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Finance for Europe

AFME EDUCATIONAL SERIES

The role of banks and financial markets in the economy

The main functions of banks and financial markets in the economy

The financial system is critical to the functioning of the EU economy and banks play a key role in supporting it. Banks and the broader financial markets, in addition to providing substantial employment and generating considerable tax revenues, serve four main purposes:

I— ***Credit provision and capital formation***: banks act as intermediaries in allocating funds from savers and investors to borrowers, whether they are individuals, businesses, corporations or the governments. Their loans support economic activity by enabling businesses to invest beyond their immediately available cash. They also allow individuals, for example, to purchase homes without saving the entire cost in advance, and governments to finance large infrastructure and other projects and to smooth out their spending by mitigating the cyclical pattern of tax revenues. Banks directly provide the main source of financing of the EU economy. When active in primary capital markets, banks help companies and governments to access finance by providing underwriting services: the bank guarantees that the amount of financing that the client wants to raise will be available by committing to purchase, at a pre-determined price, any newly issued equity shares or bonds that are not taken up by investors. By removing this uncertainty for the client, investment banks facilitate access to capital markets.

II—***Liquidity provision***: In addition to providing businesses and households with the ability to deal with unexpected needs for cash (through bank deposits that can be withdrawn any time and/or lines of credit), banks are at the centre of the financial markets, by acting as market-makers offering to buy and sell securities and related products at need, in large volumes, with relatively modest transaction costs. Market-makers bridge sellers' and buyers' needs which often do not coincide. This way, markets are able to remain liquid and investing, raising money and managing risks is made possible.

III— ***Risk management services***: Banks - mainly through derivatives contracts - offer businesses and investors tools to remove or mitigate risks linked to changes in interest rates, exchange rates, prices of commodities, raw materials and energy products. This way, they can focus on their key areas of expertise.

IV— ***Enabling payments***: Banks are largely responsible for the payments system. Electronic payments are becoming more important as people use less cash. This means that banks are processing more card payments, transfers, direct debits, etc. every day. The payment system also includes financial market infrastructure for payments, securities and derivatives, which is a core component of the financial system. Without the ability to conduct transactions safely and efficiently, modern economies would not function smoothly.

Credit provision & capital formation

Banks (by making loans to customers) and capital markets (by allowing the issuance of shares and debt instruments) create the credit and capital needed for infrastructure, education, investment and growth, and allow savings and investments to be linked.

Liquidity provision

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

Tools to manage risks

Banks offer businesses and investors tools to remove or mitigate risks linked to interest rate changes, currency exchange rates, prices of commodities, raw materials and energy products. This way, they can focus on their key areas of expertise.

Infrastructure for payments

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

Credit provision & capital formation in the EU

As shown in the graph below, 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 has heavily relied on banks' loans: around 2/3 of its debt financing is provided by banks. This contrasts with the US, where bank financing is around 30% of debt. Compared to the US, access to capital markets in the EU remains less developed.

The capacity of banks to lend is determined by the amount of capital that they hold, with regulatory limits placed on the amount of lending that banks are allowed to undertake for a given amount of capital. A significant amount of banks' capital is held in the form of shares or equity that they have issued. During periods of economic turmoil, the value of banks' loans could be negatively impacted as some borrowers become unable to meet their obligations. Where, as a result, banks suffer losses these reduce the value of their equity and can force them to reduce their lending or other assets in order to meet regulatory requirements. This process, known as deleveraging, is procyclical i.e. it may act to worsen the economic downturn that gave rise to the banks' losses in the first place. When this happens, market-based finance, can act as a 'spare tyre' – compensating for the shrinking bank lending during crises and avoiding a large corporate funding gap, which might otherwise further depress economic growth.

This is why developing deeper and more liquid corporate bond and equity markets is a key objective of the EU and of its Capital Markets Union project.

As many academic analyses have shown, banks and capital markets are not competing with each other for a limited number of investment opportunities; and capital markets are not a threat to more traditional banking models. Banks and markets are essential and complementary tools to finance the real economy.

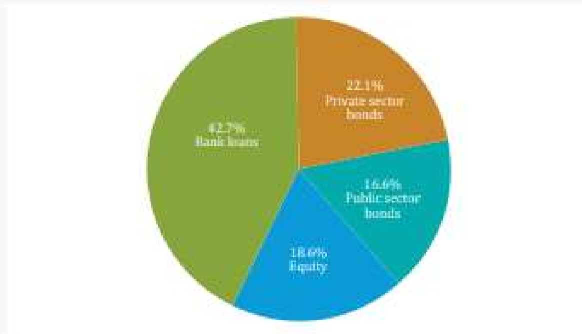
A corollary of this is that key EU projects like the banking union and the capital markets union are two mutually reinforcing initiatives, necessary to achieve the full benefits of the EU Single Market for financial services. The CMU can help enhance and broaden financing options through capital markets. This diversification objective is important for financial stability reasons. It is also particularly important for innovative and fast-growing businesses, for which access to risk capital and to capital markets is crucially important, given the specific risk profile and business needs of start-ups with very high growth potential[1].

In the EU, banks will remain the primary lenders to small and medium businesses due to the size of transactions and the local nature of commercial relationships.

[1] AFME's report on "The Shortage of Risk Capital for Europe's High Growth Businesses", published in March 2017, outlines the existing sources of risk capital for growing businesses, why shortages occur, and highlights recommendations for policymakers. Earlier AFME publications focusing on unlocking growth and jobs in Europe include: "Bridging the Growth Gap", which highlighted the gaps in equity and debt financing for small and mid-sized companies and "Raising Finance for Europe's Small and Medium-sized Businesses".

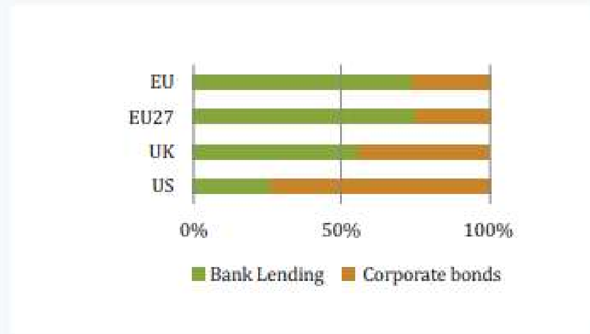
How is the European economy funded?

Figure 1: **Percentage of private and public sector debt securities outstanding, stock market capitalisation, and formal banking sector assets**



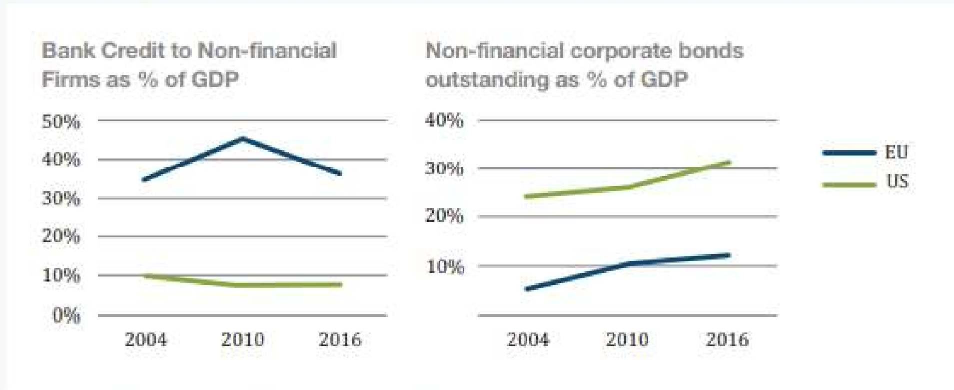
Source: ECB, AFME - 2016

Figure 2: **Bank lending vs corporate bonds as a % of corporate debt (3 years to 2015)**



Source: ECB, US FED, IMF

Figure 3: **Comparison EU / US**

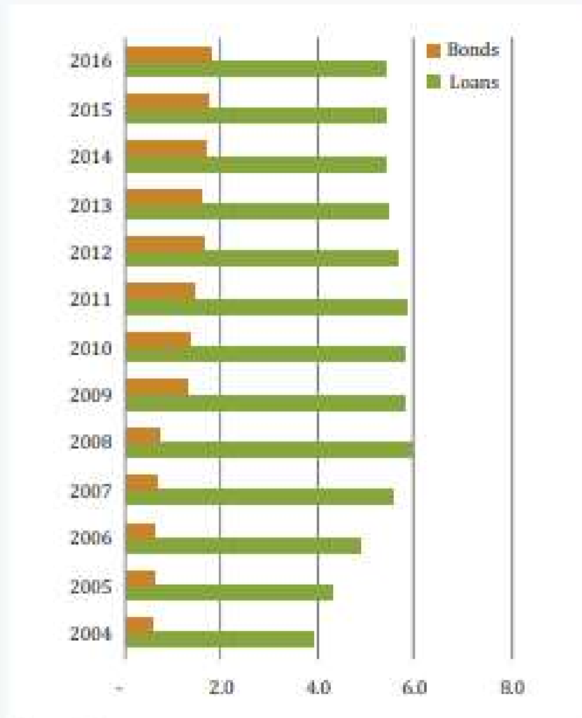


Source: ECB, Eurostat, US FED and World Bank

An overview of EU debt and equity markets

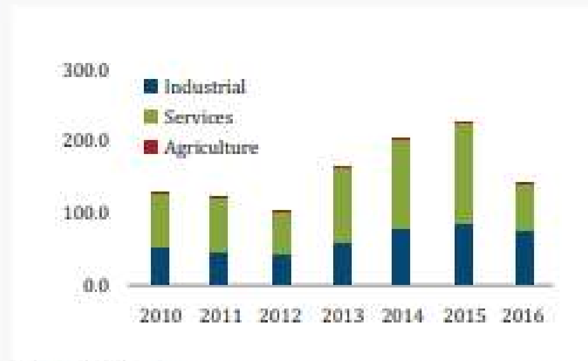
***Bank lending and bond issuance**: The graph below shows that between 2008 and 2016, the level of outstanding European non-financial corporate loans remained stable, despite strong pressure on banks and corporates to deleverage. However, since 2008, larger corporates have increasingly gone to capital markets for their funding needs.*

Figure 4: **European Non-financial Corporate Debt outstanding (tn €)**



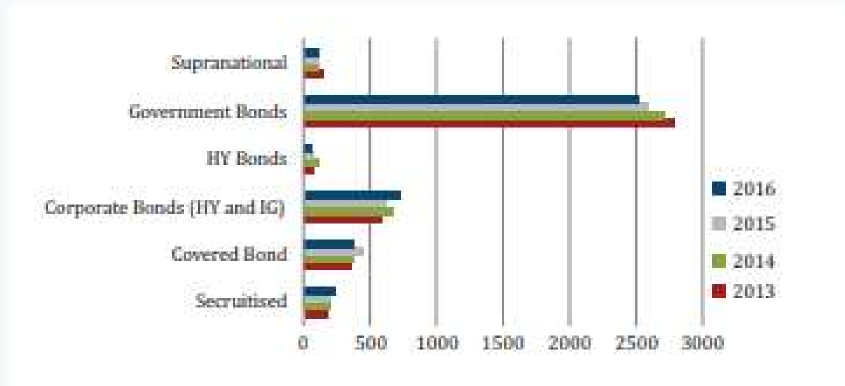
Source: ECB

Figure 5: **EU equity markets - IPO, follow-on and convertible securities issuance on EU-28 exchanges (bn €)**



Source: Dealogic

Figure 6: **EU debt markets - EU Issuance of debt securities by asset class (bn €)**



Source: ECB, AFME, ECBC and Dealogic

Investment banks help companies and governments raise finance through capital markets

The synergies and complementarities described above, are evident when considering the role played by investment banks in helping companies and governments raise finance through capital markets.

Banks facilitate equity and debt issuance by providing these important services:

Underwriting services—Investment banks help end-users access finance through capital markets by providing underwriting services, whereby the investment bank agrees to purchase, at a pre-determined price, any securities — equity shares and bonds — newly-issued by the client/end-user, that are not taken up by investors. This removes uncertainty and risk for the client/end-user by guaranteeing that they will receive the funds that they require.

Book building—Investment banks, acting as 'book runners', help their clients (users of capital or borrowers of credit) find investors (providers of capital or credit) who are willing to buy the securities that will be issued. They promote the issuance to investors in the run-up to an auction, which is used to determine the maximum price that investors are willing to pay to supply all the funds requested. They often also carry out a 'due diligence' process — to ensure adequate information is provided to investors — and help with the preparation of legal documentation.

Securitisation Activities—The provision of credit to the real economy is also supported by the role banks play in securitisation activities. 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 separate entity ("special purpose vehicle" or SPV). This entity finances the purchase of the loans by issuing bonds to investors. In this way, loans which would be illiquid can be converted into more liquid and tradable securities. European securitisations have performed well and are founded in prudently designed rules. At a time when bank lending is constrained, securitisation can boost both credit and growth by helping borrowers to benefit from capital markets. By securitising loans and selling them to investors, banks are also able to free up more capacity to make additional loans to new borrowers.

Liquidity provision: market-making services insecondary markets

Liquidity is critical to effective market functioning. Corporates, governments and investors need consistent and constant access to funding and investment opportunities at fair, accurate and transparent market prices. Liquidity is also critical for the effectiveness of monetary policy and for financial stability. 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.

This sharply increases the liquidity of many securities. Without this, corporations and governments would find it more difficult to raise finance as investors would be less willing to purchase their securities if they could not easily sell them on at a later date. Alternatively, they would demand a higher price in terms of dividends or interest for holding them, to compensate for their poor liquidity. By providing liquidity, market-making therefore facilitates the efficient allocation of economic resources.

Investors care significantly about the degree of liquidity of their investments, because it affects:

- **Direct transaction costs -** Bid/ask spreads (the difference between the price at which a dealer is willing to bid for or buy a security, and the price it asks or offers to sell that same security) are usually substantially wider for illiquid securities. The spread compensates dealers for the risk of holding a security in inventory and the risk of a price decline; it also covers its operational costs and the financing costs.
- **Time to execute a transaction -** In many debt instruments and some equities, it may take days, or even weeks, for a large position, to actually find a seller (or a buyer) who is interested in selling (or buying) at

something close to the market price. This creates risk.

- **Impact on average prices -** The average price investors pay or receive can be impacted if their transaction is large enough to move the market. They will be less interested in owning thinly traded shares whose price will move up during the process of their buying shares; additionally, the opposite would likely occur when they wished to liquidate their position.

The net effect of the above factors is to make investors less willing to own illiquid securities or, as mentioned above, to lead them to ask for a higher "liquidity premium", as compensation for liquidity risks.

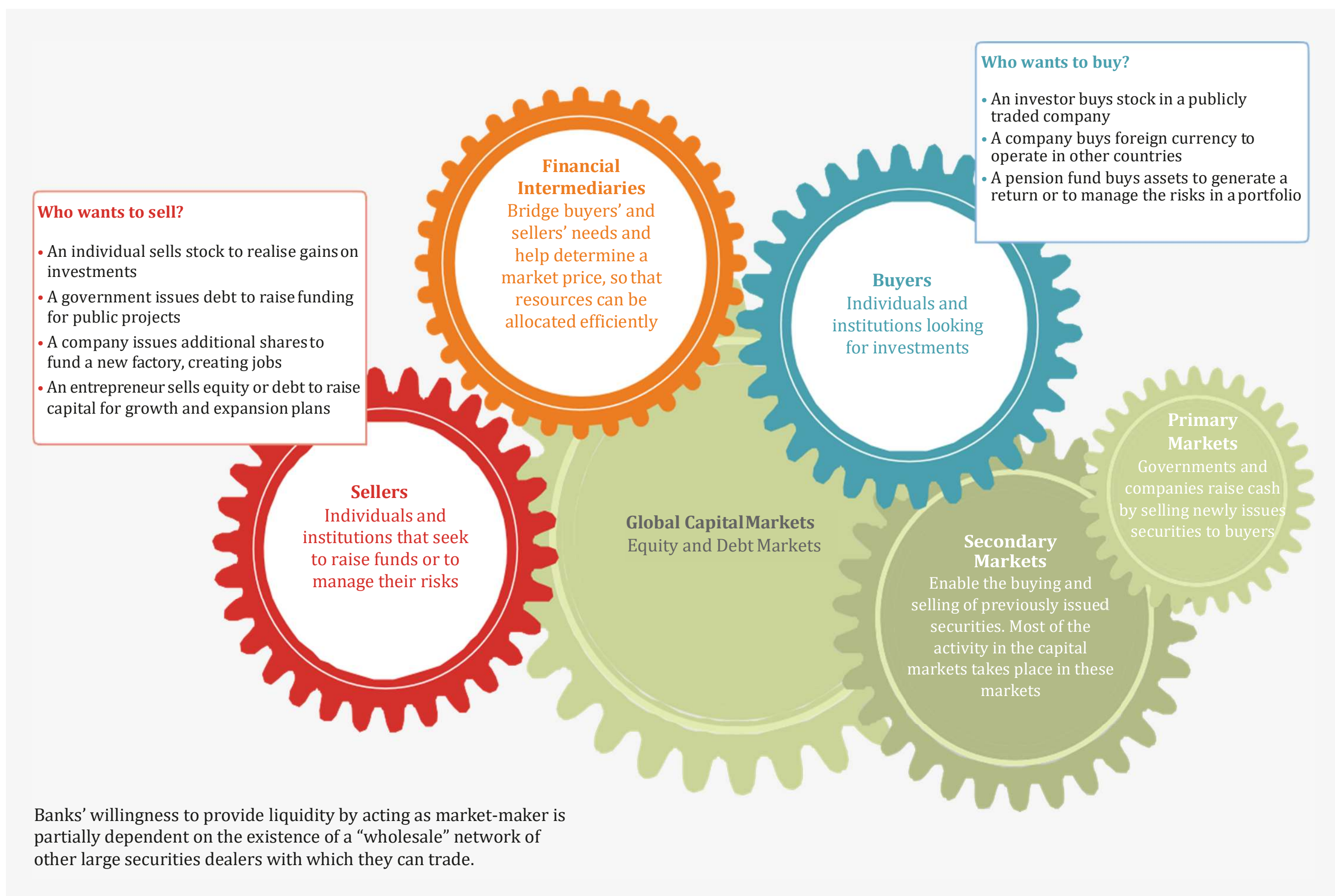
The link between primary and secondary markets

The knowledge that securities can easily be traded in secondary markets reduces investors' risk of participating in primary issuances and holding securities for longer than they would like. In this way, trading activity supports the provision of finance in primary capital markets.

This is particularly important for trading in financial instruments such as corporate bonds, many of which are not traded via an exchange, but instead rely on investors (asset managers such as pension funds or hedge funds, or insurance firms) contacting market-makers for quotes.

Market-making, liquidity and financial stability

In addition to being central for the financing of the economy, market-making activities of banks - by maintaining / increasing market liquidity - are essential in order to reduce price volatility and increase securities markets' resilience to shocks. This is essential for financial stability. It is also a key factor in the implementation and smooth transmission of monetary policy.



Banks' willingness to provide liquidity by acting as market-maker is partially dependent on the existence of a "wholesale" network of other large securities dealers with which they can trade.

What is liquidity?

Liquidity is a multi-dimensional concept, generally referring to the ability to execute large transactions with limited price impact and tends to be associated with low transaction costs and immediacy in execution.

The key 'dimensions' of liquidity include:

Immediacy - typically refers to the time it takes to complete a transaction.

Depth and resilience - a market is deep when there is a large flow of frequent trading orders on both the buy and sell side; this should lower the price impact of larger trades, creating resiliency / lower volatility.

Breadth - refers to the consistency with which liquidity is distributed within asset classes and across markets.

Tightness - typically refers to the financial cost of completing a transaction.

Measuring market liquidity is complex, but signs of deterioration are visible
The multiple dimensions of liquidity make 'measuring' market liquidity a complex exercise. However, several analyses have highlighted that a combination of several factors, including banks reducing risks following the introduction of new regulatory frameworks, have contributed to a deterioration in the liquidity environment in certain asset classes. Evidence includes the following trends:

- European corporate bond trading volumes have declined by up to 45% between 2010 and 2015;
- Evidence suggests that block trades are becoming more difficult to execute without affectingprices;
- There has been a decline in turnover ratios in corporate bond markets, where trading volumes have failed to keep pace with the increase in issuance;
- Banks' holdings of trading assets have decreased by more than 40% between 2008 and 2015, and dealer inventories of corporate bonds in the US have declined by almost 60% over the same period;
- Liquidity bifurcation - Liquidity is increasingly concentrating in the most liquid instruments and falling in less liquid assets.

The reduced dealer liquidity to date has not caused measurable economic damage due to quantitative easing programs and extraordinary monetary policy, which are reducing liquidity pressures, and because market participants are adapting by trading some instruments less frequently and in smaller sizes. However, following the unwinding of QE or in a stressed environment, liquidity risks and market fragilities are likely to be revealed, potentially resulting in higher volatility in financial markets.

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