

Funding the EU economy

The role of banks and financial markets



The role
of banks
and financial
markets in the
economy

Lending

By making loans to customers, banks create the credit needed for infrastructure, education, investment and growth, and allow savers and investments to be linked.

Liquid and efficient markets

Market makers bridge sellers' and buyers' needs. This way, markets remain liquid and investing, raising money and managing risks is made possible.

Providing infrastructure for payments

Banks facilitate payment services needed by households and businesses to carry out day-to-day transactions.

Offering tools to manage risks

Financial instruments are made available to remove or mitigate risks linked to interest rate changes, currency exchange rates, prices of commodities, raw materials and energy products.

How is the EU economy funded?

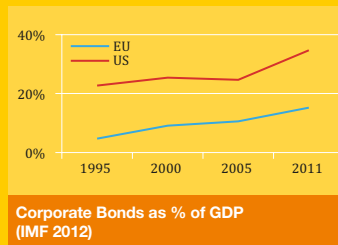
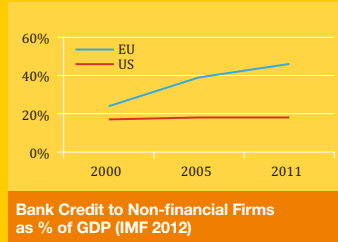
Bank loans remain the main source of financing of the EU economy, but EU corporates are increasingly raising funds from bond markets and other funding sources

Traditionally **the non-financial corporate sector in Europe depends on banks**. Around 70% of its debt financing is provided by banks. This contrasts with the US, where bank financing is around 30% of debt.

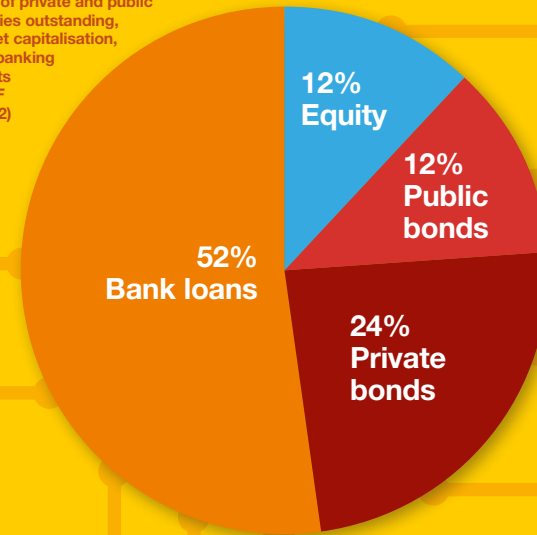
Constraints faced by the banking sector **could lead to a large corporate funding gap**.

Developing deeper and more liquid corporate bond and stock markets by complementing and substituting bank intermediation will be crucial to address this gap. Banks will remain the primary lenders to small and medium businesses due to the size of transactions and the local nature of commercial relationships.

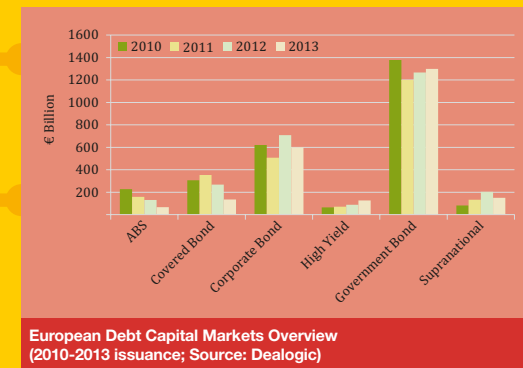
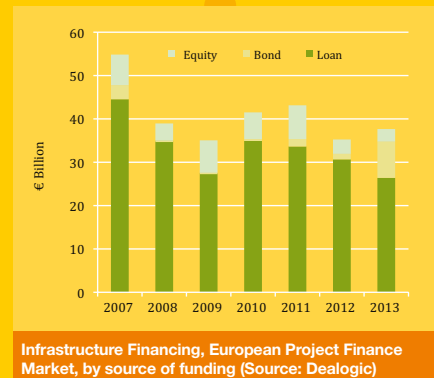
Trade: Bank trade finance is vital in promoting international trade, particularly for SMEs, which need support when expanding into foreign markets. The chart shows the flow of bank-intermediated trade finance provided in 2011, compared to EU trade with non-EU countries. (Source: BIS estimates)



Percentage of private and public debt securities outstanding, stock market capitalisation, and formal banking sector assets (Source: IMF GFSR 4/2012)



Infrastructure: Bank loans remain the main source of funding for project finance. After the crisis, these loans are growing again, although still below their pre-crisis level of €55 billion in 2007. (Source: Dealogic)



Bank lending and bond issuance: Between 2008 and 2012, the level of outstanding loans remained stable, despite strong pressure on banks and corporates to deleverage. However, since 2007, larger corporates have increasingly gone to capital markets for their funding needs.

Liquid capital markets to allocate resources efficiently

Corporates, governments, investors and other types of market participants need consistent access to a broad set of funding and investment opportunities at fair, accurate and transparent market prices. Matching sellers with buyers for a given asset, time and transaction size can be very difficult. In these cases, banks act as market makers, using their own capital and holding the asset, until a buyer or seller can be found.

Who wants to sell?

- An individual sells stock to realise gains on investments
- A government issues debt to raise funding for public projects
- A company issues additional shares to fund a new factory, creating jobs
- An entrepreneur sells equity or debt to raise capital for growth and expansion plans

Sellers

Individuals and institutions that seek to raise funds or to manage their risks

Financial Intermediaries
Bridge buyers' and sellers' needs and help determine a market price, so that resources can be allocated efficiently

Buyers
Individuals and institutions looking for investments

Who wants to buy?

- An investor buys stock in a publicly traded company
- A company buys foreign currency to operate in other countries
- A pension fund buys assets to generate a return or to manage the risks in a portfolio

Global Capital Markets
Equity and Debt Markets

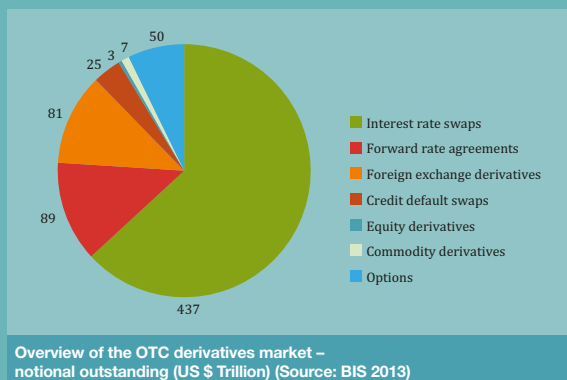
Secondary Markets
Enable the buying and selling of previously issued securities. Most of the activity in the capital markets takes place in these markets

Primary Markets
Governments and companies raise cash by selling newly issued securities to buyers

Providing tools to manage risks

Banks perform important risk-management services; diversifying and hedging risks in the real economy.

They offer their clients a broad range of tools to diversify and manage risks, and are essential to global economic activity and growth. This enables companies, investment managers, governments, insurers, energy and commodities firms to better control their financing costs and avoid the risk of volatile interest rates. They can also hedge their exposures to exchange rate risk, and better predict and control their energy costs. Banks themselves use derivatives to manage their interest rate risk and offer better services and prices to their customers.



Enabling payments

Banks offer safe, low-cost and reliable physical and electronic mechanisms to make payments for goods and services and to transfer money domestically and internationally. This facilitates savings, minimises risk and allows easy access to funds. It also provides for legal and operational reliability across all financial contracts, products and transactions.

A reformed, more resilient financial system

A multi-year effort by policy-makers and financial institutions has made the financial system more resilient and better able to contribute to sustainable growth. More than 40 major pieces of legislation in the EU have radically reshaped the way markets operate.

Reducing the risk that banks fail

The level and quality of bank capital and its capacity to absorb losses has been enormously increased. Banks will have to hold strong liquid asset buffers to be able to withstand liquidity shocks (Basel III / CRD IV package).

Solving the 'too big to fail' problem

There are new tools to deal with failing banks, including resolution powers to ensure that losses are borne by shareholders and creditors rather than taxpayers. These will address the issue of banks being considered 'too big to fail' and ensure that bail-outs are a thing of the past (Bank Recovery and Resolution Directive).

More resilient and transparent markets and infrastructures

Standards and transparency requirements across all EU trading venues have been strengthened (MIFID II Directive and Regulation). EU reforms improve transparency and reduce the risks of derivatives that are traded over-the-counter (EMIR Regulation). Requirements for settlement systems have been enhanced (CSD Regulation).

Reducing the risks from the wider system

Shadow banking is an important source of funding for the real economy. Several initiatives to reduce potential risks associated with it have been launched (AIFMD Directive, MMF Regulation).



**More stable
and safe**

**A reformed, more
resilient financial
system that serves
the economy and
contributes
to growth**

**More
transparent
and fair**

**More
integrated
and
efficient**

Transparent and reliable information

Rules to better prevent, detect and punish market abuse (Market Abuse Regulation and Directive) and rules on financial benchmarks will increase integrity and confidence. The rules on credit rating agencies aim at increasing the quality of the ratings.

Improving the protection of depositors and consumers

Protection for depositors has been enhanced (stronger safeguards in the DGS Directive and 'depositor preference' introduced in the Bank Recovery and Resolution Directive). Strong information standards for financial advice and distribution for a broad range of financial products have been established.

Stronger supervision and a single rulebook in the EU

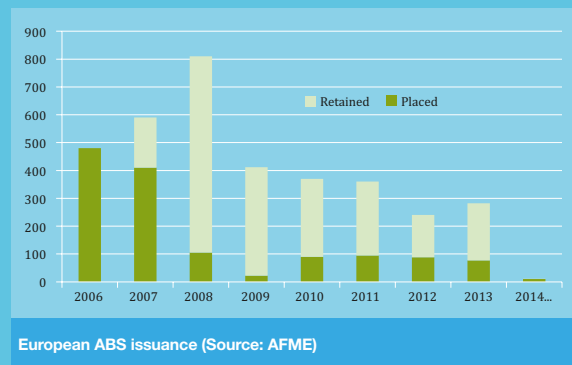
A single set of uniform rules for the financial sector and uniform application across the EU complements the European System of Financial Supervisors (ESFS), which will promote consistent supervision and coordination.

Banking Union

The creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) is a major step. It will ensure single mechanisms for prudential supervision and resolution of banks in the Euro area and other participating Member States. It will also remove the negative sovereign-bank feedback loop that weakened banks and sovereigns in some Member States and fragmented the single market.

Reviving securitisation, promoting growth

A recovery in the securitisation market can play an important role in unlocking credit markets and supporting a wider economic recovery across Europe. High-quality, prudently designed and regulated securitisation, “has the potential to improve the efficiency of resource allocation in the economy”¹



EU securitisation markets have been shrinking significantly in recent years. A reversal of this trend will require a forward-looking approach by policy makers.

Is securitisation safe?

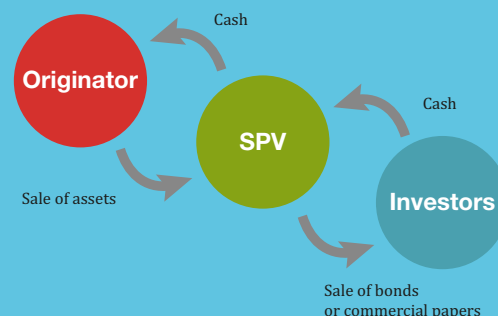
For some, securitisation still suffers from the stigma associated with its misuse before the crisis. However, it is vital to recognise that, while some securitisations – for example, subprime mortgages in the US – performed badly, European securitisations have performed well, through and since the crisis. Securitisation is nothing more than a financing technique and, when used sensibly, can help banks raise funding, and support new lending to SMEs and other key players in the real economy.

A broad range of regulations and industry initiatives has been put in place since the crisis, ensuring better alignment of risk between issuers and investors. In addition, greater transparency requirements enable investors better to assess risks. Reliance on credit ratings has been reduced, and rating criteria tightened. This will provide the basis for a new, sustainable market for high-quality securitisation in Europe.

¹ Joint statement of the ECB and Bank of England, 2014

What is securitisation?

Securitisation is the process of pooling together a large number of loans (such as mortgages, auto loans or SME loans) held on the balance sheet of a bank or other financial institution (the “originator”) and selling them to a newly created and legally separate entity (“special purpose vehicle” or SPV). This entity finances the purchase of the loans by issuing bonds to investors. The loans generate cash flows (eg the monthly mortgage payments from house owners), which are used to repay the investors. In this way, loans which would be illiquid can be converted into more liquid and tradable securities.



Because large numbers of loans are used, statistical analysis can determine the likelihood that some of them will default. Therefore, the bonds can be divided into different tranches with varying levels of risk. The lower-risk tranches can raise funding on very attractive terms while higher-risk tranches yield a higher return for investors.

Why it is important

At a time when bank lending is constrained, securitisation can boost both credit and growth. For example, a carmaker, expecting lots of monthly payments from customers who have taken out financing, can get investors to fund its business more cheaply by selling them its claim to those payments. A bank receiving mortgage repayments can bundle such loans up and sell them or use them as collateral to get funding, which it can then use to issue more loans to the real economy. Securitisation can be a vital funding tool in Europe and a channel for borrowers to access the capital markets.

About AFME /

AFME is the voice of Europe's wholesale financial markets. We represent the leading global and European banks and other significant capital market players. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

We believe that liquid capital markets and a well-functioning banking system are central to any successful modern economy. Together they enable investment in economic growth, channel funds from companies and households with surplus cash to ventures and projects that need funding, and help corporate users, investors and institutions to hedge risks and plan for their financial future.

Through our offices in London and Brussels we:

- Offer a voice for Europe's capital market participants and advocate their views at national, EU and global levels
- Build constructive dialogue with regulators and policymakers
- Offer our policy and product expertise to help achieve a balanced and stable regulatory environment
- Promote the contribution of the financial sector to society

Priorities

AFME's overarching priorities, agreed by its Board, are:

- Funding growth in the real economy through well-functioning capital markets
- Prudential Regulation – shaping the implementation of CRD4 and Basel III
- Capital Markets – leading debate on the goals for MiFID II
- Global FX – advocating consistent, coherent global regulation
- Taxation – scrutinising the proposed Financial Transaction Tax
- Securitisation – helping to restore confidence and restart the market
- Resolution – creating a robust international framework
- Banking Union – supporting EU policymakers in developing the new framework

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