have decreased considerably in recent years due to fostered NPL disposals: of the overall NPL disposals of €256 billion between end of 2015 and mid-2017, more than 60% can be attributed to countries of Groups 2 and 3. This has been made possible at growing rates due to several implemented reforms, notably in Group 3 countries where NPL growth is largely due to enforcement procedure length. Measures were taken to increase efficiency of insolvency procedures, an important step in the right direction, although there still exists room for improvement, and to stimulate secondary markets, the which increased NPL outflow rates and reduced NPL growth.

With overall European NPL ratios being below the world average, and in view of numerous recently initiated regulations on non-performing loans, including, but not limited to provisioning, management or disclosure procedures, the question arises of whether the objective of improving efficiency in NPL reduction processes can be met through additional burdensome procedures and transaction costs for banks.

Have these improvements been passed on to the corporate sector? EBF Facts & Figures 2018 confirm **an increase in the stock of outstanding loan balances to households and corporates**. At the end of 2017, the total outstanding loans amounted to 24.5 trillion, of which households and non-financial corporates accounted for 7.8 and 5.2 trillion Euros, respectively, with the **NFCs loans** standing at their **highest level since 2013**.[10]

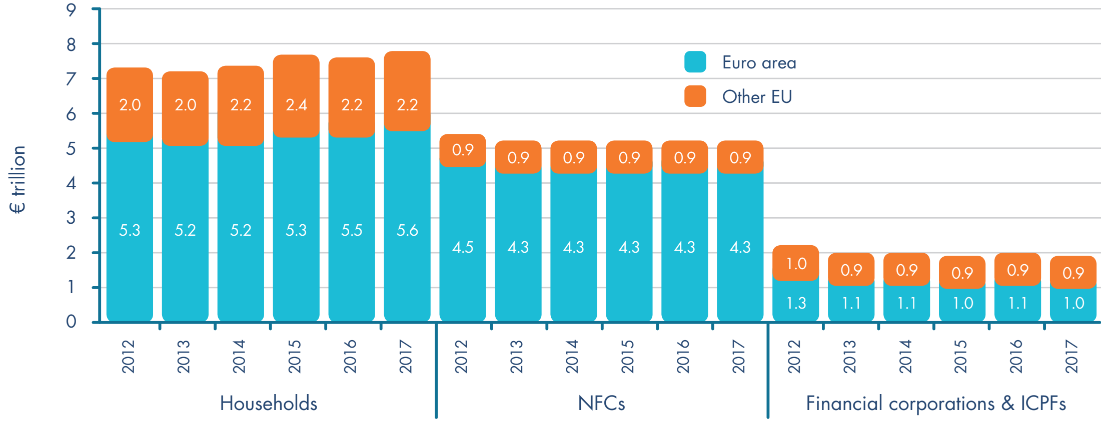
Results from the quarterly ECB's Bank Lending Survey suggested a broadly stable environment in 2017 for small and medium-sized enterprises (SMEs) and large enterprises.

Despite some minor tightening of credit standards for SMEs in Q1 2017, results signaled a slight easing, throughout the year, of credit standards, i.e. banks' internal guidelines or loan approval criteria, for new loans to both SMEs and large enterprises reflecting the tendency seen in most quarters from the start of 2014.

After reaching an all-time high net weighted percentage of 27.9 in Q1 2016, the demand for loans among SMEs remained broadly stable during 2017, closing the year with a net weighted percentage of 13.3. Demand for loans to large enterprises stabilised towards the end of the year from fluctuations seen in the previous quarters.

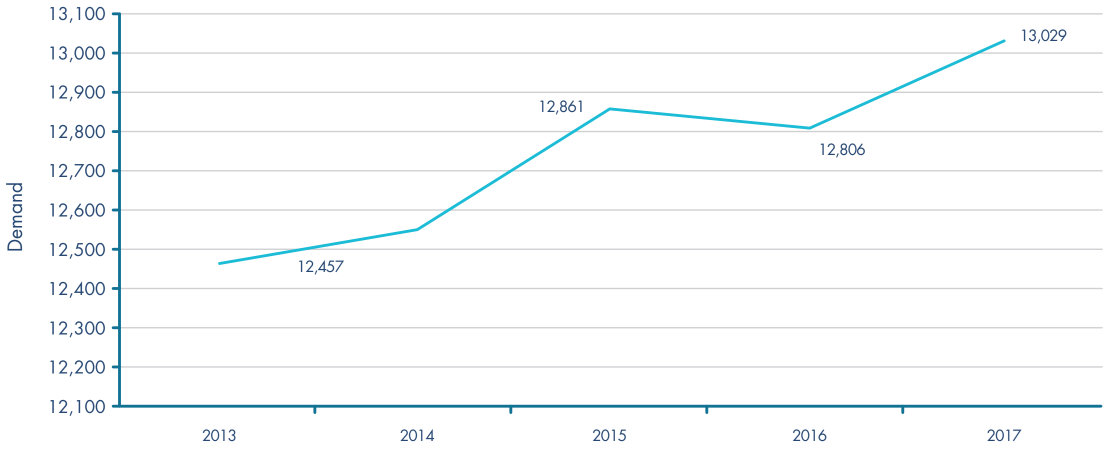
10 Facts and Figures 2018, p.4.

Loans by counterparty sector



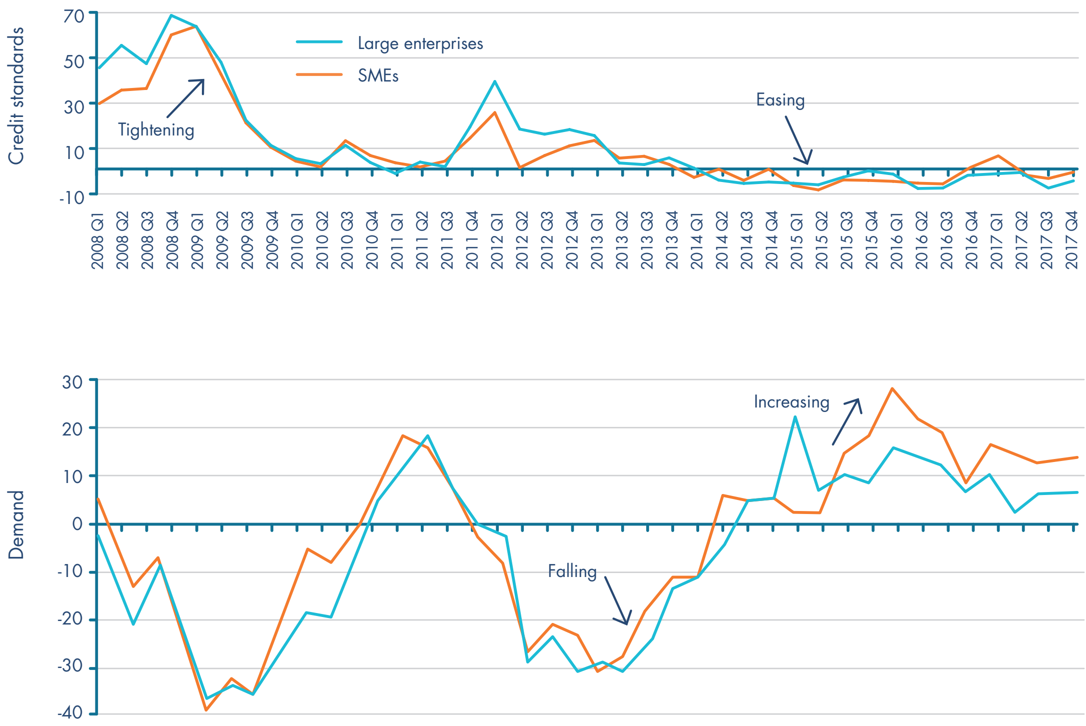
Source: EBF Facts & Figures 2018.

Outstanding loans to non-financial corporations and households in EU



Source: ECB Data – EBF own calculations.

Bank Lending Survey



Source: EBF Facts & Figures 2018.

The perspective of banking clients

Surveys which look specifically at corporate experiences and expectations also confirm that banks continue to serve their clients well. According to the most recent surveys, **close to 90% of all EU firms are satisfied with the financing they receive across all categories**: with regard to quantity, duration, cost and collateral.[11] More than **60% of companies in all sectors** wish to see bank financing become **more prominent** in their financing mix.

While it is important to monitor and improve **existing** clients' satisfaction, **access to finance** for **potential** clients is also an important metric of how well European banks serve the economy. Overall in Europe, we see continued progress in the **accessibility of finance** for the full spectrum of companies, including smaller ones. The banking relationship **– underpinned by proximity and the range of services -** plays a central role in meeting SME needs.[12] Companies of all sizes benefit from the long-term, bilateral bank-customer relationship and the professional specialisation of a bank in assessing the creditworthiness of a customer or project. **SMEs are served by a diversity of banks**, the majority of them being represented by the EBF. According to the European Commission/ European Central Bank Survey on the access to finance of enterprises (SAFE), the percentage of SMEs for which access to finance was cited as the top obstacle more than **halved** between 2009 (when the survey was first organised) and 2017, from 16% to 7%. Overall, **SME access to bank lending has improved for the fifth consecutive year** since 2012.[13]

11 Source: EIBIS 2016 & 2017 data.
12 Outcome of application for bank loans by SMEs, ECB data. There is evidence for Euro Area SMEs that the rejection rates for bank loans are decreasing, namely after 2014, and the approval rates are increasing at a steady pace in the same period.
13 Euro Area enterprises most pressing problem - Access to finance, ECB data.

At the other end of the spectrum, bank lending is also important for **large companies**, with an average of 34.5% using bank loans and 46% using bank overdrafts to finance their activities.[14] In diverse sectors ranging from shipping to textiles, to green energy, banking sector loans play a key role. The availability of long-term funding enables companies to plan over the long term. Within the Euro-area, 58% of outstanding loans of banks to non-financial corporations have a duration of **more than 5 years**[15]; in specific sectors such as export finance, the majority of products (79%) have a maturity of 5-15 years on average, with 9% of products going beyond that threshold.[16] This long-term perspective is also a fundamental aspect of sustainable financing.

Banks as Intermediaries in Capital Markets

While capital markets are often referred to as ´market-based financing´ and thus differentiated from ´banking finance´, banks too are a **key part of capital markets**. Bank and market financing work together and are far from being mutually exclusive. In fact, banks and markets are in a symbiotic relationship in terms of meeting the needs of companies and investors. Banks provide numerous financial services that go well beyond traditional lending, playing a vital intermediation function in corporate finance and supporting companies willing to raise money on the capital market:

- transformation of maturities, volumes and risks in credit lines and investment loans
- export financing
- syndicated and project financing
- professional risk management
- holistic support and funding throughout the company lifecycle and beyond economic cycles

14 Use of internal and external funds by euro area enterprises across firm size, ECB data.
15 Source: ECB Statistics. https://www.ecb.europa.eu/stats/html/index.en.html
16 According to the ICC Trade Register Report 2017: https://cdn.iccwbo.org/content/uploads/sites/3/2018/02/icc-trade-register-report-2017.pdf

- use of derivatives to hedge against risks (of fluctuating interest and exchange rates, commodity prices)
- placing pooled credit exposures with investors
- investment advice for customers
- insurance and investment product distribution
- informed analysis of risks, regulatory and procedure requirements and market developments
- assistance in equity and debt financing using the capital market
- arranging private placements
- market making; by trading securities and quoting prices banks ensure liquidity, thereby reducing volatility and making funding less costly
- underwriting, providing firms with funding security
- operation of systematic internalisation platforms
- treasury management
- custody services
- clearing and settlement services.

Simply put, banks are needed **as intermediaries, advisers and providers of both capital and risk-management expertise** for capital markets to function.

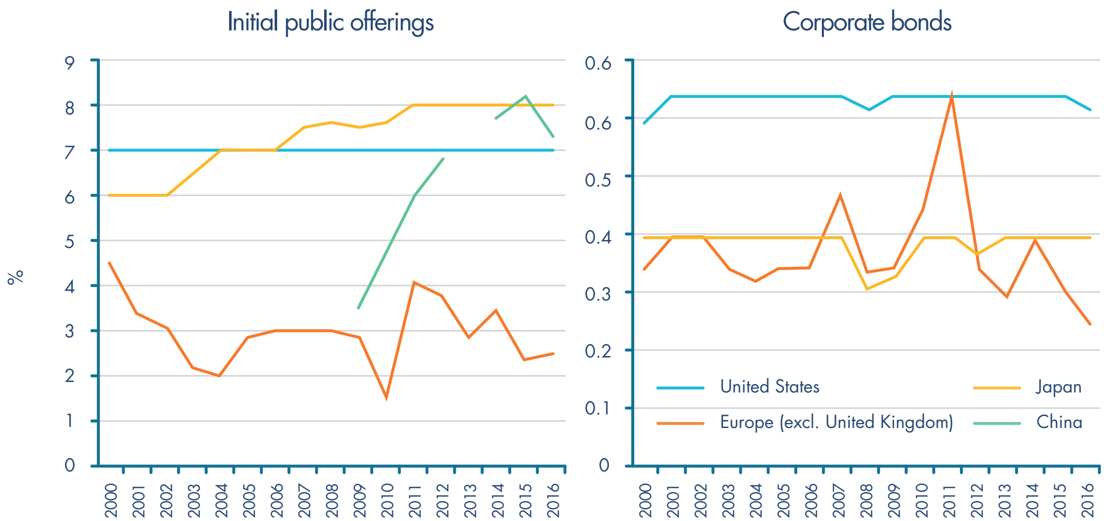
In executing these diverse roles, banks operate in a highly **competitive** environment and seek to be innovative, adaptable and flexible in serving their clients. In capital markets, as in banking, the **customer-bank relationship** is at the root of the banks´ drive to meet the specific needs of the customer in the context of a long-term relationship with the customer.

While banks are present in many dimensions of capital markets, their roles are particularly significant in the **publicly listed** equity, bond and derivative markets. As trading and clearing members of Europe´s public capital market infrastructure, they provide an important intermediation role between the investors and companies meeting on the centralised market places. In addition, banks are also present in **unlisted markets**, which are adapted to different needs, for example in terms of arranging private placements for companies. The myriad of needs met by banks reflects the rich spectrum of financing needs of companies and the investing needs of investors.

With their contribution to different parts of the ´**funding escalator**´ for companies, banks are a crucial part of the local, regional and pan-European **ecosystems,** that accompany companies on their journey from start-ups to scale-ups, to internationally successful champions.

It is worth noting that services such as underwriting are cheaper in Europe than in other large economies, such as China or the United States, which creates a positive setting for companies to go public.

Underwriting fees as a percentage of total proceeds, median values, 2000-2016



Source: OECD Business and Finance Outlook 2017.

On the other hand, due to wider structural constraints, investment banking activities have been shrinking in Europe (as well as in the US) by some measures. As the two following tables demonstrate, IPO activity is the area that has suffered the biggest decline in European investment banking activity.[17]

Changes in the market share of investment banking activities of top 100 banks worldwide, pre-crisis versus post-crisis

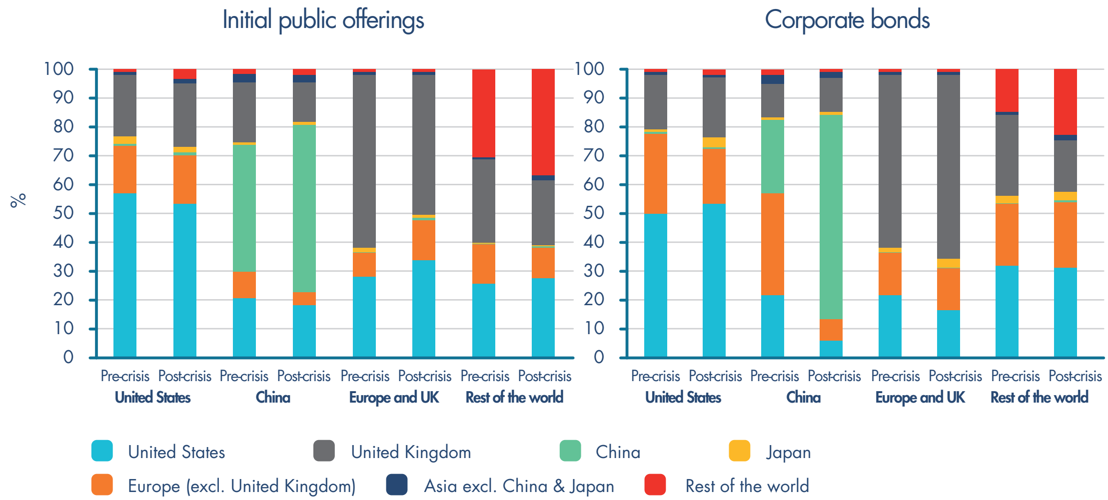
(Percentage points)

	Corporate bonds	Initial public offerings	Syndicated loans	Mergers and acquisitions
United States	-5.36	-1.24	-6.68	1.48
United Kingdom	-1.99	-1.85	-1.85	2.02
China	7.91	13.53	1.81	2.12
Japan	0.21	-3.17	5.76	-0.46
Europe (excl. United Kingdom)	- 3.27	-9.84	-2.66	-6.24
Asia (excl. China and Japan)	1.21	2.21	2.14	0.24
Rest of the World	1.23	0.37	1.57	0.83

Source: OECD Business and Finance Outlook 2017

17 OECD Business and Finance Outlook 2017

Market share of investment banks in underwriting, pre-crisis versus post-crisis



Source: OECD Business and Finance Outlook 2017.

Banks play a critical role in capital markets and, as such, support the EU's objective of overcoming the structural obstacles so that a growing pipeline of companies access capital markets and more investors are drawn to markets.

EUROPE NEEDS MORE CAPITAL MARKETS, BUT NOT LESS BANKING

If Europe needs more capital markets, does it mean it needs less banking? Quite the contrary. While certain benefits of capital markets are **unique**, so are many of the benefits of bank lending. In particular, the **long-term, bilateral bank-customer relationship** and the professional specialisation of a bank in **assessing the creditworthiness** of a customer or project. From domestic commerce to export finance, from working capital to long-term investment, from SMEs to global champions, from lending over payments to deposit-taking, **banks are critical to fuelling economic activity**.

The difference in the share of markets in the funding mix in Europe is the result of numerous **structural differences between the EU and the US**, such as the lack of a unified investor and company base which benefits from the same language, same company laws, etc. Some of these obstacles are possible to remove, while others are not. For this reason, the objective of reducing "dependency on banks" is overly simplistic. The focus must be placed on the promotion of financing in the EU, and not on replacing one type of funding with another. Such an approach will also allow **avoiding excessive risks arising from dependence on one funding model**. It must be borne in mind that capital markets, too, are vulnerable to economic cycles and market crises such as the one experienced in 2008.

Even if all obstacles were removed, arguably, the level of corporate need for banking would be higher in Europe. To take one example, the European economy is dominated by small companies. This reflects a combination of economic, historical and cultural factors that discourage firms from expanding and owners from selling. For many **SMEs** to get financing, **bank intermediation** is crucial to overcome information asymmetries and provide efficient credit assessment and monitoring. A review of MiFID II to promote SMEs' financial analysis further could encourage SME financing. Within the range of SMEs, only a small number will be suitable for accessing capital markets regularly. Even if European capital markets rose significantly, the economy would suffer if banks were unduly constrained in their ability to lend to companies.

Moreover, since **capital markets and bank financing are complementary**, Europe needs its banks to be strong in lending and in capital market services in order to achieve the multiplier effects between capital markets' financing and bank-based financing. Whether this complementarity works well will depend on the way financing solutions complement each other and are used to address financing gaps, namely the equity gap and the first-stage financing gap in a competitive and seamless financing chain. Properly designed and supervised, a Banking Union and a Capital Markets Union can create an integrated and efficient Financial Union.

With these considerations in mind, **Europe must build its capital markets in a way that retains the benefits of bank financing while facilitating the emergence of an increasingly integrated Capital Markets Union which is focused on investor and company needs and is appropriately regulated and internationally competitive**.

The urgency of the needs described above only increases with the departure of Europe's main capital market centre, London, from the Union as a result of Brexit. However, this creates also unique opportunity a necessity to redesign and reinvigorate the Capital Markets Union based on the needs and characteristics of the EU27 capital markets. **In the end, the European market needs to be i) fully integrated, ii) attractive to foreign investors, and iii) competitive with other markets around the globe.**

How regulatory conditions can help

As the European banking sector, we believe that both public and private sectors must come together to identify the most promising actions that would remove the obstacles to greater, deeper, and more unified capital markets in Europe. We acknowledge the financial sector's own role and responsibility in such a process and are willing to engage ourselves fully in the necessary work ahead. At the same time, we would draw attention to the need to ensure that bank lending faces no undue obstacles in order to guarantee the good functioning of the thus giving the Financial Markets Union optimal conditions for fostering growth and prosperity in the EU.

Some of the top priorities from a policymaker and regulator perspective:

1. **We need to review, and where needed, revise the current prudential regulation for both capital and liquidity issues where it hinders banks' lending capacity.** For example, the implementation of the final Basel III agreement is estimated to increase the cost of capital for large companies by a significant factor. Whether such an increase in cost is justified should be analysed carefully.

2. **Beyond capital requirements, companies' access to banks' basic services must not be constrained through excessive regulation**. For example, if a medium-sized business wants to open a new account in an emerging country, the bank has to comply with extensive, and recently, considerably increased know-your-customer requirements for the purpose of verifying the account holder's identity and preventing money laundering. The European banking sector has been fully supportive of these rules and considers this a necessary exercise. At the same time, the accumulative impact of such rules (in terms of costs of personnel, IT, processes) has increased substantially. For this reason, opening a foreign account may no longer be economically viable for the bank, which may only be able to offer this service in the context of a holistic customer relationship.

3. **Public and blended finance funds (such as those of the EIB, EBRD) must be used in a focused and anti-cyclical way to avoid the crowding out of private financing.** In certain countries, Central Europe, for example, public funds have sometimes led to excessive liquidity which has diverted scarce public funds away from real needs to projects that should be financed by banks. This diverts scarce public funds away from society's real needs.

4. **Retail cross-border services provision should be facilitated across the EU to create a truly integrated retail banking market**. Despite the efforts and successes of the Banking Union, the cross-border banking activity is still limited, which can be proof of the still remaining cross-border barriers which should be analysed, and the issues addressed. Digitalisation can make cross-border banking services' provision more agile, efficient and feasible; a factor that should be taken into account in the regulatory developments.

STRENGTHENING EUROPEAN CAPITAL MARKETS WITH COORDINATED ACTION

Benefits of greater capital market financing are not in question. Risk capital, which plays a key role in innovative entrepreneurship, is best provided through well-functioning capital markets. A deeper, more diversified and larger capital market strengthens the resilience of the financial system and mobilises greater amounts of savings that can be put to efficient use in the economy. Furthermore, at their best, capital markets spread asset ownership in the economy through equity holdings, provide for an efficient pricing mechanism for assets, improve company governance, reduce and manage risks through derivative products, and, last, but not least, enhance bank lending capacity through securitisation.

Despite the existence of a coordinated EU policy to integrate financial markets since 2000, and substantial international policy advice and capacity building since the 1990s, companies and investors in the EU still face national barriers and do not have access to a fully integrated market. In some regions, customers/companies do not even have access to a local or regional capital market. The patchy landscape of Europe has many geographic and sectoral gaps in terms of capital market capacity.

Moreover, the magnitude of capital market financing of the European economy has fallen as a percentage of GDP, from almost 90% in 2007 to 70% in 2016 (ECMI).[18] EU capital markets also remain much smaller compared to the US capital markets in terms of GDP (70% of GDP vs. 150% of GDP in the US in 2016 - ECMI).[19]

Europe must now move to strengthen and broaden public and private equity and debt markets thoroughly. However, one cannot ‘build’ capital markets ‘into existence’ through legislation. Capacity must emerge from incentives. This does not mean that regulation has no power. On the contrary, we need a new regulatory approach that supports capital markets. **The view of the financial sector, including capital markets, needs to change.**

The financial sector should not be seen solely as a bundle of risks that has to be regulated and supervised; its existential function is to intermediate finance from savers to investors and thus help to enable growth. Our common goal must be to allow finance to do its job in view of the severe challenges our societies and citizens are facing.

18 Appropriate ECMI reference.
19 Appropriate ECMI reference.

Based on banks' central role in capital markets, we see the following as the key priorities:

1. **Creating a Europe-wide discussion (e.g. through a "Wise Person Committee")** to define the fundamental, structural obstacles that stand in the way of an integrated Capital Markets Union. Such a discussion should help identify which areas require further progress in harmonisation (such as insolvency, accounting, and taxation) so that investors and customers can truly benefit from a unified market.

2. **We must consider best practices from regions that have successfully developed their markets**. For example, **savings' plans** that enable investors to invest in capital markets in a simplified way have been credited with boosting retail investors' participation in capital markets. Such plans, as well as other mechanisms of tax and accounting simplification, should be more specifically studied and possibly promoted. While these initiatives may go beyond the legal power of the European Commission, they should serve a coordinating and motivating role by identifying and promoting such best practices.

3. **We must develop and/or rebuild local ecosystems through regulation that is better adapted to the size of companies and markets.** Over the last 15 years, a lot of local capital market capacity has been lost due to regulatory and technological changes that have favoured centralisation. While this has led to some efficiency gains, it has come at a cost of local capacity. Direct membership of capital market infrastructure has become so expensive that companies and investors in certain markets can only access capital markets through a two or three-tiered banking system. However, a Capital Markets Union can only function if local and regional direct access is possible. We need to rebuild the missing local links by making it possible for local actors, in the ecosystem – banks, accountants, advisers, analysts, etc. – to fulfil their role efficiently and earn a decent income. This in turn is only possible through a more calibrated – and clearer, more coherent – regulatory framework. For example, the Authorised Market Practices under the Market Abuse Regulation is a good way of promoting positive local initiatives while maintaining the necessary balance towards convergence.

4. **We must develop private capital markets and alternative ways of financing to function as complements to capital markets**. Alongside public equity and debt markets and bank financing markets, we need alternative sources of funding (e.g. venture capital, mezzanine financing sources) to bridge the gaps between entrepreneurs and the public markets. While there is value in many types of funding in this area, we need to look more closely at best practices in banking such as the German *Schuldschein* model, which is a product similar to a private placement that mixes elements of a loan and a bond, offering companies access to an investor base that would otherwise be out of reach. Developed by the banking sector, this product has been tried and tested for decades and is currently spreading cross-border, attracting non-EU investors. Banks remain as intermediaries and ensure that companies have the most varied and flexible ways of financing at their disposal.

5. **We must foster the development of a pan-European securitisation market,** in particular for SME and real estate loans, with a review of the Securitisation Regulation.

6. **Prudential regulation (like financial market regulation) must not handicap banks' capacity to finance the economy in terms of funds available for, or the activities that can be offered in, capital markets**. The current prudential regulation, covering both capital and liquidity issues applicable to the banking sector, hinders banks' ability to provide intermediary services. More than a decade after the financial crisis, there is a need to start assessing if we have the right balance in capital requirements as well as in other regulations of bank activity. With this in mind, a study on the impact of prudential regulation (Basel III agreement, FRTB reform, etc.) on both the market liquidity and the functioning of the financial markets, should be undertaken. Capital requirements are needed for banks/investment firms to act as intermediaries and liquidity providers. Most importantly, there is no room for national particularities which prevent banks and other actors from offering their services cross-border.

7. **We must build an equity culture in Europe,** accompanied by a more supportive regulatory framework that allows retail investments in a range of products through modifications where necessary (for financial products (MIF II, PRIPS and IDD)).

THE NEED FOR INVESTOR PROTECTION AND FINANCIAL EDUCATION

A market needs investors in order to exist. A well-developed financial system relies on active investors who are willing and able to provide funding. Developing a European Capital Markets Union will require mobilising a substantial amount of savings.

To reach this objective, three crucial factors should be considered.

1. **Investors must be able to invest across national borders without undue obstacles.** At the same time, an appropriate and stable investor protection framework is needed, to allow investors to trust the market and to prevent risks from being transferred to the taxpayers. Initiatives such as cross-border distribution of funds or modification of the prospectus regime will be helpful when striking this balance. More can be done to make the framework more efficient for retail investors, e.g. by reducing redundancy of the information provided to clients.

2. **Retail investors must have greater choice and control.** Regulation must leave room for financial institutions to offer innovation and creativity to provide consumers with products tailored to their specific needs. An important principle is that investors must be able to invest in capital markets through both direct and indirect ways. There is a fine balance to strike between this goal and the goal of investor protection, the PRIIPs Regulation.

3. **Financial education:** While it is vital to strengthen consumers' trust in financial services through proportionate regulation, there is also a strong need to promote financial literacy. The EBF has spearheaded an industry initiative called the Financial Education Platform. Going forward, we will look for more ways of cooperating with the public sector and the rest of the industry to build up the skills of retail investors across the European Union.[20]

20 EBF on Financial Education: https://www.ebf.eu/priorities/financial-education/

COMPETITION NEEDS TO BE FAIR

The EU needs banks that face fair competition, both domestically and internationally. Only fair competition will ensure that the end-users – companies and investors – of banks and their competitors will have access to the best services, on the best terms. In the absence of fair competition, not only will banks lose market share, but customers will, in the end, face worse terms.

Three major aspects are affecting competition in the European financial sector:

1. **digital field**
2. **international competitiveness**
3. **attractiveness to the rest of the world**

In the **digital field,** a new playing field is being created with the appearance of new non-banks, especially 'fintech' companies. Technological developments must be encouraged to improve the efficiency of banking and capital markets in the coming years. The regulatory framework must allow this while ensuring investor and customer protection, transparency and a level playing field based on equal treatment of incumbents and entrants.

While new technologies must be encouraged, any undue advantages for newcomers will harm competition and damage efficiency, investor protection and stability in the long run. The EU needs banks which can be strong partners in a digitalised world. Banks must operate in a setting of fair rules applicable to all players. The same services and risks should be subject to the same rules and the same supervision. Banks are adapting their business models to new demands from the economy while retaining their core values and principles, and, in particular, while complying with ever-increasing critical compliance requirements (AML, KYC, etc). As long as all competitors operate under the same conditions, banks can work in partnership with non-banks, to the benefit of the customer. Conversely, if banks have to compete with non-banks on unequal terms, they may be forced to withdraw from certain business lines or abandon them completely. Expertise, built up over decades, would be lost. These financial services would no longer be available to businesses or households in the way they are now.

The second element regarding fair competition relates to the **international setting.** For European banks to continue to play an important role in the international economy, they must face fair competition. This requires striking a balance between the protection of markets and investors within a globally consistent framework, and, the autonomy needed in the financing of the EU economy. European banks must be able to compete fairly. For example, US investment banks have recently become subject to smarter regulation. The financial market regulation in the EU should also be revised to make sure that its actual goals are met. Otherwise, the new US policy will have an adverse impact on EU companies, inter alia, on their cost of capital compared to their US counterparts, translating into competitive disadvantages in the global markets for goods and services.

Finally, the EU's capital market must **remain competitive and open to foreign investors and markets** in the future. It is important to maintain the attractiveness of the EU markets for foreign investors, intermediaries and issuers, while retaining the EU's sovereignty in setting its own regulatory and supervisory framework and safeguarding the interests of its Single Market.

EUROPEAN BANKS COMMIT TO SUSTAINABILITY

Underpinning our vision of a stronger and more integrated Financial Market Union is the financing of a **sustainable economy**.

Public and private initiatives are both crucial for financing the Europe of tomorrow and future generations, accelerating sustainable development and unlocking funds required to build durable societies. With the EU and its partners in a leading role, we need to define a sustainability path, up until 2050, to align the development of long-term sustainable finance with political objectives. Financial and environmental policies and the relevant regulatory framework must be **coordinated** across government agencies and departments to ensure that financing reaches the intended goals. We underline that a **holistic approach** is needed to avoid the overlapping of initiatives carried out autonomously by different institutions or agencies of the EU.

While being ambitious, Europe must also consider the limits of sustainable finance, which addresses the set of risks associated with wealth generation and investment, and cannot prevent the impact of extraction, acquisition and deterioration of resources. We support a gradual shift towards a **more circular economic paradigm** – as is currently promoted by the EU – to reduce the risks of excessive resource use and over-dependency on foreign raw materials.

We are especially keen to see that the European Commission recognises the importance of **private finance** in order to achieve its goals. For this reason, it would be beneficial to promote a **stable cooperation** between public and private actors. Such private-public partnerships would also be in the interests of **consumers and investors**, who are becoming increasingly concerned about how their spending and investing habits potentially affect the environment and the need to promote sustainable growth or mitigate climate change.

Banks can play a key intermediation link to a greener and sustainable business environment. We regard taking responsibility for a future low-carbon economy as an essential for European banks. The Sustainable Development Goals provide significant indications in this regard. European Banks are also fully committed to mitigating the risks and seizing the opportunities of a low-carbon and climate-resilient future and have launched many initiatives in recent years to promote and consolidate sustainability.

There are many **international best practices** that could be actively promoted. Existing financial products, including bonds, securities, and hedging instruments are being redefined and new investment solutions are being created to meet the increasing demand for green, social investments. In particular, a number of banks have been working together with the UNEP Finance Initiative to develop analytical tools and indicators to strengthen the assessment and disclosure of climate-related risks and opportunities. Banks have welcomed the recommendations proposed by the **Financial Stability Board's Task Force on Climate-Related Financial Disclosures**.

Public entities need to act as **facilitators of sustainable projects**, unlocking the possibilities of private financing, allowing a better screening and monitoring of initiatives, together with a common taxonomy that would provide banks with a sound and reliable basis for setting their high-level policies for credit allocation.

In this context, we, European banks, support the **European Commission's Action Plan on Sustainable Finance** to achieve the Paris climate targets and will align with their plans to deliver on these goals. In particular, the EBF as a recognised representative of those European banks would be happy to support the work of the Technical Expert Group on Sustainable Finance on a **sustainable finance taxonomy** as the cornerstone for the other actions of the EC's Action Plan, such as, the promotion of a European label for sustainable finance.

Within the Action Plan, the EBF recommends the following actions.

1. **Capital requirements for nuancing and investing in green assets and projects must be analysed further while ensuring financial stability.** The EBF sees merit in incentivising green lending and investment without jeopardising the credibility and effectiveness of the current risk-based prudential network in the EU. Any such mechanism must be based on a solid analysis and adequate data. Hence, we support a sequential approach: first, work on the taxonomy and disclosure must clearly define what is green; second, risk measurement must assess the risk profile of green projects; third, if there is evidence, prudential requirements must match the risk profile.

2. **Climate change and sustainability must be embedded in the EU decision-making process.** With regard to the discussions on the new post-2020 EU Multiannual Financial Framework, climate change and sustainability issues should become a dominant cross-cutting trend across all the EU budgets. Similarly, the EBF suggests that *ex ante* impact assessments of EU legislative proposals be accompanied by a climate impact assessment and an assessment of how they will contribute to the Paris Agreement objectives.

3. **Rules affecting public investments must be streamlined.** Sometimes the rules on state aid and/or European accounting rules for public bodies can make environment and climate investments more difficult; the EBF asks the Commission to check whether there is room for making these investments more appealing in accounting terms without jeopardising the objectives of these rules.

In conclusion, the new framework that will be ushered in by the Sustainable Finance Action Plan should fuel the development of innovative and sustainable products. European Banks will fully engage in this process and push the boundaries to ensure that they are at the forefront of all progress.

Brussels / 56 Avenue des Arts, B-1000 Brussels
Frankfurt / Weissfrauenstrasse 12-16, D-60311 Frankfurt am Main

+32 2 508 37 11 **www.ebf.eu** **info@ebf.eu** **#ebf**

twitter.com/ebfeu
linkedin.com/company/european-banking-federation-ebf-