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Association for Financial Markets in Europe

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Financing the Recovery: The Role of Financial Markets in Rebuilding the European Economy – AFME & BusinessEurope webinar

Over a year into the pandemic and Europe is in danger of facing a new wave of restrictions. Despite Europe's banking system performing resiliently in 2020 and public authorities providing unprecedented support to businesses, it is clear this support will eventually need to be rolled-back according to panellists at AFME's and Business Europe's webinar on Europe's economic recovery. As Europe recovers from the pandemic actions will be needed to promote alternative sources of funding.

On March 19, AFME and BusinessEurope held a webinar on Europe's economic recovery. The call featured senior policymakers from the European Parliament, European Commission, European Central Bank, and the Ministry of Finance of Portugal.

In his opening remarks, **Markus Beyrer**, Director General of BusinessEurope, highlighted the uncertainties and likely uneven progress towards the economic recovery. On the positive side, manufacturing has performed relatively strongly, with export demand from the US and China playing a positive role. Also, many businesses are now better prepared to face the lockdowns. However, Beyrer also noted that business confidence remains low, making it unlikely that business investments will pick up soon. In this context, viable businesses need to be protected and a too sharp withdrawal of support measures (e.g. the moratoria on debt or the guarantee measures) would be damaging. But of course, we cannot stay in "crisis mode" forever. Beyrer stressed the importance of the Recovery and Resilience Facility to boost investments and transform the EU economy. But private investment is also important and businesses need to have access to the finance they need.

Beginning discussions, **Isabel Benjumea** MEP spoke of the need to improve the European financial system, highlighting this could be facilitated by further integrating European financial markets and addressing low-levels of bank profitability and developing financial markets capacity. Crucially, Benjumea spoke of the need to learn lessons from the 2008 financial crisis and how the burden of financing the recovery should not solely fall on banks: a more diversified financial system is essential. To support the recovery, public intervention needs to be complemented by private investments and a complete Capital Markets Union, together with the completion of the Banking Union, can enable those investments.

Michael Cole-Fontayn, Chair of the AFME Board, summarised the finding of AFME's recent report on "Recapitalisation of EU businesses post Covid-19", which reveal that many mid-size and SME corporates do not wish to give up control of their business but are willing to pay a premium not to dilute their voting rights, as well as are willing to distribute a share of profits to investors. Hybrid instruments are therefore likely to be well suited to address these needs. AFME recommends exploring the development of a new EU-wide hybrid instrument designed specifically for non-financial corporates and SMEs. He welcomed the recent French measures to support the provision of "equity loans" – a form of subordinated debt - to firms which were affected by the crisis but remain viable. Michael stressed the need to maintain momentum on the long term priorities like CMU and Banking Union.

1. **Panel discussion 'The performance of European Banking and Capital Markets During the Pandemic '-** moderated by: James Watson, Director, Economics Department, BusinessEurope

Speakers:

- **Edouard Fernandez-Bollo**, Member of the Supervisory Board, European Central Bank (ECB)
- **Erik Fossing Nielsen**, Global Chief Economist, UniCredit
- **Klaus Günter Deutsch**, Head of Department Research, Industrial and Economic Policy, Federation of German Industries
- **Michael Lever**, Managing Director, Head of Prudential Regulation, AFME

Edouard Fernandez-Bollo, highlighted the following three aspects: firstly, the EU financial system has shown resilience (operationally and financially), even beyond what was expected. Banks' solvency ratios will be stronger in 2021 than is 2020, despite very significant provisions for credit risk. This is also the result of the many support measures that public authorities, national and EU, have adopted since March 2020. Secondly, the support measures will need to be removed but carefully, and banks will need to anticipate and monitor the effect of this phasing out. Thirdly, the issue of low banks' profitability remains as a structural vulnerability, which has been aggravated by this crisis. Banks will need to adapt their business models, increase revenues, reduce costs, to respond to this structural challenge and to concentrate on the sectors which will lead the recovery.

Erik Nielsen noted that banks will remain central in the EU, as a shift towards more diversified capital markets will take time. He noted however that while it is true that banks are stronger and part of the solution, the main reason is the guarantees provided by the governments, and should these guarantees be withdrawn too quickly the impact on banks would be significant, which could lead to a credit squeeze. Erik insisted on the major issue of low banks' profitability: for the past 10 years the European banking system has not been able to generate a ROE above its cost o capital. This limits banks' ability to remain well capitalised. Reasons include the very low growth, the policy mix. On the need to reduce costs: while certainly important it can be the only solution (a 35% reduction would be needed to bring ROE to the average level, an unrealistic reduction); higher revenues are needed, but let's not forget that they represent an implicit tightening of the monetary conditions. How to square this circle remains an open and difficult question. Erik noted the larger size of the fiscal stimulus in the US, a direction the EU might have to follow.

Klaus Deutsch, highlighted the strong fiscal response of EU institutions and governments, which has protected companies from insolvency. Financing conditions for EU businesses have remained relatively good. These support measures have been designed on the assumption of a pandemic under control by Q2 this year; given that vaccination programs might actually require to be completed in Q3 or Q4, these measures need to be prolonged. Also sectors like leisure, travel, hospitality, which have a relatively large share in some countries, will need special attention, to avoid long-term repercussions. Klaus stressed the key role played by the ECB in providing liquidity to the system. He also cautioned about an implementation of the Basel standards which could lead to significantly higher capital requirements for banks, constraining their ability to lend. Klaus suggested the need for an EU framework for how to avoid insolvencies in businesses which, while viable, are particularly hit by the pandemic (e.g. travel / tourism sector).

Michael Lever stressed the important role played by banks in this phase, with record levels of net lending to the economy and with the ability to absorb extensive moratoria and to facilitate high level of debt issuance in capital markets. Michael highlighted the uncertainties around the recovery and a trend toward tightening of credit conditions. In any case debt financing cannot be the only source of financing: innovative recapitalisation tools are also necessary. Michael noted that bank consolidation in Europe, which would require progress on Banking union, would help address banks' low profitability.

2. **The second panel discussed 'The Road to The Recovery - Policies to Ensure Access to Finance and Well-Functioning Banking and Capital Markets'-** moderated by Stefano Mazzocchi, Managing Director, Advocacy, AFME

Speakers:

- **João Nuno Mendes**, Secretary of State for Finance, Ministry of Finance, Portugal
- **Martin Merlin**, Director, Bank, Insurance and Financial Crime, European Commission, DG FISMA
- **Véronique Ormezzano**, Head of Group Prudential Affairs, BNP Paribas
- **Tarek Tranberg**, Head of Public Affairs and Policy, European Association of Corporate Treasurers (EACT)

The second panel focused on the necessary policies to ensure access to finance and well-functioning banking and capital markets.

João Nuno Mendes shared optimism, emphasising the strong consensus between EU authorities on the need to implement exceptional measures to support Europe's economic recovery. The recovery plans that will be adopted in the coming months will define structural, and not purely liquidity, measures. Also, the idea of new hybrid instruments to recapitalise EU businesses is a particularly important one. He highlighted how Europe's recovery provides an opportunity to revitalise capital markets and act as a catalyst for entrepreneurship. Progressing on the Banking Union is also crucial and a roadmap will be presented by mid-2021. On Basel III, Joao said implementation should avoid possible impacts on the recovery.

Martin Merlin distinguished policies between those that could be implemented in the short-term versus the long-term. In the short-term, new instruments such as hybrids - proposed in AFME and PwC's report on Recapitalising EU corporates - could be looked to fill Europe's immediate equity gap. Additional short-term measures also included effectively implementing new regulations such as Basel III and wisely calibrating prudential regulation so that we do not unnecessarily penalise banks' ability to invest in the European economy (particularly equity investments). Insurance companies' ability to invest in equities can also be strengthened in the context of Solvency II. Martin agreed that financial regulation needs to be calibrated carefully; however it is not "the only show in town" and we cannot overburden it with too many objectives in addition to financial stability. For long-term measures, progress on the Capital Markets Union project was identified as an important goal for this legislature. Martin also stressed the positive impact that keeping momentum on the long-term objectives can have in the short term, thanks to the signalling and confidence-building effects.

Veronique Ormezzano welcomed the bold steps undertaken by the EU institutions and member states, which have enabled banks to continue to support their clients and the economy. Veronique summarised the recent French scheme, which will guarantee (up to 30%) investments funds which would invest in such loans: banks will provide the loans to firms and will then transfer these loans to investments funds in which institutional investors will invest. In order to align all interests, banks will keep a minimum share of each loan (probably 10%). This measure will also apply to subordinated bonds, in order to mobilize private equity funds. Business can start reimbursing the debt after 4 years. Veronique also highlighted the need to consider the competitiveness of Europe's financial sector when implementing new reforms. Particularly important will be the implementation of Basel III as well as the upcoming stress-tests. Sustainability objectives are also crucial, but appropriate transition arrangements need to be adopted. The importance of reviving securitisation markets in Europe to support growth was also stressed.

Tarek Tranberg summarised the many challenges corporates face in this environment, both in terms of short term "survival" and in terms of structural changes (e.g. shift to sustainable objectives). Corporates have managed the emergency phase thanks to their ability to access liquidity support from banks, with government support. This support should be maintained until there is a risk of prohibitively high financing costs. Recapitalisation instruments are essential to avoid excessive debt. In a CMU context easing some of the listing requirement for smaller companies would be important. However, bank lending will remain crucial and for corporates, it is important that Basel III implementation does not result in a reduced ability to access bank loans or risk hedging. Corporates are also worried about initiatives to standardise corporate debt markets.