You often hear people describing what is happening in Europe as a debt crisis. I think in Europe as a whole we have a debt problem but we have a growth crisis. What ultimately matters for Europe is not just the debt itself, but the debt dynamics – and that is a question of growth.

Exhausted mainstream politicians across the EU, having committed themselves to austerity for the last three years suspect, rightly in my view, that a return to growth is about all that can save them at this point.

The next political cycle is going to be about growth and the new European Commission in 2014 will no doubt launch itself as the “growth Commission”. This time they, and the EU member states, need to mean it and stick to it and make the difficult choices that deliver it, both in respect of the Eurozone and the Single Market. Britain should, of course, be maximising its influence within the EU to help achieve this, not marginalising itself.

I think what we’re interested in today are the areas where the intermediary role of financial markets becomes key to growth. Where they channel investment and why, and with what net outcome for long-term growth.
In its recent Green Paper on long term investment in the EU the European Commission pointed out that the EU faces a particular squeeze on medium and long term investment as banks shrink their balance sheets and risk averse investors pull back from what they see as riskier asset classes – asset classes like business lending and capital for infrastructure that are key for growth.

**Capital for growth businesses**

- Both in policy and political terms we start with a basic question here which is: to what degree can or should we be trying to influence the incentives in credit or capital markets towards our favoured recipients of capital? Markets are imperfect although regulators and ministers are hardly geniuses either.

- But consider this. The UK in the City of London has some of the deepest credit and capital markets in the world. But in the years leading up to the crisis of 2008, UK banks were extending less than 10% of their lending to UK companies. The rest was wholesale lending or consumption or property lending.

- Now, I struggle to see that as an optimum outcome for the UK as a whole. But it makes the point that what we need from the economy as a whole is not more lending and more credit but better targeted lending and credit.
We can experiment with using risk weights to incentivise SME lending, but risk weighting can’t really change the fact that lending, especially to SMEs, is among the more risky kinds of debt. So we need a mix of improved financial education for business borrowers to help improve their credit worthiness, and banks more committed to the particular discipline of patient lending to growing businesses.

The ECB has also experimented with allowing banks to borrow from it against securitised packages of business loans and I wonder if there is scope for other forms of securitisation – ‘EU small business bonds’? You’re the experts – you tell me.

SMEs are very politically fashionable, and they are obviously vitally important to the European economy. But we also need to remember that nine in ten SMEs in the EU – which basically means nine out of ten European companies - employ one or two people, never borrow significantly and don’t scale up and grow.

They deserve brilliant, cheap banking services, including short term credit like overdrafts to cover cash flow. But they are not where we need to look for major finance for growth.

It seems to me that one of our interesting political and policy challenges is coming up with targeted solutions for that relatively small group of companies that do scale and grow. They tend to be run by people who
don’t want to surrender their equity in the company to a venture capitalist, and they often don’t have the borrowing record and the assets to collateralise large loans. They often look too risky for commercial lenders and they are too small or untried to borrow on capital markets.

- My gut feeling on growth capital when I was in government after returning from Brussels was that we could try and play around with the incentives on large privately owned banks to get them to lend— which is capital intensive and is risky – or we can start with an institution whose incentives are different.

- A few banks here in the UK have experimented on a small scale with hybrid mezzanine funding for growth businesses like this, in some cases updating the state backed model we experimented with in the UK in the 60s with the ICFC. But it is hard to build a commercial banking model on it – which is not the same as saying it is unprofitable on the right timeframes and with the right incentives.

- That seems to me to be the strength of the German KFW bank that we studied in government, and the rationale for the idea of the Green and Business Banks that the coalition government has inherited from its predecessor. Maybe there are other good examples from across the EU that we can examine, even, dare I say it, in France. But it seems to me that this is the next policy frontier – combining the lending disciplines of the private sector (but not the
short term profit incentives) with the patient capital and creditworthiness of the state.

- It is worth mentioning in passing that there is also an elephant in room in the form of the Eurozone crisis. We talk about the toxic link between banks and sovereigns in the EU, but we also have a form of contamination from sovereigns and banks to business lending. Because wholesale rates vary so much across the Eurozone, pretty much identical businesses pay different costs of capital in different parts of the EU.

- This is a problem will only truly be resolved by fixing the underlying perceptions of sovereign and bank weakness, which is a large part of what Banking Union is about and why its formation is necessary. But in the meantime it is adding to the obstacles to recovery in southern Europe and undermining the whole notion of the single market for capital.

**Growth capital for infrastructure**

- The same questions of risk and return seem to me to attach themselves to the 2 trillion euros in new infrastructure investment the Commission estimates that we need by 2020. A large part of this is going to have to come from private capital but while the attraction of infrastructure as a mature asset for institutional investors is clear enough, the challenge has always been with construction risk.

- It seems to me that governments are often quick to exhort on investment in infrastructure, but typically
slower in producing the kinds of bottomed out propositions and commercial structures needed and that the market needs to make investment decisions with the specific risks attached to construction.

- They can also be slow to accept that investors need income from infrastructure and that can often mean an element of user pays. That is the trade-off for taking the taxpayer out of the picture upfront.

- Still I see a couple of interesting European developments here also. The EIB has just launched its first Project Bond for the Castor gas storage facility in Spain. The EIB took 300mn of the 1.4bn issue itself as an anchor investor. Nine further energy and transport projects have been approved in six EU countries.

- We come back to the point about the right mix of public and private. The EIB acting as a credit enhancer in this way seems to me to be the right way of thinking about how to deploy the public balance sheet – especially given the retreat of the big financial insurers in this area. The EBRD have a wealth of experience to draw on here also, including in their experience of getting governments to produce investment-ready projects and to progress them properly even when the finance is available.

- I know that the UK is looking at something similar – probably a form of guarantee – for infrastructure lending by insurance companies, who should in principle be ideal creditors for the long term stable
returns on infrastructure. To make a success of this insurance companies will need to develop their own depth of experience in infrastructure portfolio management.

- As with SME lending, securitisation may also have a role to play here. At least one EU bank has plans to develop an ‘originate and distribute’ model for infrastructure lending, using securitisation for institutional investors to spread construction risk rather than syndication across a group of banks. This is an interesting model – but I suspect it will still need to be combined with some public participation to take off the sharper edge of construction risk – especially for the largest projects.

Some political conclusions

- I think we can identify a few key political threads here and I want to finish by tugging on them.

- First, I started by posing a question about the way we think about trying to impose political or social priorities on the flow of capital or credit. I think this is a legitimate area of interest and activity for government although you don’t have to look much further than the Chinese banking system to recognise the risks of politicised lending in pursuit of growth. The market’s role in pricing risk is imperfect, but it is vital.

- But that still leaves us with a problem if the perception of risk for the things we need – like large-
scale renewal of our infrastructure or growth capital for innovative but untested businesses - is greater than investor appetites. Especially if we want these investments at scale and need to enlist the hundreds of billions in patient capital locked up with Europe’s more risk-averse institutional investors.

- So we do need to think about ways we can use state guarantees or the public balance sheet to change the risk dynamics for private capital. Not in a way that turns the taxpayer into a patsy for private profit-making, but in a way that reflects the inherently joint public-private exercise of financing the foundations of growth. The whole discipline of public investment in growth in Europe needs a new generation of finance professionals to drive this forward.

- Second, and for this reason, I think the next political cycle needs to be defined by a much greater sense of collaboration between policymakers and the financial services industry. For the last five years policymakers have been understandably committed to fixing a system they believed was out of control. We have tried to a do a huge amount and we are bound to have got some of it wrong – we might as well accept that and be ready in due course to keep an open mind about reviewing it.

- The industry’s frustration and warnings about the unintended consequences of regulation have too often sounded a bit self-interested, but they have a point. The next political cycle needs to be a calmer assessment of how our new regulatory settlement is
holding up against the kind of priorities I have described today.

- I also think there are real, growing issues of financial inclusiveness – tougher conduct rules risk driving a lot of retail investors away from equity ownership, or the kinds of packaged investment products that might channel savings towards infrastructure – as the Commission has proposed with its idea of Long Term Investment Funds.

- We need a conduct model that keeps the access to financial expertise cost effective, accountable and inclusive. We need a prudential model that does not choke off the kind of lending and risk-taking we need for growth – by which I mean sustained, economy-wide growth, not just growth in bank profits and returns on equity. This is not industry special pleading – it is an urgent warning about the need to see regulatory change in the round.

- After a decade in which finance in Europe lost its way in some respects – both as an industry and as a field of regulation – we need a decade in which both sides redeem themselves by creating the conditions for financing our future.

- I actually think that this is a huge and fascinating challenge for the finance industry and finance professionals and regulators. If I can paraphrase Lord Turner, it is the very definition of ‘socially useful’.
And if I can end on a slightly parochial – but I think profoundly important - third point. I have deliberately stressed today the European nature of these problems. The cost of capital for an SME in Andalucia rolls up to decisions in Frankfurt and what is or is not agreed on Banking Union in Brussels. 80% of the debt of the EIB Castor Bond was taken up by institutional investors in Europe but outside of Spain. The notion of a single market for capital goes to the heart of the European Union.

If that single market in capital has a capital, it is London. That’s the reality. The capital markets experience and expertise in this city is an asset to Europe, just as Europe is the market for credit and financial expertise that sustains London more than any other outside its own domestic one. Two sides of the same coin.

London’s frustration at the pooling of European sovereignty on financial markets regulation is often overstated and poorly expressed. But it reflects the extent to which that regulation is often felt in this city disproportionately more than anywhere else.

Losing London’s place in the EU and its influence in the EU on these questions would be a tragedy for both the UK and for Europe. So without wanting to stretch the point, I would argue that the question of how we keep the UK politically engaged and influential in Europe is critically important for Europe’s growth – a point that is frequently made to me by continental business people and politicians.
It is also, come to think of it, rather important for AFME’s future! And on that note, perhaps I can conclude.

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