Finance for Europe

Association for Financial Markets in Europe

Press release

New AFME & zeb report examines role of capital markets in Germany

Underused and unpopular – can capital markets help Germany meet the major financial challenges of future?

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- Germany is lagging behind other countries with respect to capital markets financing.
- German companies rely almost exclusively on bank loans while households still avoid capital markets for investing and retirement provision.
- There is an annual funding gap of EUR 175 billion needed to achieve the German government's ambitious climate targets by 2030.
- There are increasing signs views are changing with respect to the role of the capital markets in the German financial system.
- In Germany, the proportion of capital market instruments is significantly lower than in other countries, however, an equity culture is growing among young investors in Germany.
- The German statutory pay-as-you-go pension system is beginning to falter in the face of an ageing society. To address this challenge, a pension scheme, partly based on capital markets funding, will be essential in the future.
- Capital markets could help to finance future investments in Germany, including via new sources of financing, such as securitisations.

The Association for Financial Markets in Europe (**AFME**) has today published a new report on **the role of capital markets in Germany**. This study, prepared by zeb Consulting, shows the potential that stronger financing via capital markets offers for Germany.

Among the key findings, the report shows that for decarbonisation efforts alone, the bar is set very high in Germany. The German government has committed to reducing greenhouse gas emissions in Germany by at least 65% by 2030, compared to 1990 levels, under the Climate Protection Act.

Adam Farkas, CEO of AFME, said: *"Germany, Europe's largest economy, faces the immense challenge of raising approximately EUR 175 billion in financing every year until 2030 just to drive decarbonisation efforts. It is clear that the public sector and banks alone will not be able to finance these massive investment requirements. If the German government wants to fulfil its ambitious goals of transforming its industry, infrastructure and transport in the coming years, it will need to turn towards the huge potential of financing via capital markets. Further integration of Europe's capital markets will support and deepen Germany's competitiveness and prosperity in the future."*

Dr. Dirk Holländer, Senior Partner at zeb, said*: "Our international comparison of pension systems shows that countries with state-dominated pension systems have a less pronounced private equity culture in contrast to systems with capital markets funded elements. In Germany, a trend towards private pensions provision via the capital markets is starting to be seen. Nevertheless, German households continue to invest almost 60% of their financial assets in deposits or life insurance. Without a fundamental change in the current pension system, the development of capital market-related private provision will only progress relatively slowly."*

Key findings:

Ongoing low use of capital markets financing by German corporates

- Traditionally, companies in Germany have preferred bank financing to capital markets finance. The high proportion of bank loans as a company's main source of financing is striking: in Germany this is 29%, in France 24%, while only 12% in the USA. The entire corporate client business of banks in Germany is dominated by loans. The securities business, which is the provision of services in connection with the purchase, sale and custody of securities, is significantly smaller across all customer segments.
- Meanwhile, the market capitalisation of all listed companies in Germany is just under 50% in relation to gross domestic product (GDP). This is not only low compared to the United Kingdom (around 140%) and the USA (around 220%), but also compared to France, where the stock market capitalisation of companies in relation to the country's total economic output is over 100%.
- The relatively low market capitalisation of German companies compared with German economic output reflects the ongoing low use of capital markets as a source of financing for German companies. This is often attributed to family-run businesses, 94% of which have a turnover of under one million euros.

Bank loans alone cannot meet upcoming investment needs

- At the same time, innovation and modernisation are having a direct impact on the capital ratios of German banks. According to the report's estimates for the German market as a whole, banks will no longer be able to raise the funds required to decarbonise the economy in the future, even though they currently have a relatively good CET1 ratio (common equity tier 1 ratio) of 15.4%.
- Moreover, increasing regulatory requirements and investments in digitalisation will mean that banks have less room to manoeuvre in the coming years. Additional sources of financing beyond traditional bank loans will, therefore, be necessary. In order to close the obvious financing gaps to achieve the decarbonisation targets enshrined in the German constitution, capital markets represent an additional source of financing that has been little used in Germany to date, but appears unavoidable in the future.

Volume of private equity and public equity in Germany behind peers

- Furthermore, Germany lags behind as it relates to risk capital and is not maximising the potential of venture capital. In 2022, private equity financing in relation to GDP was 0.4%. In the USA, on the other hand, this stood at 3.6%; representing almost ten times more venture capital. The ratio in the UK is 1.1% - more than twice as high as in Germany.
- For small and medium-sized enterprises (SMEs), capital market instruments or institutional private equity (outside of investments by family and friends) only play a very minor role.

The "Schuldschein" model remains specific to Germany

- In addition, a special German structure - the Schuldschein – which combines the characteristics of loans and bonds still represents an important financing source. The issuance of "Schuldscheindarlehen" rose to almost EUR 40 billion in 2022, with banks acting as the first lenders and transferring tranches to investors.
- Although the volume of Schuldscheindarlehen has been increasing for several years and is more than 3-times larger than the classic securitisation market, the fact that they are not publicly traded hinders a wider use by foreign investors

Securitisation is an important part of the market

- Securitisation could free up bank capital, increasing capacity to finance the real economy. Companies could access new sources of funding and become less dependent on their bank. The Federal Ministry of Finance and the German Bundesbank have emphasised the advantages of these structures.
- In addition, Germany, together with France, have set out a roadmap to strengthen securitisation as a source of financing for the real economy. The revival of the securitisation market (as a successor to the Schuldschein market) could significantly improve the position of larger, capital market-oriented banks.

IPOs are shifting abroad

- Since 2019 there has been a growing trend towards cross-border IPOs by German companies, as the share of IPOs on foreign stock markets has increased significantly, particularly in the US.
- There is a clear industry pattern emerging: 52% of German companies listing abroad are in the biotechnology sector, while 19% are in IT/e-commerce.
- Firms with a cross-border IPO not only grow faster after getting public equity, there is also a tendency for these companies to increasingly shift their business away from Germany to other countries.
- For example, the number of foreign-listed German companies increased by 19.1% after their IPO, while the share of their German business fell by 33%. In comparison, German companies listing in Germany grew by 11.7% after their IPO, with the share of their German business increasing by only 1%.
- Against this backdrop, a major concern is that if German business activities shift to other regions in the future, then the country's growth potential will suffer.

The German pension system is under pressure to adapt

- State benefits account for more than three quarters (76%) of retirement income in Germany, with only 8% coming from occupational pensions. As the population ages, increasing pressure is being put on is the statutory, pay-as-you-go pension system to adapt. In the future, a state pension alone will no longer be sufficient to cover the cost of living in old age. The working population is becoming increasingly aware of this issue and is strengthening private efforts to provide for their own retirement. However, the process is a gradual one. In particular, the younger generation is increasingly starting to make private provisions. For example, the number of share owners between the ages of 20 to 29 has tripled in recent years.
- At around EUR 100 billion a year, the subsidies paid out of the federal budget currently cover 30% of all statutory pension insurance expenditure. By 2040, however, the ratio of contributors (15-64 year olds) to pensioners (over 65 year olds) will fall below 2:1. The pay-as-you-go pension system needs supplementary solutions to ensure that retirement income is adequate, with the German government currently considering the idea of a state pension fund.

Could modernising the German pension system be a solution?

- The German government is currently working on a legislative initiative called "Generationenkapital" which would modernise the pension system by building a capital stock from public funds to use earnings to stabilise pension contributions. Currently, the plan is to finance the pension fund from the state budget and invest in capital markets. With start-up financing of EUR 10-12 billion per year, a fund of around EUR 200 billion is to be created by 2035. However, the implementation of this pension fund remains vague in view of the budgetary situation.
- However, nearly 60% of German households' financial assets remain invested in bank deposits or life insurance policies. Typical capital market-related investments such as bonds, pension funds, investment funds and equities have a niche existence in Germany. Seizing opportunities through

capital markets, particularly by expanding the pay-as-you-go pension system to include capital market-funded components will be vital.

This study was prepared by zeb Consulting on behalf of and in co-operation with the Association for Financial Markets in Europe (AFME).

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About AFME

1. AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu
2. Follow us on Twitter, formerly X @AFME_EU

About zeb Consulting

As a leading strategy, management and IT consultancy, zeb has been offering transformation expertise along the entire value chain in the financial services sector in Europe since 1992. We have five offices in Germany – Frankfurt, Berlin, Hamburg, Munich and Münster (HQ) – as well as 10 international locations. Our clients include European large-cap and private banks, regional banks, insurers as well as all kinds of financial intermediaries. Several times already, our company has been classed and acknowledged as “best consultancy” for the financial sector in industry rankings. Further information can be found on the zeb website: www.zeb-consulting.com/de-DE