



Europe's Unfinished Business

A collection of essays to mark AFME's 10th Anniversary

September 2019

The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues.

We represent the leading global and European banks and other significant capital market players.

We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society.

We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

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Foreword

Michael Cole-Fontayn
Chairman, AFME



On behalf of AFME and its members, I am pleased to present this volume of essays considering what the future may hold for Europe's banking and capital markets. This seems an apt moment for reflection, for a number of reasons.

First, as AFME is celebrating the 10th anniversary of its foundation, we felt this was an appropriate time to take stock of what has been achieved in that period, and what still has to be achieved. From the title of this volume "Europe's Unfinished Business" it can be inferred that while we acknowledge that strong and steady progress has been made, we think there is much more still to do to develop an integrated banking and capital market in Europe - a key objective that AFME was established to promote and which you will see all our contributors support.

Second, with the euro crisis in abeyance if not completely banished, with bank balance sheets now rebuilt and more resilient, Europe's financial community and those who supervise, regulate and create the legislative framework for it have moved beyond crisis management to consider the most important next steps required to build an effective Banking Union and Capital Markets Union for Europe. The appointments of a new European Commission and new leaders both for the European Council and of the European Central Bank mark a changing of the guard and a passing of the baton in which the future of our financial markets and the way our economy is financed are central issues.

Third, we are all aware that there are immediate challenges that need very careful handling. One complex set is provided by Brexit, where it will take time and patient effort, as well as reserves of trust and mutual respect between the regulators, to establish a settled modus operandi between Europe's largest financial centre and the economic bloc it is leaving. Another is the need to finance new sources of European economic dynamism or transformation, such as high-growth companies and the move to a lower-carbon economy. Yet another is ensuring that the global framework for wholesale financial markets and flows remains as open as possible in the current uncertain geopolitical and commercial climate. All of these require thoughtful and concerted action from the leaders of Europe's institutions but also from financial practitioners and firms and from society at large.

The good news is that the need for a more integrated financial services market across Europe is now close to a consensus priority for those shaping the legislative agenda. While there is much disagreement on detail, and indeed, the concept of Capital Markets Union means many different things to different people, the fact that it has come to be seen as an important goal is itself an achievement. It is also a reason for hope that the next few years will see renewed action on these agendas. The establishment of a working group comprising the Finance Ministers of Germany, France and the Netherlands, to make recommendations to the incoming Commission is an important signal in this respect.

At AFME we will continue to work simultaneously to promote the dismantling of barriers to cross-border banking in Europe and the enactment of reforms that will reduce and ultimately remove impediments to the smooth, efficient functioning of trans-continental capital markets. These are not competing goals, but complementary and mutually reinforcing ones.

The ultimate goal, as we have argued elsewhere, is an integrated Financing Union, in which banks and capital markets work in tandem to create a more diversified and resilient financial system. This would provide material support for Europe's real economy by allocating investment more efficiently, increasing stability, eliminating residual sources of systemic risk and lowering the cost of capital.

In a volatile, uncertain, complex and ambiguous world, it is a task that we simply can not afford to fail - but it does demand intense and patient engagement on the part of our industry, of the kind that AFME was established to foster. And it requires firms themselves to be active in advocating for, enhancing and in effect "owning" CMU.

"The ultimate goal is an integrated Financing Union"

I would like to extend my deep thanks to all of the illustrious contributors to this publication for their enthusiastic support and participation.

Simon Lewis, who is stepping down after 10 extremely successful years as AFME's founding CEO, kicks off with his reflections on the evolution of the organisation and the industry over this period. It's a ring-side view of what by common consent was one of the most turbulent decades in the history of the European Union and its banking and capital markets.

Bank of England Governor **Mark Carney** looks ahead to the possibly even more seismic changes coming towards us in the worlds of digital payments and of addressing climate change. We are very grateful to the Governor for sharing his views with us towards the end of his distinguished period in office, enriched by his valuable work with the Financial Stability Board.

We are also privileged to have a perspective from the man who in many respects can claim to be the author of many of the positive developments in European financial and monetary policy over the last 20 years, **Jacques de Larosi re**, who sets out an ambitious but realistic agenda on implementing CMU and advancing monetary union for the incoming European Commission.

“AFME will continue to promote the dismantling of barriers to cross-border banking in Europe”

As the European Commission under Jean-Claude Juncker that has served for the last five years prepares to move on, we are also pleased to be able to publish an essay from Commission Vice-President **Valdis Dombrovskis**. He celebrates the progress made during this period towards a European Capital Markets Union, but acknowledges the work that still needs to be done and the new challenges that are emerging.

France has a pivotal role to play in the immediate future of European finance, and so we are pleased also to include a contribution from Finance Minister **Bruno Le Maire**. He argues that Europe needs to put new impetus behind the creation of a deeper and more integrated financial market that can generate better investment returns and more diverse funding sources for companies.

Dame Elizabeth Corley of Allianz Global Investors brings us a fresh perspective on the changing world of asset management and in particular the dramatic rise in sustainable investing.

Sir Howard Davies, who now chairs RBS but has worn many different hats in a distinguished career, tells us why it is right to worry about the consequences for Europe's financial industry of Brexit and gives us some ideas on how best to prepare.

Jean-Pierre Mustier, who now heads one of the largest pan-European banks, UniCredit of Italy, gives us a pragmatic view on how best to drive a competitive and somewhat more integrated banking industry given the diminishing political demand for “more Europe”.

From the world of hedge funds, **Xavier Rolet**, best known as the dynamic CEO of the London Stock Exchange for several years, provides a challenging view of Capital Markets Union, arguing that Europe badly needs to decrease its dependence on bank debt and increase access to equity finance if it is to grow and create jobs.

Finally, **Davide Serra** of asset management boutique Algebris Investments provides a concise and balanced analysis of the fragmentation that is still holding European financial markets back. His and the other articles here reflect the depth and sophistication of the debate which is now taking place across Europe on these issues, which AFME will continue to be more than happy to facilitate and advance in the next 10 years.



Reflecting on AFME's first 10 years

Simon Lewis OBE
Chief Executive, AFME



When I was approached to become the founding Chief Executive of AFME in the Summer of 2010, I was working as the Director of Communications at Number 10 Downing Street. During my time in that role, I saw at first-hand the political turmoil which had been created by the financial crisis of 2008-2009. I was part of the delegation that supported Gordon Brown at the Pittsburgh G20 Summit in September 2010 as he led the negotiations to establish the architecture of the reform programme required to repair the international banking system.

The story of AFME's first ten years is in many ways the story of the post-crisis period. Created in the teeth of the dramatic events that unfolded during 2008 and 2009, AFME's principal role has been to ensure that the much-needed process of regulatory reform has been implemented without significant negative unintended consequences for Europe's capital markets, and in doing so to ensure as far as possible, a level playing field for capital markets globally.

***“A trade group
is only as
good as its
members”***

A trade group is only as good as its members. AFME has benefitted enormously from being able to speak on behalf of Europe's wholesale banking industry spanning US, UK, European and Asian banks, all with deep roots in Europe's capital markets. Our guiding principle has always been constructive engagement and advanced technical skills blended with effective advocacy. This has not always been an easy process because our industry had lost much of its credibility with policy makers and regulators.

Indeed, in my early days as CEO, in some parts of the European Commission there was very little appetite to take meetings with AFME given the perception that the industry still had a long way to go to prove itself.

The ambitious regulatory reform programme in Europe, led by Michel Barnier, the then European Commissioner for Financial Services, was wide-ranging and comprehensive, embracing changes to capital, liquidity and pre and post trade transparency. His road map of reform became well known to the industry and policy makers and was, as predicted, implemented on time.

It was particularly important for AFME to engage with policy makers from the perspective of agreeing the need for reform whilst being able to point out areas for improvement or of inconsistency with other parts of the international programme agreed at Pittsburgh.

Much of this work was painstaking and detailed, combing through thousands of pages of text at EU and Basel level, to highlight areas of concern or proposals for improvement. In total there were 87 pieces of primary legislation with particularly heavy lifting around the CRD4 package of reforms covering the capital requirements for banks, and MIFID II which introduced a whole range of new requirements around pre and post trade transparency.

A key milestone in our journey was the work we started in 2012, looking at one of Europe's fundamental structural problems, namely the lack of sustainable economic growth. For policy makers, and politicians, this is a critical area and our early work identified the big difference between Europe and the US in the funding of smaller and growing businesses which are so often the engine of economic growth. In Europe, this is compounded by the over-reliance on traditional bank lending which has, in itself, been under significant pressure since the crisis as a result of the shrinking balance sheets of banks.

“There has been significant progress on CMU but there is still much more to be done”

In addition, Europe's banks have shrunk compared to their US counterparts. Indeed the story of the last 10 years has also been the way in which the US banks have become much more competitive and stronger both internationally and in Europe. This itself has put added pressure on Europe's capital markets and the fact there are still too many banks in Europe is a continuing challenge for policy makers and investors.

Our 2015 report on “Bridging the Growth Gap” in Europe made a significant contribution to the discussion on growth which led to the creation of one of the great unfinished projects of the EU, the Capital Markets Union (CMU).

This was launched in September 2015 under Michel Barnier's successor, Commissioner Jonathan Hill, in the form of an action plan with the aim of developing a true single market for capital across the EU. During the course of the Juncker Commission, there has been some significant progress on CMU, particularly in respect of opening up some parts of the equity market for smaller companies. But there is still much more to be done, particularly in a post-Brexit world in which the EU is about to fundamentally change its relationship with Europe's largest financial market.

Since 2016, a somewhat unexpected challenge for AFME has been to help its members to prepare for the likely impact of Brexit on Europe's capital markets. Our very first report on Brexit, published in the summer of 2016, setting out a roadmap of the likely milestones and political and regulatory challenges, has been used as a tool kit by policy makers in EU capitals including London, Paris and Frankfurt. Our fact-based approach to Brexit, as with every subject we tackle, has given policy makers clearly articulated guidance on how to tackle the specific challenges facing Europe's capital markets, whatever the outcome of the Brexit negotiations.

“The industry needs to get ready for the next wave of change”

Probably the biggest recurring theme for AFME and its members over the last ten years has been the challenges and risks presented by the dramatic loss of trust in the industry as a result of the financial crisis. In particular, the ‘too big to fail’ issue has cast a long shadow over the banking industry as the perception continues to be that banks were saved by the taxpayer and we are still living with the consequences. The reality, however, is that with the recovery and resolution legislation now in place at European and global level that risk has been significantly minimised. Banks are now much better capitalised, much better run and in much better shape to face any further financial crisis.

A loss of trust in any institution or industry cannot be resolved in the short term, and making the case for stable and effective capital markets in Europe must remain a long-term priority for AFME. Capital markets have a critical role to play, not just in funding the real economy, but matching pools of capital with individual savers including pensioners and other investors. This becomes even more important during a period when individuals are being asked to take greater responsibility for their own long-term financial security.

Central to the process of restoring trust is the need for a continuing focus on transparency. This is already enshrined in legislation such as MiFID II but it requires more than that. The industry and its leaders will need to be able to explain more clearly and be more openly accountable for how they run their businesses, how they conduct themselves and how they communicate with all their stakeholders.

Finally, the industry needs to get ready for the next wave of change as the rise of technology and a new generation of Millennials make their mark. Understandably, the new generation views the industry differently from mine. They entered the world of work in the midst of a major recession following the financial crisis and are much more focused on the role of business in society. I hope the work we have done during my tenure has helped make the case for how financial services benefit society, but this must be maintained as young people demand a more socially responsible approach from business.

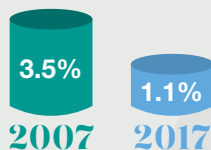
I am confident that, having spent the first ten years creating a strong role and clear identity for AFME, we can on behalf of our members look forward to the next 10 years and beyond as a period when we can continue to make the case for capital markets and their contribution to society, and in the process, persuade policy makers and the public that the lessons of the financial crisis have truly been learned.

A snapshot of Europe's capital markets over the last 10 years

Since the 2008 financial crisis, regulation has led to a more resilient banking system



Banks are now better capitalised and much less likely to fail.



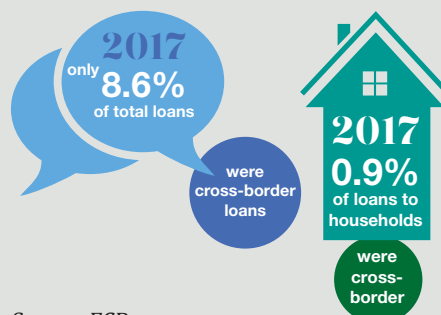
Probability of bank default

Source: ECB

However, profitability remains weak and the overall size of EU banks has shrunk compared to US banks



European banking remains fragmented and cross-border capital flows have declined



Source: ECB

But in order for markets to power investment, innovation and growth in the longer term, we need more liquid and integrated banking and capital markets

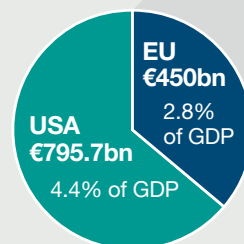
The EU economy is still heavily exposed to a struggling banking sector, with relatively small capital markets when compared to the US



Ratio of loans to market finance: EU



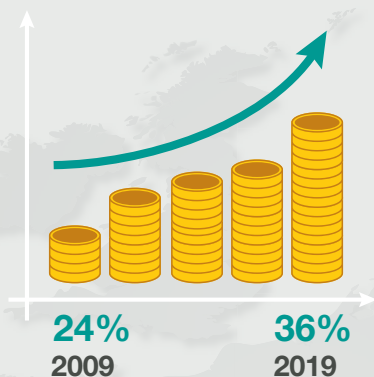
Ratio of loans to market finance: US



Overall size of EU versus US capital markets

Source: AFME

An uptick in market-based financing is gradually happening in Europe with more companies being financed via debt securities and non-bank loans



Source: ECB

Today, the banking sector is rapidly being transformed by technological changes and new digital players



Harnessing technology means banks can increase efficiency, lower cost and therefore fund customers and EU growth

There is huge potential for growth in capital markets across the EU

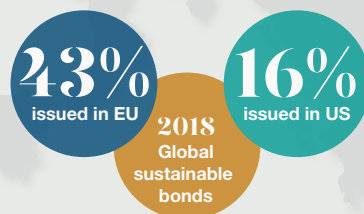


Source: New Financial

This growth would significantly reduce the reliance of the EU economy on bank lending, drive innovation, and boost investment in jobs and growth.



Europe is the global leader in sustainable finance. As a percentage of global issuance, the EU28 remains ahead of the US and China by a significant margin, thanks to the rate of growth of sustainable bonds issuance since 2016

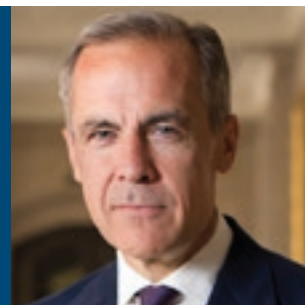


Source: Climate Bonds Initiative and Dealogic



How will the next 10 years look?

Mark Carney
Governor, Bank of England



It is a pleasure to contribute to AFME's tenth anniversary publication. We sit on the cusp of a transformation in global finance, and the ability to anticipate and adapt to the opportunities and challenges on the horizon has never been more important.

In June, I delivered my annual Mansion House speech on 'Enable, Empower, Ensure: A New Finance for the New Economy'. The speech drew out the Bank's response to an independent review, launched a year earlier by Huw Van Steenis, on the future of the UK financial system. This included a series of recommendations to the Bank.

As the title indicates, there is a new economy driven by rapid advancements in technology, demographics, and a path to a carbon neutral economy. This economy requires a new finance – one that serves the digital economy in a sustainable, inclusive and resilient manner. On the part of the Bank of England, we must ensure that our infrastructure and regulations evolve so as not to stifle innovation whilst securing monetary and financial stability.

Here, I will set out some of the fundamental changes coming in finance and touch on the changes they require of the Bank of England.

The digital economy

Payments

The very nature of commerce is changing, with online shopping on the up and the use of cash declining. This is placing new demands on finance for seamless, zero-cost transactions. Whilst the UK has led some of the most important payment innovations, such as the Faster Payments System, the UK is now beginning to lag behind in some areas. UK card payments – whilst convenient and popular – can cost up to 2% of the total transaction value and take up to three days to reach the merchant. The scope for improving cross-border payments is bigger still.

Most fundamentally, a new payments system must end the inequity that the people with the least money pay the most for financial services.

To empower competition, we need to level the playing field between old and new. This means allowing competitors access to the same resources while holding the same risks to the same standards. In 2017 the Bank of England was the first G20 central bank to open up its wholesale payment system (the real time gross settlement system or RTGS) to non-banks. We can go even further. The Bank of England has announced plans to consult in 2020 on opening access to our balance sheet to new payment providers.

“Big data is opening up new opportunities for more competitive financing of SMEs”

The potential transformation in retail payments is even more fundamental, with the advent of new payments infrastructure such as Libra – a new proposed international stablecoin. Libra could improve financial inclusion and lower the costs of payments.

The Bank of England approaches Libra with an open mind but not an open door. Unlike social media for which standards and regulations are being debated well after they have been adopted by billions of users, the terms of engagement for innovations such as Libra must be adopted in advance of any launch.

Libra, if it achieves its ambitions, would be systemically important. As such it would have to meet the highest standards of prudential regulation and consumer protection. It must address issues ranging from anti-money laundering to data protection to operational resilience. Libra must also be a pro-competitive, open platform that new users can join on equal terms. On its part the Bank will lead the way on these issues, as well as monetary and financial stability implications, at the G7, G20, the FSB, BIS and IMF.

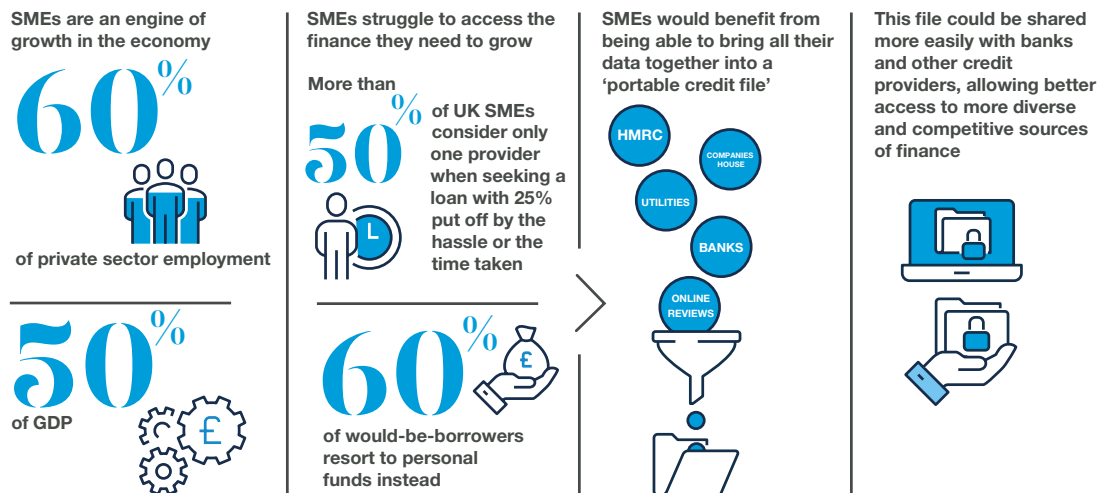
Competitive SME financing

Big data is opening up new opportunities for more competitive financing of SMEs. SMEs are the engine room of our economy, generating around 60% of all private sector employment and half of all private business turnover. And yet SMEs face a £22bn funding gap as they struggle to obtain external financing, often owing to a lack of credit scoring history, burdensome legal requirements and fewer tangible assets to borrow against. This should not be the case in a data-rich world, where lenders could access a broader set of information – such as customer sales and reviews – on which to base credit decisions. To make real inroads, SMEs must be able to identify, incorporate and easily share relevant data to their business with finance providers through a national SME financing platform. Already, messaging standards adopted in RTGS include tagging payments with a unique ID- a Legal Entity Identifier (LEI). The Bank of England is considering how to extend this to corporate payments. This could mean, inter alia, that CHAPS payments to/from non-financial firms could be included in a portable credit file.

\$10 billion

**Additional amount expected
to be invested by banks
in AI systems by 2020**

How an open data platform could deliver a portable credit file for SMEs



Source: Bank of England "New economy, new finance, new Bank: the Bank of England's response to the van Steenis review on the Future of Finance" (June 2019)

Strengthening resilience: big data and climate change

As much of life moves online, a trail of data is created. Indeed, more data was created in the past two years than in all the years that came before. And this data is creating enormous opportunities for the new finance to serve customers better and to manage risks more effectively.

This is encouraging heavy investment in the Cloud, Machine Learning and Artificial Intelligence from the financial sector which sees AI-enabled solutions as central to fraud detection, credit assessment, and wholesale loan underwriting and trading. In fact, banking is already the second biggest global spender on AI systems (after retail) and is expected to invest a further \$10bn on AI by 2020. Embracing these new general purpose technologies fosters financial resilience; heralding leaner, faster and tailored financial services, with cost savings passed onto customers.

However, careful attention will also have to be given to risks, including those associated with the single point of failure and market concentration. Accordingly, the Prudential Regulation Authority will issue a Supervisory Statement in the autumn that sets out its approach to ensuring the benefits and associated risks of cloud computing are managed.

Additionally the Bank of England is collaborating closely with the tech industry, banks, insurers and financial market infrastructures to see what can be done to streamline lengthy and costly regulatory data submissions.

“The threats from climate change are existential”

Transitioning to a carbon-neutral economy

The threats from climate change are even more existential. This year, the then Prime Minister, Theresa May, declared a ‘climate emergency’ and Parliament pledged to make the UK the first G7 country to commit to net zero emissions by 2050.

This will require enormous change and a massive reallocation and investment of capital towards sustainable infrastructure—on some estimates as much as \$100 trillion globally over the next decade. Firms that anticipate these developments will be rewarded handsomely; those that fail to adapt will cease to exist. This will have enormous ramifications both for the financial system and for financial stability.

**\$500
billion**
Outstanding UK
green bond market

New finance can smooth this transition and the UK is leading the way. UK underwriters created the green bond market (\$500bn outstanding) and major UK financial institutions were the first adopters of the Task Force on Climate-related Financial Disclosures (TCFD).

The Bank of England has already been overhauling its supervisory approach in anticipation of these major shifts e.g. through our published Supervisory Statement setting out expectations for banks and insurers on climate-related financial risks; a PRA-FCA established Climate Financial Risk Forum to work with firms; and now a stress test on the UK system that is the first of its kind to test for resilience against different climate pathways using macroeconomic models.

Such measures must go hand in hand with comprehensive disclosures and robust risk management. Fortunately the momentum is growing. Current supporters of the TCFD control balance sheets totalling \$120 trillion and include the world's largest financial institutions. Disclosure must become mandatory, but first, we must get it right. Market standards should be as comparable, efficient and decision-useful as possible. The Bank will become the first central bank in 2020 to adopt the TCFD recommendations across our entire operations. We have also pledged to reduce our carbon footprint by almost two thirds by 2030.

Conclusion

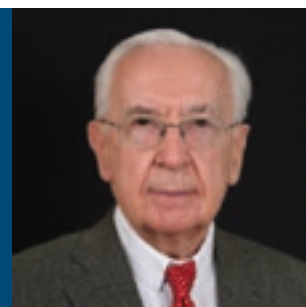
The new finance has the potential to unlock stronger, more sustainable and more inclusive growth. Consumers should have greater choice, better services and equal access to finance. Banks should be more productive and supervision more efficient. But big change brings new challenges, and the financial system must prepare to remain resilient to the risks whilst taking full advantage of the enormous opportunities.

“Market standards should be as comparable, efficient and decision–useful as possible”



Time for Bolder Action on Capital Markets Union

Jacques de Larosière
Honorary President, Eurofi



There are two ways of tackling the important and urgent subjects of Capital Markets Union and Monetary Union: either by analysing the economic fundamentals or by examining the regulatory requirements.

The core idea of CMU is the creation of diverse capital markets to fund the business sectors of the economy, industry, agriculture and services, and in addition the ability to finance public sector deficits.

In the world today the depth and shape of financial markets and exchanges are very different. The US is dominant with more than 50% of overall global market capitalisation; Japan and the UK are in

distant second place with 12%; Europe (excluding Switzerland) is in third with just 10%. In the US companies are financed 25% by bank credit (i.e loans) and 75% by the financial markets (bonds, listed shares on stock exchanges, private equity etc). In Europe it is the exact opposite.

50%

US share of overall
global market
capitalisation

How can we explain the dominance of American capital markets? Perhaps the principal driver is that Anglo-Saxon capitalism in the US strongly encourages personal enrichment, a culture less prominent in Europe.

European enterprises do not benefit from the excess of European savings over investment (the US has a savings deficit). For example Dutch and German investment does not irrigate countries in the south of Europe, but rather tends to be placed outside the Eurozone, particularly in Asia. Therein is a real paradox - excess savings in the Eurozone do not contribute effectively to European investment.

European savings are principally composed of monetary assets (bank and bank savings accounts, bonds) not shares. Hence European firms need to find equity finance from the rest of the world which explains why there are many non-EU funds invested in European firms. The lack of powerful pension funds in the EU, investing in Europe for the longer term, exacerbates these trends.

To illustrate further, European insurance portfolios are made up of approximately 38% European bonds, 33% UCITS shares, 5% listed shares, 5% non-listed and 10%-plus other diverse instruments. In the US shares dominate. If we really want an equity-based financing ecosystem in Europe - optimal for macroeconomic risk sharing, innovation and stability - regulation has to change. Solvency II today, for example, discourages equity investment by excessive capital charges. More generally the debt-equity fiscal bias, whereby interest on debt is tax-deductible but equity is not, is another serious structural handicap to the development of Capital Markets Union.

The absence of pension funds in Europe is also at the heart of the problem. In Europe, public financing of pensions represents 10% of GDP and private pension funds only 0.8%. Again, in the US the situation is the opposite. US pension funds are the biggest financial market investors in the US with over \$20 trillion of assets.

A vibrant CMU will not emerge in the EU unless we understand the swathe of barriers that are preventing the development of efficient European financial markets. Consider these other comparisons:

49%

Average European public spending as share of GDP

38%

US public spending as share of GDP

- The state weighs less heavily in the US economy than in Europe - public spending is 38% of GDP in the US, compared to 49% on average in Europe, and circa 56% in France.
- For the last decade or so productivity has increased substantially in the US but virtually stagnated in the Eurozone.
- For these reasons capital is more attracted to the US and this explains the higher valuation of US companies over their European competitors.
- The high level of non-performing loans in some European countries acts as a brake on international investors. What is required is rigorous economic and budgetary policies to inspire confidence that sovereign risk is not as fundamental as some claim.
- The fact that the potential growth rate is higher in the US explains also why US interest rates are higher than in Europe.

“A vibrant CMU will not emerge unless we understand the swathe of barriers”

- In addition, banks, which are essential for any financial market, are much more profitable, better capitalised and more powerful in the US. J.P Morgan's capitalisation is around \$360 billion, no less than around seven times higher than the individual valuations of UniCredit, Banco Santander, Deutsche Bank or BNP Paribas. In Europe there is a somewhat simplistic view that developing its capital markets will substitute for bank activity. This is profoundly wrong. There will not be efficient capital markets in Europe without strong banks able to compete internationally; banks able to prepare companies for listing, underwriting bond issuance, providing risk capital and the crucial links to investors, securitising assets and facilitating the financing of mergers and acquisitions.
- Another very important factor is that European bank profitability is considerably handicapped by the prevailing negative interest rates of today, new FinTech and BigTech competition and some over-burdensome regulation (not to mention that in the US the large real-estate securitisation market allows banks to offload property assets from their balance sheets and thereby reduce their overall capital requirements).

For banks to be profitable, it is necessary, given their capital requirements, that they should earn a return on equity. The problem is that in Europe the yield is only 4%, but in the US 12-15% which enables US banks to raise capital much more easily. If you have a situation where capital costs 10 and the return is only 4, it is not surprising that the valuation of European banks today is less than their tangible book value.

Concerning the regulatory and supervisory tool-box, the EU must fully unify and harmonise its financial market rules and supervisory practices, as has happened with the Single Supervisory Mechanism. The EU needs a beefed-up ESMA to become a fully fledged European Securities and Exchange Commission. In spite of ESMA's remarkable work under its constrained mandate, this has not so far happened, inter alia, because Member States, to some extent understandably, want to keep retail investor protection under their control. This in turn has led to inconsistent application and supervision of EU laws.

“The next five-year European political cycle must be bolder and more decisive on CMU”,

The recent changes aimed at strengthening ESMA are simply insufficient for a true Capital Markets Union. For example ESMA needs greater supervisory, investigatory and sanctioning powers, the responsibility to supervise key EU infrastructures (CCPs etc) and ongoing control of equivalence determinations, which is particularly important in the context of a future Brexit.

The next five-year European political cycle, beginning in November, must be bolder and more decisive on CMU. The next European Commission should immediately set up a group of top experts to chart the way forward for CMU. The High Level Group should provide a limited set of key proposals, selected on the basis of their positive economic impacts and with a clear timetable for delivery. Thereafter a Tripartite Political Agreement should be sought between the European Council, the European Parliament and the European Commission on the Plan with rigorous monitoring to ensure its deliverability over the next few years.

225

**European interest
rate basis points
below US levels**

Finally monetary policy matters a great deal to CMU. Today European interest rates are 225 basis points below American levels. It is an error to believe very low, very long term interest rates are favourable for investment. In fact they encourage the yield curve to flatten or invert. More nuanced Eurozone monetary policy is needed to avoid the damage of negative interest rates to the economy (“la politique de gribouille”).

In summary, a big range of issues must be tackled to deliver a real European CMU. It needs strong political leadership, courage and a serious plan founded on sound, fundamental economic principles. And urgency.

***“The EU must
fully unify and
harmonise
its financial
market rules
and supervisory
practices”***



The future role of Capital Markets Union in Europe

Valdis Dombrovskis
Vice-President, European Commission



Stronger and more vibrant capital markets will play an important role in delivering continued prosperity to European citizens and companies. Right now, Europe's economy is still predominantly financed by banks, but as the financial crisis showed, relying too much on one source of financing can create risks. Banks tend to lend more when times are good and less when times are bad, which exacerbates the economic cycle. Capital markets can act as a counter-balance to that. This is one reason why the Capital Markets Union has been an important priority of the European Commission.

Another is that deeper and more liquid capital markets provide European businesses with more choice on how they raise the funds they need to grow and create jobs. In particular, alternative market-based sources of financing, such as venture capital and crowdfunding, are important to finance innovation, start-ups and scale-ups, which are important engines of job creation. Stronger capital markets will also give more and better opportunities for EU citizens to place their savings. This, in turn, would make the EU financial system more resilient, lead to a stronger Economic and Monetary Union, and promote the international role of the euro.

Over the course of the Juncker Commission's five-year mandate, the EU laid the basis for a well-integrated single market for capital. The European Parliament and the Member States gave strong political backing to the Capital Markets Union, by agreeing on 11 out of 13 legislative proposals that the Juncker Commission put on the table. These achievements are 11 concrete steps that can deliver real benefits for Europe's citizens, companies, and for the EU economy.

New EU rules for securitisation, covered bonds or personal pensions create new opportunities for market players to develop attractive products. Likewise, simplified rules for prospectuses and easier access to SME Growth Markets will make it easier for European businesses get new growth funding from capital markets.

11 of 13

**Capital markets proposals
agreed by European Parliament
and EU Member States**

“Supervisory authorities have at their disposal new tools for supervisory convergence”

Finally, supervisory authorities have at their disposal new tools for supervisory convergence. Even if the level of ambition of the political agreement reached by the European Parliament and the EU Member States could have been higher, the revised rules on supervision of central counterparties and the review of the European Supervisory Authorities are positive steps. This is because it is not enough to have a single rulebook, if the rules are not applied in the same way in all Member States.

But in spite of these achievements, the work is not complete. While overall the Capital Markets Union has enjoyed wide support at the highest political levels, concrete support on specific legislative files has sometimes been lacking. In the years to come, several challenges will still need to be addressed if the EU's capital markets are to reach their full potential.

First, the EU needs to continue strengthening its capacity in terms of funding sources for companies, saving and investment opportunities for citizens, market infrastructure, and financial market supervision in the face of a changing geopolitical context. With the United Kingdom leaving the EU, it will be even more important for the remaining 27 EU Member States to remain focused on this goal. Yet a single market for capital does not imply replacing London with one other European city. Instead, the Capital Markets Union is about linking a number of financial centres to form a joint and integrated capital market, based on a single rulebook, passporting, and a close convergence of supervisory practices.

Second, the Capital Markets Union needs to remain closely integrated with global capital markets, while protecting financial stability in the EU. The EU system of equivalence is one of the most developed in the world. It is also clear that the UK and the EU financial systems will remain interconnected. To ensure this, close cooperation on regulatory and supervisory issues will be needed.

Third, the EU must maintain its support for local and regional capital markets. Capital markets vary across countries in terms of liquidity, depth or size. At the same time, small and medium size companies are the backbone of the European economy. We need to ensure that they all have access to funding regardless of where they are located. This is why it will be important to promote convergence among economies and ensure that the benefits of capital markets development are spread evenly across the EU.

Fourth, capital markets have a vital role to play in the transition to a climate-neutral economy. The EU has a strategy to build a climate-neutral economy by 2050. The scale of investment needed to achieve this objective is massive. Public funding will simply not be enough. We need to keep sustainable finance high on the agenda to fund the transition to a climate-neutral economy by 2050. Of course this is about contributing to the well-being of the planet and of future generations; but it is also about seizing the many business opportunities offered by the transition to a climate-neutral economy. The European Parliament and the EU Member States have agreed new rules on the next generation of low carbon benchmarks and on how financial market participants disclose the sustainability aspects of their investment decisions.

Still lacking, however, is an agreement at EU level on a classification of green economic activities; or taxonomy. Such an instrument would allow for translating EU and international environmental, climate and energy standards into a language that can be used by investors to more easily channel their funds into sustainable and green projects. This is the cornerstone of the EU's sustainable finance strategy - one which will also serve as a basis to develop eco-labels and standards for green financial products.

Finally, European capital markets should fully embrace technological change. Despite rapid technological development, there is still plenty of unrealised potential for ground-breaking innovation in the financial sector. With the blockchain and distributed ledgers, capital market trading and post-trade infrastructure can be made cheaper and more efficient, while increasing safety and opportunities for consumers and investors.

2050

**Deadline to build an EU
climate-neutral economy**

***“European capital
markets should
fully embrace
technological
change”***

A first step for Europe to seize these opportunities is to allow innovative solutions to scale up across the single market. At the same time companies – both new and old – need help to innovate, while protecting consumers and safeguarding financial stability. One example is crowdfunding, for which the Commission has tabled a proposal to allow crowdfunding platforms to operate across the EU, based on a single licence. Beyond this, efforts must continue to build a Digital Single Market and to make sure the EU’s regulatory framework keeps pace with financial sector innovation.

Even as the current Commission reaches the end of its mandate, the contours of Europe's future challenges are already becoming clear:

- A protective Europe, which empowers citizens to save for their future in a safe way and with a currency that better protects its citizens and businesses;
- A competitive Europe, which gives companies access to the funding they need to be successful in the global marketplace;
- A fair Europe, which spreads the benefits of capital markets to all countries and regions, not just to a few financial centres;
- A sustainable Europe, which takes the lead in funding the transition to a climate-neutral and environmentally sound economy; and
- An influential Europe, backed by strong capital markets and a stronger international role for the Euro.

Stronger capital markets have a clear role to play in achieving these objectives. Much has been done already, but it is also something European policy makers must continue to work towards, to the benefit of all EU citizens and businesses.

***“Stronger capital
markets have a
clear role to play”***



The future of the Capital Markets Union

Bruno Le Maire

Minister of the Economy and Finance, French Government



Between 2015 and 2019, the Banking Union and Capital Markets Union (CMU) have made progress towards a more resilient and consistent framework for financial services in Europe.

The Capital Markets Union has been conceived mostly as a risk-lowering, private risk-sharing tool alongside the Banking Union. It can indeed usefully help absorb macro-economic shocks at EU level. Important steps have been taken in this regard by the outgoing Commission, for example by promoting simple, transparent and standardised securitisation.

Our markets today remain extremely fragmented – this is true in the case of asset management or insurance products, and the Pan-European Personal Pension Product (PEPP) negotiation showed how difficult it is to offer a truly pan-European horizon beyond national barriers.

Significant gains in terms of resource allocation will stem from a better pooling of European savings, which are abundant but need to be channelled to European businesses more effectively. According to the OECD, financial assets held in safe, low-return currency or deposits account for 40% of households' portfolios in the EU 27, compared with only 10% in the US. Financial markets should provide European citizens and businesses with diversified investment opportunities to fuel growth and consumption across the continent. This is the main objective of Capital Markets Union.

However, new challenges arise. We see the emergence of a multipolar financial landscape in Europe. A new challenge is to turn relatively isolated financial centres into a truly integrated European financial network for the benefit of customers and businesses. We need a stronger European financial market able to offer the depth, liquidity and diversity that is the hallmark of other major financial centres in the world.

93

Unicorns in the USA

36

Unicorns in China

15

Unicorns in Europe

Besides, EU companies need more equity to grow and innovate, but they are less inclined to obtain public listings than before. It is a striking fact among most developed capital markets. In the EU too, entrepreneurs are sceptical that their business can be valued in Europe as much as it could be elsewhere and that existing trading venues can deliver efficient financing.

In this new context, I see three main challenges for the year to come.

First, European companies need to gain access to deeper and more diversified funding sources.

Why are there 93 unicorns in the US, 36 in China and only 15 in Europe? It's not mainly a matter of creativity or talent, it is above all a matter of access to equity. And today we're lagging behind our main rivals.

Private equity has gathered momentum, but it should scale up in the field of venture capital. It is estimated that 0.8% of US GDP is invested in venture capital, when this figure only reaches 0.15% for the EU. Europe needs more funds that can issue large tickets. We need to invest much more to stay in the innovation race – on artificial intelligence, on space, on energy storage.

The review of Solvency 2 can bring a significant contribution to this objective by favouring investment in equity.

0.8%

US GDP invested in venture capital

0.15%

EU GDP invested in venture capital

“The development of high quality sustainable finance is a growing concern”

Our second priority should be to build a greener financial industry.

We fully share this goal and we have been implementing reforms in this area in France. That is why we launched a common action plan for green finance with all French financial players last July. French players will work on individual strategies to end coal financing.

Europe is undoubtedly right when pioneering the field of sustainable finance. The development of high quality sustainable finance is a growing concern among EU citizens and a key priority for the next EU mandate.

The EU has already taken significant steps through its green assets taxonomy project and the disclosure framework on sustainability for financial entities. In March 2018, the European Commission released an action plan for financing sustainable growth, which aims at orienting capital flows towards sustainable investment. It should build upon robust common standards to avoid market fragmentation which would arise from diverging labels and definitions. The taxonomy will be an important tool in this respect: it will help corporates and investors share a common language.

We need to go further and enhance non-financial reporting through a genuine European reporting standard on social and environmental performance for corporates. It will make it easier for investors to better allocate their portfolio to sustainable assets.

Thirdly, we should make sure that our European financial industry is fully equipped to take part in the ongoing technological revolution.

Data science and information technology are disrupting financial services. Spearheading this revolution would position Europe at the forefront of innovation in customer services, payment systems, market infrastructure and collateral management models.

Two technologies are gaining traction: blockchain and the emergence of virtual assets; the advent of artificial intelligence and machine learning. In a not so distant future, these innovations will irrigate the entire field of financial services. An SME raising funds in 2030 will probably resort to crowdfunding or token emission rather than a traditional initial public offering.

“Relationships with third countries are becoming a crucial topic”

France was one of the first countries to adopt an ambitious regulation on blockchain and digital assets. At a time when global crypto currencies are ramping up, it is necessary to develop a similar framework at European or global level.

These new technologies are deeply intertwined with market and customer data management. European citizens are increasingly concerned with data protection and privacy. This is one of the many challenges raised by several projects of virtual currencies. Along with the other members of the G7, France made it clear that no private entity can claim any monetary power which is an essential part of the sovereignty of our nations.

We should therefore aim for an enhanced data management regulatory framework, encompassing all aspects, including data collection, handling, processing and storage. It should also cope with our relations with third-country entities, where data are often stored and processed.

Lastly, recent political developments demonstrated that relationships with third countries are becoming a crucial topic. Equivalence regimes are effective tools to settle mutually profitable relationship with third-country financial players. When designing these regimes, we need to strike the right balance between open markets and the protection of our legal sovereignty. Based on reciprocity, EU markets should remain open to fair competition. It means a constant level playing field between market participants inside and outside the EU, under the close scrutiny of EU supervisory agencies.

In all these areas we should go further in the development of an integrated EU capital market, grounded in our own values: a finance industry mindful of the end investor, supporting sustainable and innovative growth. That is why I created, with my Dutch and German counterparts, a working group to relaunch the Capital Markets Union initiative. I'm looking forward to discussing the next steps with all financial stakeholders, to build an ambitious agenda for the new EU term.

***“We should aim
for an enhanced
data management
regulatory
framework”***



A sustainability revolution comes to investment management

Dame Elizabeth Corley

Senior Advisor and former CEO, Allianz Global Investors



A quiet revolution is going on within the world of investment management. It crosses geographies, asset classes and investment approaches. It is revolution, not evolution, because evolution is a slow and gradual adaptation. Revolution is dramatic and the changes taking place within this long-term business are remarkable and fundamental.

The changes are happening within a growing market, which can sometimes disguise how fundamental they are. According to the 2018 PIE review, assets managed by the top 400 asset managers in the world grew to €65.7 trillion by end-2017 from €26.5 trillion at end-2009.

Investment management is a market with relatively low barriers to entry, yet with significant benefits of scope and scale. This has led to an increasing concentration of assets in the largest firms, plus the survival of a long tail of specialist boutiques dedicated to a particular approach to investing.

Such a market structure accelerates the pace of innovation (for example there are now over 5000 ETFs) and intensifies competition. Firms that once were able to prosper with traditional (or, some would say, undifferentiated) investment products will continue to lose market share.

Just as there are few barriers to entry, so too are there normally virtually no barriers to exit. A prolonged downturn in performance; departure of a key individual or team; an investment approach falling out of favour – all lead to an accelerating outflow of assets that can be in the order of billions. And clients expect to be able to get their money back on demand. Even large institutional investors will not wait happily for more than a few months to transfer away from a manager that has fallen out of favour.

So, while headline statistics suggest a flourishing market, for many providers, the pace and impact of change on their business is significant, and will continue.

€65.7 trillion

Assets managed by the top 400 asset managers in the world in 2018

But this is only one aspect of the revolution. Digitalisation will be a further accelerator. The potential for extraordinary benefits to be achieved by successfully harnessing AI and other machine learning approaches is already being seen in some investment strategies. Investment management thrives on data and analysis: a search for unique insights that reveal undervalued opportunities or mis-priced risks.

Operational costs will continue to fall, despite increasing investments in cyber defence and data protection. Blockchain will be applied not only to custody, operations and investment accounting functions but also to support tokenisation, for example of illiquid assets.

However, while these developments will equip the investment management industry for an exhilarating future, they are still essentially exerting their effects within the industry system itself. And it is those factors beyond the system that could yet be the source of the most profound change in the decade to come.

“Current models of development need a degree of reinvention”

The external context for investment management in the 2020s

Since the turn of the century, there has been a continuous and growing debate about where the value creation boundary should be drawn. There is now an almost universal acknowledgement that capital markets are not effective at pricing in externalities – either in terms of risks or the true costs of consumption of human and natural resources.

Despite the fact that global growth over the last 30 years has lifted millions out of poverty and introduced life-changing technologies, entrenched environmental and social problems remain. Indeed, both environmental conditions and inequality have worsened while the very rich and those with assets accumulated in the previous century have benefited disproportionately from growth.

So the realisation has spread that current models of development need a degree of reinvention, with a proliferation of initiatives in the last ten years leading to the UN Sustainable Development Goals, which UN Member States agreed to in 2015. This has prompted many national governments to develop strategic policy responses, notably with an emphasis on the environment.

There is a consequential expectation from policy makers and regulators that the financial services sector will respond to the challenges of fulfilling these goals. Naturally, the first reaction is to consider the risks that arise within the system and to demand mitigation. The FSB Taskforce on Climate Related Financial Disclosures (TCFD) is catalysing consistent, climate-related financial risk disclosures for use by companies in providing information to their stakeholders. The Sustainability Accounting Standards Board (SASB) has produced a Materiality Map® that identifies sustainability issues likely to affect the financial and/or operational performance of companies.

These are crucial developments, driven with a sense of urgency. However, the Global Goals extend well beyond climate alone and the response within the private sector and financial markets will need to go further than risk mitigation. It is not only regulators and governments that are demanding that this should happen.

There is strong and growing interest among asset owners and individuals that their savings, investments and other financial products should be ‘sustainable’. Barely a week goes by without the publication of a survey evidencing this growing trend. As of last year, Bloomberg estimated that assets managed globally using a broad definition of the approach had reached \$23 trillion at the start of 2016, a 73% increase from four years prior. In Europe, the number reached \$12 trillion.

**\$12
trillion**
**European sustainable
managed
assets in 2016**

But what is sustainable investing and are investment managers clear about client and wider societal expectations when they offer it? There are almost as many definitions as there are surveys and the rapid development of the

market is adding to, not diminishing, the variations in terminology used. As a result, even though clients are interested, they are also confused.

Just as the TCFD is focused on developing a consistent disclosure framework to support communication between the providers and consumers of capital so, too, there is a need for a simple, common language to use across all aspects of sustainable finance and, specifically, investing.

“There is a need for a simple, common language to use across all aspects of sustainable finance”

\$70 trillion

Assets represented by
1,600 UNPRI members

Defining what good looks like

Sustainable investment has the power to be noticeable because it can make savings, even for retirement, relevant and personal. More than that, it is a vital opportunity for financial services companies to build deeper customer relationships and contribute to restoring trust in the system and its institutions. Therefore, it is vital that the quality of what is offered is high and that clients can make informed decisions with a clear understanding of what good should look like.

In 2005 a ground-breaking study used the term Environment, Social and Governance (ESG) for the first time. The concept built on a well-established investment approach of Socially Responsible Investing (SRI) which typically allowed savers and investors to exclude certain types of companies from their portfolios for ethical or faith reasons.

ESG went beyond that: it was based on the assumption that ESG factors can be relevant financially. This formed the foundation for the launch of the UN Principles for Responsible Investing (PRI) in 2006.

The subsequent growth in signatories has been impressive. UNPRI has over 1,600 members today representing more than \$70 trillion of assets. Further, across the industry in recent years, there is a widespread trend for asset managers to make ESG considerations a fundamental part of mainstream investment strategies.

“Job done”, you might say? Not yet. Many investment managers still only use ESG factors to screen for and avoid risks. Avoidance and mitigation may be relevant as an investment strategy if the value perimeter is purely the financial results of the fund or mandate. However, it does nothing to address the fundamental need for adaptation or mitigation capital in industries with a high carbon footprint, for example, or to recognise the need to press for change in poor business practice. Do clients who choose an ESG solution based on exclusions alone know of its limitations?

The role of investment management within the capital system is to deploy capital effectively and efficiently to meet customer needs. Seeking to protect their capital from downside risk is an inevitable floor to value creation – finding sustainable returns within specified risk parameters is what really meets expectations.

“Sustainable investment is a vital opportunity for financial services companies”

In its report, Better Business, Better World the Business and Sustainable Development Commission identified the 60 biggest market ‘hot spots’ worth up to \$12 trillion a year in business savings and revenue. It suggests that the total economic prize for implementing the Global Goals could be two to three times bigger. The investment opportunities embedded in this can only be imagined.

In a continuing lower interest rate world, where increasing amounts of information flow through to price formation, the ability to spot discrepancies on a sustainable basis will take investors into new territory. ‘Market beta’ is virtually free – the successful firms will need to push the boundaries of investment. But they will need to take regulators, clients and advisers with them; the level of inertia in the industry remains very significant.

So the question is, can we develop language and methodologies that will enable rapid innovation and the search for value – and values – that will be needed in the coming decade? If we persist with a Tower of Babel approach, and attach proprietary relevance to glossaries that should be open-sourced, the industry will defeat its own intentions.

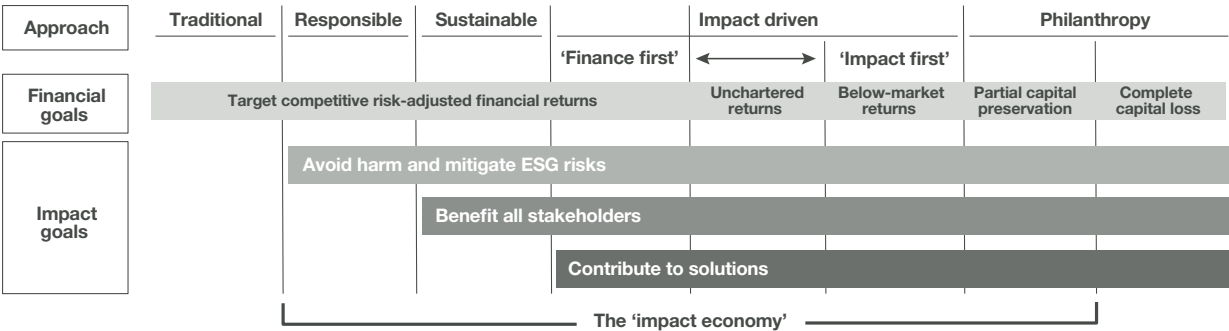
***“Great strides
have been taken to
speed up consistent
and transparent
disclosures”***

With TCFD and the EU Commission’s work, great strides have been taken to speed up consistent and transparent disclosures, notably in climate-related areas. It will be essential that this is complemented by the adoption of common frameworks that will allow clients to understand what is being done with their money. With the rise of sustainable investing, the attention being given to how to describe outcomes that go beyond financial considerations is growing.

Beyond risk mitigation and avoidance, there is the potential to consider the goals of an investment in terms of either the benefits that will flow from it to all stakeholders and/or the contribution it makes to solutions that will benefit the planet and/or its people. For more than two years, a global group of financial services market participants has been developing a toolkit for financial professionals to use when considering sustainable finance.

The Impact Management Project engaged and consulted widely to produce a “Spectrum of Capital”, that considers the investment approach; financial goals/constraints; and what the impact goals might be. There is increasing realisation among ESG investment specialists that, in order to differentiate, they will need to deepen their processes, from pre-selection through to engagement, measurement and reporting. And despite the additional work required, the more rigorous approaches are attracting client assets. Even at the ‘Impact Driven’ end of the spectrum, the assets under management are substantial (\$502 billion).

Choices and strategies for investors on the ‘spectrum of capital’



The deployment of this capital, with a focus on returns that go beyond financial, allows asset managers to answer their clients when they ask about the full impact of their savings or investment and their contribution to meeting the Global Goals.

Describing outcomes and benefits, for people or planet, can resonate more with savers and investors than financial returns alone. Having a personal interest in savings and pensions helps to overcome inertia. Regular contact is one of the ways in which trust can be established and maintained. Both these developments will be critical if savings rates are to increase and we are to avoid the prospect of millions retiring with insufficient income to support them.

Of course, financial markets will need to adapt to create vehicles and instruments - as well as standards – that will enable capital deployment. The Green Finance and Impact Investing Institutes, set up in the UK with government backing, have been established to do just that.

Customers and employees alike are smart. A product that is badged sustainable but is produced and sold in a way that does nothing to contribute to measurable and intentional improvement will ultimately disappoint those who buy, and those who produce it.

Without clarity of what good looks like, even well intentioned product innovations can miss the mark and add to, rather than reduce, scepticism and lack of trust.

Summary

As Samuel Johnson said, “To improve the golden moment of opportunity, and catch the good that is within our reach, is the great art of life.” Never has there been a more important and appropriate time for the investment management industry to grasp that moment. There are firms already determined to do just that. Others aspire to do so, but struggle to leave outmoded business priorities behind. And some duck down and do the minimum necessary, waiting for the storm to pass in the belief that there will be a reversion to the norm. They may, of course, be correct - but this is an increasingly risky bet to take as the next decade looms.

***“Financial markets
will need to adapt to
create vehicles and
instruments that
will enable capital
deployment”***



Observations of a central banker, regulator, academic and banker

Sir Howard Davies
Chairman, RBS



I have observed the capital markets of Europe for several decades as a central banker, regulator, academic and now as a banker. It is often said, and with some justification, that capital markets in Europe have developed slowly by comparison to the US, and that Europe remains unhealthily dependent on bank finance. That proved a serious drawback in the financial crisis, and still holds back recovery today. When bank credit contracts European firms suffer, as many have no access to the capital markets, unlike their US counterparts.

It is not exactly a surprise that it has been hard to construct a genuine Capital Markets Union (CMU). Knitting together the legal and regulatory systems of 28 countries is not a task for the fainthearted. When he was the Commissioner responsible for CMU, Jonathan Hill tried to give the idea more impetus. Some suspected a national motive, in that insofar as a CMU had developed it had done so on the banks of the Thames, rather than the Main or the Seine.

I doubt if that was Hill's motivation, it was certainly not in the minds of the Commission staff who did the real work. But the reality is that as European capital markets converged and merged London was the principal beneficiary. Indeed London's dominant position has strengthened considerably in the decade since the crisis. That is one reason why Brexit is such a problem for Europe's financial sector.

Should British banks be concerned about this post Brexit? I think so. RBS has been reshaped as a largely domestic institution, but we are nonetheless greatly interested in the future of Europe's capital markets. We own a large retail and commercial bank in Ireland and, to cope with the loss of 'passporting', we have set up an investment banking operation based in Amsterdam, a happy legacy of our otherwise ill-fated acquisition of ABN-Amro – perhaps the only one.

After Brexit it is highly unlikely that the model of recent years, whereby activity has concentrated in London, will continue. So is it all over for Capital Markets Union? Will it drop into a shadowy half-life, like EFTA or the Europa League, or can the concept be reshaped?

I am confident that the capital markets of Europe can be developed further, but it will require a sustained effort involving a wide range of both official and private sector actors. Success depends above all on identifying correctly the needs of final users, both issuers and investors, rather than just those of the intermediaries and of providers of finance, which is where much of the focus has been in the recent past.

Legislation to facilitate capital market development is in itself a necessary, but not a sufficient, condition for success. Success depends rather on the development of the whole ecosystem; education of and capacity building in potential issuers; education of potential investors in the benefits and risks of capital market investment; and the construction of an efficient market infrastructure.

The main prizes from a successfully developed capital market, whether labelled CMU or not, are well known; for users of funds, diversification of sources of finance with the benefits that a richer mix of sources, including a greater proportion of equity and debt securities, will bring; for investors, the benefits of a more diverse range of investment instruments, with greater diversification of risk and higher potential returns; and for banks the opportunity to improve their customer risk profile with greater use of capital market products and reduced dependence on bi-lateral bank finance, strengthening the weaker areas of the EU banking system.

“In some jurisdictions the necessary knowledge capacity is absent”

The weaknesses of the current capital market arrangements are familiar. Some are fundamental, such as the shortcomings and inconsistencies in insolvency arrangements, and will need to be remedied if the potential benefits are to be realised across the EU. Many need attention at the national level, so consistent system-wide guidance is needed as to what is required. Market participants are well placed to offer such advice, whether to national governments or to the Commission.

In countries where capital markets are well established a key feature is the presence of banks that are able to give both capital market and banking advice to their clients. The provision of such a service means that a single firm can help a client graduate from a pure borrowing relationship through the introduction of venture capital, then private equity, to private placements and issuance on the public markets. Parts of the EU are not well served by firms with this capacity.

In some jurisdictions the necessary knowledge capacity is absent. On the issuer side this will involve training to raise firms' corporate financial reporting and governance standards to the level needed for capital market issuance. That will typically be the responsibility of a business ministry. On the investor side it will involve education both at the institutional and retail level in the benefits and risks of capital market investing, which will typically be led by a finance ministry. The Commission is aware of these needs and has launched some initiatives in the capacity building area. A much more extensive and coordinated effort, in which the industry can assist, will be necessary if the benefits of an increase in cross border capital market activity are to extend across more than a few Member States.

“Any change in the flow of funds within the EU will have significant economic consequences”

A large part of the European capital market ecosystem has historically been in London, both in terms of supply of funds, market liquidity and infrastructure. 47% of the EU's equity capital is raised through UK capital markets (including IPOs and secondary offerings). 41% of the EU's M&A activity is facilitated by investment banks (including banks headquartered outside the EU, operating from their branches and subsidiaries in London). 43% of euro FX trades and 37% of all FX trades worldwide are executed in the UK. And, as I said, the degree of concentration has been increasing in recent years.

So, addressing the potential disruption to both flows of funds and access to infrastructure which Brexit will bring will be critical both to avoid disruption of existing capital market business in the short term and to develop the market in the longer term.

The extent of the change from the present Single Market arrangements will determine how European capital markets will develop. There is bound to be pressure for business to be moved, but whether this benefits users will depend crucially on how easy it is to build parallel and duplicative infrastructure and how much it costs. That needs clear-minded and rigorously critical analysis. The French have talked of a red, white and blue carpet rolled out for banks who move to Paris. They will be more impressed by the IT and the legal framework than the floor-covering.

47%

Percentage of EU equity capital raised through UK capital markets

43%

Euro FX trades executed in London

37%

Global FX trades executed in London

In particular, as London currently hosts a pool of capital derived from across the globe, much of which provides the supply of capital to EU markets, any change in the flow of funds within the EU and in inflows and outflows in relation to the rest of the world will have significant economic consequences. It is not enough for other centres to target businesses based in London. They must show themselves to be attractive to funds and businesses elsewhere.

“New supervisory arrangements will be essential in the case of systemic infrastructure”

The precise mutual access arrangements will therefore be critical. They will need to be determined on the basis of proper economic analysis and not politics or prejudice. It is possible that some intra-EU27 business could be on-shored and shared between different centres, but it will need to be established just how this would be done, how the infrastructure would be provided and what the costs would be. The analysis needs to be strictly rational given the risk of potentially harmful action to protect or promote individual national market places. If not handled correctly, this could dissipate the potential economic gains from deepening the market. The fact that the future location of the European Banking Authority was determined by the toss of a coin is not a favourable precedent.

It could be better for Europe as a whole to preserve some, perhaps much, of the existing cross-border access which firms in London enjoy. Those jurisdictions which host successful international capital markets invariably have an open approach to inflows of capital and how it may be deployed. So addressing and maintaining the EU's openness to capital will be critical. Such openness tends to go without saying in jurisdictions with successful capital markets, but the case could need to be argued in some Member States, which will need to decide whether they are prepared to bear the costs involved in not being open.

Those activities not covered by the existing third country equivalence arrangements need particular attention. Without it, gaps in coverage could stand in the way of, for instance, the bundling together of capital market and banking products which is often the means through which many clients are most effectively served.

Because there will no longer be a shared legal system post-Brexit, new supervisory arrangements will be essential in the case of systemic infrastructure and systemic firms will require some kind of robust joint supervision. Although the UK will probably not be part of the single market in financial services and the cooperative arrangements which are integral to its functioning, structures will be needed which, as far as possible, replicate the existing ones.

If a way could be found for the UK to participate in the principal fora currently providing the framework for supervision, there would be benefits to all parties. The inefficiencies which would result from the UK being in future only able to engage bilaterally with each of the national supervisory agencies are palpable. Some form of association with the European Supervisory Authorities, like that available to the EEA countries, would do much to help keep open channels of communication and the exchange of views on policy development and supervisory techniques. The idea that on Brexit day the FCA leaves ESMA, without sending a forwarding address, is clearly absurd given the interconnectedness of European markets.

The maintenance of uniform practices for information exchange as currently carried out under the auspices of the ESAs would greatly diminish the risk of fragmentation. And some supervisory decisions will need to be taken on a much more collaborative basis than has been necessary in the past. The evolution of new capital market structures will bring new systemic risks, which points to the maintenance of an extremely close relationship with the European Systemic Risk Board. Getting all these connections right will be critical. The Governor of the Bank of England has been vice-chairman of the European Systemic Risk Board. Some other institutional link will be needed to replace that connection, which is likely to fall away.

I believe that a viable action plan can be constructed to deepen and improve capital markets in Europe, but it will need to take account of the reality that financial market players have the obligation to reflect very carefully on how their business models - where and how they undertake their business, and with whom - are to take account of shifts in the regulatory architecture. It will require strong technical expertise as well as political will if the public authorities are to make decisions which will benefit Europe as a whole.

***“The evolution of
new capital market
structures will
bring new systemic
risks”***



Making Europe's banks more competitive

Jean Pierre Mustier
CEO, UniCredit



Building a positive future for Europe

The European Union has led to the most prosperous and longest ever period of peace across the continent. This stability is the result of decades of governments, people and companies playing their part to ensure a successful Europe. Now, with the growing shift of economic strength towards Asia, Western populations are feeling increasingly disenfranchised and are losing faith in their traditional political establishments and institutions. Many Europeans are uneasy about how global trends in technology and competition are changing their world and whether our current models for government, business and society will continue to work for them in the future. In European politics, the UK's struggle with Brexit fallout serves as a strong reminder in continental Europe on the dangers of "less Europe". At the same time, it is unlikely that we will have "more Europe" for the time being. Serving clients across borders throughout Europe, it is the duty of pan-European companies such as UniCredit to help rebuild confidence in a joint, fair and prosperous future.

Pan-European banking

For the financial industry, not having "more Europe" in the short term could mean a slowdown of the next steps for the banking and Capital Markets Unions. At the same time, truly European banks, such as UniCredit, prove that the Banking Union is not a necessary condition for successful pan-European champions. This model brings significant benefits for clients, the economies of individual countries and the European Union as a whole. For UniCredit, there is a clear competitive advantage in providing its strong domestic banks in Italy, Germany, Austria and Central and Eastern Europe with the economies of scale of an integrated group. The outcome is a combination of local excellence and a more competitive and performing product for the client.

A slowdown in the implementation of different proposals might mean it will take more time for other European banking players to reach a similarly critical size. This comes at a cost to the region's corporate and retail banking clients as scale brings the advantage of cost efficiency and easier access to, and availability of, financing. If the European banking industry is not perceived as one sector with a single set of rules – including the convergence of risk models and accounting treatment – it will remain challenging to attract international capital, in order to efficiently finance clients and economies.

As long as there is dwindling support for “more Europe”, we should focus on pragmatic regulatory measures that would facilitate financing and limit the downside of fragmentation. For example, the recent adoption of new EU rules for standard minimum coverage on bad loans will apply to future NPLs. Moody's recently published a report stating that it sees this step as credit positive for European banks, because they will all be subject to the same prudential standards.

“We should focus on pragmatic regulatory measures”

Despite remarking on a significant improvement in the asset quality of European banks in recent years, the ECB's 2018 annual report states that high levels of NPLs remain a concern for a significant number of euro-area banks. The “Banking Package” has brought regulation that supports the massive disposal of NPLs, which encourages a further de-risking of banks' balance sheets, lowering the capital impact on Pillar 1 and Pillar 2.

However, agreement is still needed on the harmonisation of out-of-court settlement procedures for the seizure of collateral, which would also significantly help banks to dismiss NPLs.

Other additional pragmatic regulatory measures could include further empowering the Single Supervisory Mechanism, both within and outside the eurozone. Creating conditions for the free flow of liquidity and capital (in excess of local regulatory requirements) between subsidiaries of the same banking group would support their more efficient allocation and improve the financial stability of the group and the banking system as a whole, strengthening overall resilience to possible crises. This could also be supported through national waivers, where cross-border groups could manage their liquidity and capital at a consolidated level, rather than for each individual subsidiary.

Becoming more competitive

An adequate level of competition guarantees the best possible service for customers. It allows them to demand more – in terms of both products and services – while paying less. Businesses can do best when they can compete on a level playing field and the European Commission is working on strengthening the World Trade Organisation rules on subsidies, also starting a dialogue with China about these and fair competition. This will support Europe's leading banks – the ones that best know how to innovate and serve customers well – to succeed and support Europe's best companies to compete on a global level.

US banks have largely won the battle in terms of serving global companies with their corporate and investment banking needs – such as advisory and M&A. However, these same banks do not currently pose a real competitive threat to stronger European banks in the commercial banking sector, where local players continue to excel. That said, European bank profitability will barely exceed the cost of capital in the future. With top line growth following GDP evolution, banks will need to focus even more on efficiency, through the optimisation of costs and processes, together with staff development and the continuous application of effective risk management, lowering the cost of capital. European banks, for the most part, currently trade at a significant discount to tangible book.

While the GDP of Europe is comparable to the GDP of the US, European banks lack scale when compared to their US peers. In the second half of 2018, the average market cap of J.P. Morgan – a leading US bank – was €320bn vs. €50bn for its European equivalent. US banks benefit from a laxer regulatory environment and strong tax incentives, so it is likely that the profitability gap will keep increasing, given that US banks can rely on a large, integrated domestic market.

European banks need to focus on their strengths and develop economies of scale to lower the cost of production of their products, especially to accompany SMEs in their growth. The next evolution of the Capital Markets Union needs to focus on providing more capital to SMEs through the development of banking regulations and long term savings initiatives, encouraging investors to take equity risks to provide venture capital, growth capital and patient minority capital – while banks continue to provide adequate financing.

“European banks need to focus on their strengths and develop economies of scale”

“It is crucial to develop training for existing team members”

Achieving scale through organic growth can be challenging, particularly in a market that is still fragmented. In the short term, it can be achieved through the creation of contractual networks – “synthetic mergers”. These are innovative transactions or cooperation agreements to pool resources. For example, UniCredit contributing its ECM brokerage to Kepler Cheuvreux, now the leading independent European brokerage house, in exchange for a long-term contractual agreement has brought concrete benefits to UniCredit's ability to serve its clients. Similarly, UniCredit entered into a long-term agreement with asset management firm Amundi, today a top 10 world leader combining the previously sub-scale asset management operations of UniCredit, Credit Agricole and Société Générale.

The emergence of new players (FinTechs and BigTechs) and new regulation (i.e. PSD2) are a source of inspiration for banks, to improve customer service with more flexible products and more interesting tasks for their workforce. Banks can leverage their substantial client base and available capital to replicate successful FinTech offerings or partner with selected ones for a white label service, while guaranteeing the security of their clients' assets. Banks should also create support for an arm's length market environment, such as reverse GDPR and access to certain BigTech customer data – ensuring a two way street to ensure fair competition, which is to the benefit of all players and clients.

At the same time, technology is changing how things are done, with more automation and digitalisation. The nature of banking jobs is changing, with roles moving away from more manual and repetitive tasks. It is crucial to develop training for existing team members who will have to take on new, more client-focused tasks. Stronger data analysis skills will also be needed, to leverage the increasing volumes of customer data. To retain and attract new talent, banks need to become ever more transparent, developing meaningful business models that are not solely focused on economic profit, taking into account a whole host of other issues, such as social banking, ethics and respect, community support and volunteering.

According to the European Commission, eight out of ten Europeans say they're interested in whether companies act responsibly, but only just over half believe that business has a positive influence on society. Acting responsibly will increasingly help distinguish a business from its competition and that, for the European banking industry, is a very strong call to action.

8 out of 10

Europeans interested in whether companies act responsibly

50%

Believe business has a positive influence on society



Why Europe needs more equity and less debt

Xavier Rolet
Chief Executive Officer, CQS



Few organisations have advocated the need for transformational reform of Europe's capital markets as well as the Association for Financial Markets in Europe. Every time my travels took me to Brussels or other European capitals, wearing my Equity/SME/Innovation hat, I would run into Simon Lewis or one of his colleagues, highlighting the need for thoughtful reforms to put Europe's formidable arsenal of financial services expertise at the service of the real economy. Their contribution should rightly be acknowledged and celebrated.

55%

US owned global financial assets

10%

Global financial assets owned by the UK, Germany and France

Nevertheless, the much advertised European Capital Markets Union project has made little progress in one key respect: the share of bank lending as a percentage of total European corporate funding still exceeds 80%, and continues to grow. Compare this with the United States, an economy roughly the size of the EU which turns over five times Europe's modest daily equity volume of ca \$40 billion.

This raises the cost of long-term equity capital for European corporates and increases their dependence on debt funding, bank debt in particular. Note that bank debt only accounts for 18% of all the sources of corporate funding in the US.

According to market information provider Statista, in 2018, the United States still accounted for 55% of global ownership of financial assets, and its stock markets for 53 percent of world equities, versus less than 10% for the UK, Germany and France combined.

Europe is also missing out on new growth and capital accumulation: a full 50% of global growth in Assets Under Management is accounted for by China alone since 2017, and that trend is expected to continue well into the next decade, according to Casey-Quirk, an asset management consultancy. The resulting higher cost of equity capital is particularly punitive for small European businesses, which do not have access to the global funding options available to larger companies.

Meanwhile, even if we have largely recovered from the crash of 2008, popular anger continues over the austerity and suffering it caused, and questions remain. Italy's GDP remains 15 percent lower than its 2007 pre-crash level.

Have the tens of thousands of pages of complex new financial regulations such as EMIR or MIFIR made us any safer? Some central bankers have stated publicly that they think we are now safer and in a good position to withstand future financial shocks to the economy. Will these statements hold true as trade wars loom and slow-growing EU economies struggle to adapt to political instability and the potential disruption caused by Brexit? The contentious three-year old debate on the potential repatriation to the eurozone of tens of trillions of euro-denominated over-the-counter derivatives is just one example of potential systemic issues still awaiting a long-term resolution.

Each one of the major economic crises in the recorded history of our modern capitalist economies has had the same origin: a banking collapse. Its root cause: our inability to properly monitor, regulate and manage leverage in the banking industry. Has that changed?

A recent Asset Quality Review by the ECB revealed that the combined balance sheet of the three largest banks of one of the EU's largest nations was roughly equal in size to the combined balance sheet of the three largest US banks (Wells Fargo, Citi and JPMorgan), an economy seven times its size.

Banking crises have come and gone, as banks over the years have used different asset classes to leverage their balance sheet to achieve earnings enhancing performance, whether commercial property, Latin American or Asian sovereign debt, savings-and-loans or subprime mortgages. Leverage is opportunistic and non-linear: it only requires a large and expanding asset class to maintain earnings enhancing momentum. So the question remains: although European banks have de-levered substantially since 2008, do they remain a risk to themselves and to the real economy owing to their leverage and the size and contents of their balance sheets? Some investors seem to think so: according to published reports, for example, the hedge fund Bridgewater built a major short position in the European banking sector last year.

Another Capital Markets Plan for the European Union?

Are there other, complementary ways of funding the European real economy and its army of 23 million SMEs in order to create the 20 million jobs the EU needs? The answer is yes. A stable, job-creating economy based on innovation requires access to a different kind of funding model: a patient, permanent, upside-orientated, long-term, un-leveraged source of capital. It was invented here. It's called Equity.

A re-calibration of our economy towards equity funding might even save considerable amounts of taxpayers' money (that few are even aware is being spent on their behalf) as leverage in the financial sector continues to be heavily subsidised by the public purse.

***“A stable, job–
creating economy
based on innovation
requires access to
a different kind of
funding model”***

**€570
billion**

**Taxpayers' money used
to subsidise financial
services debt in 2016**

According to Mark Esposito and Terence Tse, respectively from Harvard University and ESCP Europe, European Treasuries spent €570 billion of taxpayers' money in 2016 to subsidise debt in the financial services industry through the deductibility of interest, adding further leverage to the banking industry in the process. No doubt the stewards of the existing, debt-centred European funding model would argue in favour of maintaining the status

quo for stability reasons on the grounds that bank debt remains quite possibly the best, most cost-effective way to finance large corporations who can offer lenders the security of their cash flows and existing assets.

But what of the army of start-ups, scale-ups and SMEs who have neither, and must plan several years ahead as they develop the new technologies of the future or new export markets? Debt in general, and bank debt in particular, may not be the best financial tool when it comes to funding capitalism's most effective job and value creation tool: innovation.

“A fiscal re-calibration toward patient capital equity is needed”

Fast-growing innovative businesses, ambitious exporters and global SME businesses need more than the downside-focused logic of debt funding and its assorted monthly payments, guarantees, liens, covenants and protections. How does an entrepreneur develop export markets, requiring years of investments, if he or she has to worry about the next month's repayment? The same applies to investment in research and development.

Recent research by the ScaleUp Institute, a not-for-profit organisation promoting better conditions for UK companies to scale up, shows that 16% of UK high growth firms use equity and there is a direct correlation between even faster growth and an equity stake. Forty percent of companies that saw revenue grow at an annual rate of more than 100% for two years were companies that have used equity financing, compared to 18% of companies that saw revenue growth of 20 to 40%. Thus it seems that the more equity investment a company has received, the more likely its revenue is to be growing at a rate faster than 100% a year, enabling it to create high paid jobs and to invest.

Compare the favourable tax treatment of debt to the quadruple taxation of every pound or euro of equity income through its life-cycle: income tax, capital gains, dividend and a financial transaction tax, called stamp duty in the UK. Adding it all up, there is an almost 40% fiscal gap between the cost of debt and equity. As a result, not only do European banks remain highly leveraged, but European equity markets remain underdeveloped. This matters because the more liquid a capital market is, the lower the cost of capital will be for corporate issuers, and the greater its resiliency in tough times. In 2009, after debt and interbank money markets had seized up, global equity markets continued to provide liquidity for corporate issuers and banks alike.

As a famous politician (no friend of capitalists) once asked: “What is to be done?”. Perhaps the following might be considered: given the abundance of private capital in this low-rate environment, public investment is not needed. A fiscal re-calibration toward patient capital equity is. It would most likely involve capping the deductibility of interest for financial institutions to guard against excessive leverage, which would more than cover a reduction in the quadruple taxation of equity income. Abolishing stamp duty for retail investors would be a good start.

We need to increase the demand for equity finance from SMEs. In the UK, the coordination of a National Capital Market Plan to facilitate access to equity capital for the UK's 5.4 million SMEs by creating a one stop shop for high growth businesses would be an important step. The recent launch of British Patient Capital and the work of the British Business Bank are important steps, but cross agency working is needed, including the financial regulators and biggest investors, to ensure a fully joined up approach to financing high growth businesses.

Innovate UK has identified that businesses can miss opportunities to secure equity investment because of misunderstandings of what investors look for, as is noted in their recent report *Scaling Up: The Investor Perspective*.

Recognition of finance programmes by scale-ups should be improved: only 24% of UK high growth businesses are aware of the Business Growth Fund, 16% of the British Business Bank and 5% of the Business Finance Guide. This shows it is important to increase the consistency and quality of guidance and education on growth capital finance. There is a clear opportunity for policy makers to create a long-term and ambitious growth mind-set towards external finance and to better signpost opportunities for appropriate growth finance to scale up businesses.

As challenging as these statistics may appear for the UK, the rest of the EU is faring far worse. The London Stock Exchange Group's ELITE programme, now globally successful, has helped thousands of very promising, high-growth unlisted SMEs raise private equity or debt from growth-oriented global investors, but its growth in Europe could have been even faster with support from existing EU government data sources helping to identify fast-growing firms more quickly.

It might also be asked: why, apart from the occasional conference or award-winning ceremony, has the European exchange industry done so little to help scale up the EU's 23 million SMEs?

A re-calibration of the fiscal treatment of debt vs equity in the EU would certainly help reduce long-term over-reliance on bank lending and promote greater access to patient long-term capital. This would provide a more stable funding framework to give our high growth SMEs an opportunity to create high paid jobs. By reducing our dependence on bank financing, we can diversify our economy and remove some of the conditions that led to the 2008 crisis.

Facilitating greater retail access to the millions of opportunities offered by EU entrepreneurs and innovators might even make capitalism popular again. At a time when the UK is struggling to exit the EU, and when the political bond between Berlin and Paris looks more fragile than ever, the EU may have one last opportunity to re-calibrate its economy from a downside, debt-based model to a more prosperous upside-oriented technological future that requires equity funding.

“By reducing our dependence on bank financing we can diversify our economy”



Securing the future of a European single capital market

Davide Serra
Founder & CEO, Algebris Investments



Few sectors have undergone as deep or sustained a regulatory change as the European financial sector since the global financial crisis. The crisis showed the cost of endangering financial stability in an integrated economic area where cross-border spillovers are magnified by financial integration. It also revealed that the EU single market for capital was *single* in name only.

Since then, significant progress has been made. In its first phase, the European response was to move in the direction of harmonised rules and strengthened co-operation. The 2009 de Larosière report opened the way to the creation two years later of the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB). The underlying rationale was to ensure closer cooperation and a better exchange of information between national supervisors, to prepare uniform standards, and to ensure supervisory convergence and coordination.

The second phase, triggered by the Eurozone crisis, has been a swift move towards centralisation. The EU Banking Union, featuring an EU-wide single rulebook, centralised banking supervision by the Single Supervisory Mechanism, centralised resolution by the Single Resolution Mechanism, as well as the delegation of active macro-prudential competencies to the European Central Bank (ECB), was the boldest institution-building step since the crisis.

The single rulebook ensures common benchmarks. Common supervision guarantees cross-country consistency, and aims to reduce the likelihood of banking crises *ex ante*. Common resolution fosters clarity on how to manage any crisis that might occur nonetheless. But is this enough? Faced with heightened uncertainty induced by Brexit on one hand, and by a US administration unsupportive of economic multilateralism on the other, Europe cannot afford any missteps.

The key pieces of the puzzle

Banking Union today is incomplete, and it will not serve the goal of strengthening the European financial system as long as it lacks a European Deposit Insurance Scheme (EDIS). EDIS is necessary to give depositors and investors enough confidence to effectively break the vicious circle between banking crises and sovereign crises – a stated objective of Banking Union. Absent such confidence, the risk of negative feedback loops from bank failure remains, and it will weigh on the resilience of the European financial system at a time when external circumstances (in particular the protectionist threat coming from the other side of the Atlantic) make the risk of a new crisis non-negligible.

On a separate but related note, the ambition to boost the role of the euro as a global currency – shared by the European Commission as well as some Member States – is unlikely to succeed, if the credibility of the EU Banking Union is undermined by the absence of this key pillar.

For the past year, the discussion on EDIS has been inconclusive – hampered by policy makers' inability to strike a balance between 'risk sharing' and 'risk reduction'. This indecisiveness is a risk that Europe cannot afford to take at this time.

“The ESM is poorly equipped to address liquidity crises”

In December 2018, the Eurozone finance ministers also decided that the European Stability Mechanism (ESM) will provide a backstop to the Single Resolution Fund (although limited in size) and agreed on a reform of the ESM toolkit. In the case of a crisis, the ESM will play a major role in the activation of the ECB's Outright Monetary Transactions (OMT) programme, by determining whether the crisis incurred by a country is one of liquidity or one of solvency.

But as noted by several other commentators, the ESM is poorly equipped to address liquidity crises. The conditionality envisioned by the Eurogroup for the ESM's Precautionary Conditioned Credit Line (PCCL) is so strict that about half of the 19 Eurozone members would not qualify for PCCL today¹, let alone in an unfavourable economic situation or in a crisis. This is problematic, because in the absence of an agile and transparent PCCL option, the risk is that liquidity crises that could be solved relatively easily will morph into solvency crises that the ECB would then not be allowed to address.

A level playing field

Against the push to centralisation, two functions have remained decentralised. Anti-Money Laundering (AML) supervision, for example, remains a national prerogative. Money laundering impairs the level playing field that Banking Union aims to create, and it can be a serious geopolitical threat. To ensure that AML oversight is conducted in a rigorous, efficient, and strict way, this function should be conducted at the same level at which banking supervision is carried out – i.e. centralised at the European level.

Another key function that has escaped centralisation is insolvency. If a public interest is established, then the resolution of financial institutions is carried out at the EU level under clear and predictable EU rules and procedures. Insolvency, on the other hand, is left under national insolvency laws – which differ markedly across countries when it comes to the length and operational aspects of the process, as well as to the authorities in charge. This fragmentation creates significant uncertainty on the side of those who invest and operate across borders, and should be addressed by initiating a harmonisation of national insolvency frameworks, if not by defining a single EU insolvency law.

¹ See e.g. <http://bruegel.org/2018/12/does-the-eurogroups-reform-of-the-esm-toolkit-represent-real-progress/>

A true single market

Even a complete Banking Union will be of little use if Member States do not all fully commit to it. As also highlighted in the latest IMF report on Euro Area policies, many national authorities continue to favour ring fencing of capital and liquidity, and fragmented national legal provisions challenge centralised supervision in areas where the EU legal texts are insufficiently strong or unclear. Examples include powers to limit related party lending, tighter loan classification and provisioning, or the oversight of corporate governance and potential imposition of sanctions.

This fragmentation is extremely problematic because it limits the appeal of cross-border bank mergers. Only a minor proportion of bank M&A deals carried out in the past 10 years were cross-border in nature, and we have seen how strong the ‘home bias’ motive can be in the context of the recent failed acquisition talks between Deutsche Bank and Commerzbank. Yet if European banks are to be a viable business in the future – against the challenge of alternative FinTech players – they need to become truly ‘European’. The regulatory fragmentation we have today hinders this change.

Similarly, regulatory fragmentation also holds back the potential development of a truly European Capital Markets Union (CMU). The investment fund market is a very telling example. Investment funds offer an important option to channel private savings into the economy and diversify the funding possibilities for companies that traditionally are over-reliant on bank loans. The European Commission estimates that the EU investment funds market amounts to about €14.3 trillion, but is far from having reached its full potential.

Europe made an important step in the direction of developing this capital market with the UCITS (Undertakings for Collective Investments in Transferable Securities) Directive, which made it possible for European investors to buy funds across borders – something that was previously difficult due to domestic regulation or tax laws. UCITS is a rare example of Europe committing to creating a fully integrated jurisdiction to facilitate the marketing and selling of funds approved in one country throughout the whole EU.

“Integration can be fragile if not supported by the right institutional structure”

Yet today, 70% of total assets under management are held by investment funds authorised for distribution only in their domestic market, and only 37% of UCITS (and as little as 3% of alternative investment funds) are registered for distribution in more than three Member States². Similar to the issue of bank cross-border M&A deals, the problem is mostly attributable to regulatory barriers. In February 2019, political agreement was reached by the European Parliament and Member States on new rules to address this concern, but much more remains to be done.

The European path towards regional regulatory and supervisory integration offers important lessons for observers in other parts of the world. It shows how far the pursuit of closer monetary and financial integration can reach. At the same time, our recent history shows how fragile integration can be, if not supported by the right institutional structure. While a lot has been done, much remains to be finished, and the ever more challenging environment that Europe will need to navigate demands swift action.

70%

**Investment fund assets
authorised for distribution
only in their domestic market**

37%

**UCITS registered for
distribution in more than
three Member States**

² See e.g. http://europa.eu/rapid/press-release_IP-19-861_en.htm



Biographies

Michael Cole-Fontayn

Michael Cole-Fontayn is Chairman for the Association for Financial Markets in Europe, a role he has held since September 2015, with him being elected as “Independent Chairman” in January 2018, following his retirement from BNY Mellon in December 2017.

Michael spent 35 years with BNY Mellon, serving as Chairman of BNY Mellon Europe, Middle East and Africa from 2011 to 2017. In that role Michael was responsible for BNY Mellon’s governance culture in Europe, Middle East and Africa (EMEA) and led regional strategy development, execution and the delivery of enterprise initiatives in the region.

In October 2018, Michael was appointed Chairman elect for The Chartered Institute for Securities and Investment (CISI). He is also a member and co-chair of the Wholesale Banking Group of the European Financial Services Chairman’s Advisory Council (EFSCAC). He also sits on the advisory council/ advisory board for TheCityUK, FICC Markets Standards Board and the Official Monetary and Financial Institutions Forum (OMFIF).

Simon Lewis OBE

Simon Lewis was appointed Chief Executive of the Association for Financial Markets in Europe (AFME) in October 2010. Previously, Simon was Director of Communications and the Prime Minister’s Official Spokesman at 10 Downing Street. He has held a number of senior corporate roles including Director of Corporate Affairs at Vodafone, Centrica and NatWest. Simon was appointed as the first Communications Secretary to The Queen in 1998.

Simon has a degree from Oxford University in Philosophy, Politics and Economics. He also holds an M.A. in Political Science from the University of California at Berkeley as a Fulbright scholar. Simon is a board member of TheCityUK and a member of the Chatham House North American Advisory Council, as well as a member of the Academy’s Advisory Board.

Simon was appointed an OBE in the 2014 New Year Honours List for public service and services to international education through the Fulbright Commission.

Mark Carney

Mark Carney is the Governor of the Bank of England and Chair of the Monetary Policy Committee, Financial Policy Committee and the Prudential Regulation Committee. His appointment as Governor was approved by Her Majesty the Queen on 26 November 2012. The Governor joined the Bank on 1 July 2013.

In addition to his duties as Governor of the Bank of England, he serves as First Vice-Chair of the European Systemic Risk Board, a member of the Group of Thirty and the Foundation Board of the World Economic Forum.

Mark Carney was born in Fort Smith, Northwest Territories, Canada in 1965. He received a bachelor's degree in Economics from Harvard University in 1988. He went on to receive a master's degree in Economics in 1993 and a doctorate in Economics in 1995, both from Oxford University.

After a thirteen-year career with Goldman Sachs in its London, Tokyo, New York and Toronto offices, Mark Carney was appointed Deputy Governor of the Bank of Canada in August 2003. In November 2004, he left the Bank of Canada to become Senior Associate Deputy Minister of Finance. He held this position until his appointment as Governor of the Bank of Canada on 1 February 2008. Mark Carney served as Governor of the Bank of Canada and Chairman of its Board of Directors until 1 June 2013.

Jacques de Larosière

Jacques de Larosière entered the French Treasury in 1958, working mostly on international financial matters. From 1974 to 1978 he was Undersecretary for Monetary Affairs and from 1978 to 1987 was Managing Director of the International Monetary Fund. He was appointed Governor of the Banque de France in 1987 and President of the European Bank for Reconstruction and Development in 1993.

He was Advisor to the Chairman at BNP Paribas from 1998 to 2008, President of the Observatoire de l'Épargne Européenne in 1999, Chairman of Eurofi in 2000, and co-Chairman of the Committee on Crisis Management and Crisis Resolution in Emerging Markets of the Institute of International Finance from 2003-2009. He has been a Trustee of Reuters Founders Share Company, a member of the Group of Trustees for the Principles for Emerging Markets, and Chairman of the Strategic Committee of the Agence France Trésor.

He has been Chairman of the Advisory Board of MidEuropa Fund, a member of the International Advisory Board of China Development Bank, and member of the Board of Directors of France Telecom. He was a director of Stichting NYSE Euronext and trustee of NYSE Group Trust I.

In 2009, he chaired a high level committee on the reform of the European financial supervisory architecture, whose recommendations were agreed by the European Union Parliament and Council of Ministry in 2010.

Valdis Dombrovskis

Valdis Dombrovskis is the Vice-President of the European Commission responsible for the Euro and Social Dialogue, and is also in charge of Financial Stability, Financial Services and the Capital Markets Union.

Prior to that, he served three consecutive terms as Prime Minister of Latvia and was elected as a Member of the European Parliament and Head of the Latvian Delegation in the EPP Group. He has served as a Member of the Saeima (Parliament) of Latvia and was Latvia's Minister of Finance from 2002 to 2004.

Prior to joining politics, he worked as a senior economist and chief economist at the Bank of Latvia. Together with Anders Aslund, he co-authored the book "How Latvia came through the financial crisis", which was published in 2011.

In November 2014, Valdis was awarded the Order of the Three Stars, the highest State Decoration of the Republic of Latvia.

Bruno Le Maire

Bruno Le Maire is a French politician and diplomat. He currently holds the position of Minister for the Economy and Finances in Edouard Philippe's government under Emmanuel Macron's presidency.

An alumnus of the *École normale supérieure*, holder of a higher degree (*agrégation*) in French language and literature, graduate of Sciences Po Paris and former student at the *École nationale d'administration* (ENA), Bruno Le Maire began his career as Foreign Affairs Adviser at the Ministry of Foreign Affairs (known as the Quai d'Orsay). In 2002, he became Strategic Affairs Adviser to the Minister of Foreign Affairs followed by Adviser to the Minister of the Interior in 2004. In 2005, he joined Prime Minister Dominique de Villepin at Hôtel Matignon, first as an adviser and then as his Chief of Staff from 2006 to 2007.

In June 2007, he was elected as MP for the first constituency of the Eure *département*. In December 2008, he was named Minister of State for European Affairs in François Fillon's government before being appointed Minister for Agriculture and Fisheries in June 2009. He held the latter position until May 2012.

In 2012, he was re-elected as MP for the Eure *département*. In October 2012, he resigned from the foreign affairs advisers corps of the senior civil service. In November 2014, he was candidate for the presidency of the UMP party and took part in the centre-right primary for the French presidential election in November 2016. In 2017, he was re-elected as MP for the Eure *département*.

Dame Elizabeth Corley

Elizabeth Corley was CEO of Allianz Global Investors, initially for Europe then globally, from 2005 to 2016 and continues to act as a senior advisor to the firm. She was previously at Merrill Lynch Investment Managers and Coopers & Lybrand. Elizabeth serves on three company boards as a non-executive director – Pearson plc, BAE Systems plc and Morgan Stanley Inc.

Elizabeth is active in representing the investment industry and developing standards within it. She is a member of the CFA Future of Finance Advisory Council and the Advisory Council of the AQR Institute of Asset Management at the London Business School. She is chair of an industry Taskforce for the UK government on social impact investing. Additionally, she is a member of the 300 Club and the Committee of 200, as well as being a trustee of the British Museum. She is also a published author and fellow of the Royal Society of Arts. In 2019, Elizabeth was awarded a DBE for services to the Economy and Financial Services.

Sir Howard Davies

Howard Davies was appointed Chairman of the Royal Bank of Scotland in 2015. Previously, he was Chairman of the Phoenix Group, the UK Airports Commission, Director of the London School of Economics and Political Science and chaired the UK Financial Services Authority.

Howard was the Deputy Governor of the Bank of England from 1995-97 and Director General of the Confederation of British Industry. He also worked in the Foreign and Commonwealth Office, the Treasury, McKinsey and Co, and as Controller of the Audit Commission. He is a Professor of Practice at the French School of Political Science in Paris.

Howard chairs the Risk Committee at Prudential plc, is a member of the Regulatory and Compliance Advisory Board of Millennium Management LLC and has chaired the International Advisory Council of the China Banking Regulatory Commission. He has been a director of Morgan Stanley and GKN plc, a trustee of the Tate Gallery and director of the Royal National Theatre.

He is the patron of Working Families, has published five books focused on the financial markets and regularly writes for The Financial Times, Times Higher Education, Project Syndicate and Management Today.

Jean Pierre Mustier

Starting his career in Société Générale, working primarily within the Corporate & Investment Banking division, Jean Pierre Mustier held numerous senior positions in various markets and financing activities. In 2015 he became a London based partner of Tikehau Capital, an investment management group, with specific focus and responsibility for Tikehau's international expansion; he also advised many financial institutions and completed large amounts of fundraising for various social enterprises and non-profit institutions, also as trustee. He was appointed Chief Executive Officer of UniCredit in 2016.

Xavier Rolet

Xavier Rolet is Chief Executive Officer of CQS, a member of the CQS Board of Directors and Chairman of CQS' Management Committee. Prior to joining CQS he was Chief Executive Officer of the London Stock Exchange. He was Chief Executive Officer of Lehman Brothers in France, having been a member of the European Operating Committee and co-head of Global Equity Trading in New York. Xavier started his career at Goldman Sachs & Co. in New York and has also worked at Credit Suisse First Boston and Dresdner Kleinwort Benson.

He has an MSc in management science and finance from the KEDGE Business School, an MBA from Columbia Business School and a post-graduate degree from Paris-based IHEDN (Institute of Advanced Studies in National Defence). He served as a second lieutenant and instructor at the French Air Force Academy.

Davide Serra

Davide Serra is the Founder and CEO of Algebris Investments, a global asset management boutique that currently manages \$10 billion of assets.

He is recognised as one of the world's leading experts on financial services and is often consulted by the world's central bankers and regulators on policy matters. He has been awarded the Commendatore designation, a decoration of the Order of Merit of the Italian Republic.

Davide is Chairman and Trustee of the Hakuna Matata foundation, a registered UK charity which he founded with his wife, focused on assisting orphaned children in central Tanzania. Davide is a graduate cum laude of Bocconi University in Milan, Italy and holds a Master CEMS. He played volleyball professionally in Italy from 1985 until 1990, reached Series A1, and is a keen alpinist.

