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Financing European Growth: the challenge for markets, policy-makers and investors

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Ladies and gentlemen,

Let me thank the Association for Financial Markets in Europe as well as the organizers of this conference for inviting me here today. It is a great pleasure to have an opportunity to contribute to this roundtable. I truly believe AFME is addressing an extremely important topic, and it is important we are having this discussion at this point in time.

I am pleased to share with you some thoughts on financing growth in the EU from ESMA's perspective as a financial market regulator and supervisor. In particular, I would like to address the role of financial-market regulation for economic growth.

Financing Europe's growth – banks and alternative funding sources

Let me commence with some thoughts on the relationship between finance and economic growth. Safe and sustainable financing is a key precondition for the growth of our economies. It promotes investments and enables innovation as key factors in the equation. The findings by John Llewellyn and Bimal Dharmasena in their report underline this central link, and I would like to take the opportunity to commend both of them on their very interesting and valuable analysis.

In particular, the report highlights a crucial problem we may be facing in the coming years, namely a financing gap left behind by the struggling banking sector particularly in the EU, but also elsewhere. The future of the European banking industry and its role in financing and investment going forward is a crucial issue, and it occurs to me that a lot will need to be done in order to bring that industry back on solid grounds. But this certainly is a topic for many more conferences in the future.

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Let me instead focus on the other question which arises in this context, namely, which part of the non-bank financial sector could fill this potential gap? Alternative ways of funding of investments and businesses are a natural place to look, and securities markets in particular may play a role in this process. Let me review three areas which are frequently raised in this context:

i. *Capital market financing:* Equity and bond financing are the two most important alternatives to the traditional credit channel. Together, the two markets represent a key source of funding in the U.S. They contribute substantially to funding in many emerging economies. And also in continental Europe, where bank finance is the most common source of funding since many decades, equity and corporate bond markets have made important strides starting in the 90s. However, credit funding still remains the dominant source of private-sector funding in the Euro-area. Hence, in the future there is ample additional space for securities markets.

ii. *Shadow banking:* Today, shadow banking has come to be recognised as an important part of the financial system, and as a significant source of intermediated funding for the financial and non-financial sector alike. After all, it is estimated at 11 trillion Euros in the Euro-area, hence about one-third of the conventional banking sector. The problem in shadow banking, of course, is the shadow. As important as its intermediation function may have become, the sector has retained a tainted image, owing to its role in the crisis, its inherent complexity, and the many critical risks involved. These risks still need to be understood better, and there can be no doubt that the sector will continue to have the full attention of regulators and supervisors. However, I would like to emphasise that, in the EU and the U.S. alike, regulators have taken important steps in the past years not only to cast light on this segment of the financial market, but also to make it a safer place. Due to those efforts today most shadow banking activities are already addressed by existent regulations. In addition, multiple regulations are in the process of implementation. The focus of regulators shifts now to the optimization of that regulatory framework. We need to ensure that shadow bank activities and traditional banks are not exposed to incentives for regulatory arbitrage between the two sectors. Rather, shadow and traditional banking, and also their regulation, should complement each other.

iii. *Financing of small and medium-sized companies*: Any funding gap will hit SMEs the hardest, because they have been the most reliant on bank financing in Europe. I am glad the conference report raises this important point. At the same time, SMEs find it particularly hard to access conventional capital markets, owing to low issuance volumes and market liquidity. The emergence of trading venues and platforms targeted at SMEs is an encouraging sign, though, and these may play a more prominent role in the future, given the pressure in conventional credit markets. Likewise, specialised private equity funds may become a richer source of capital-raising, just as newly emerging alternative forms of funding.

These three areas of financial market activity – capital markets, shadow banking, and new forms of SME financing – may indeed play a vital part in alleviating potential credit-funding gaps.

However, let me also sound a note of caution. The extent to which we can rely on any of these funding channels as alternatives to the traditional and critically important bank funding business in the EU is not unlimited. At least three aspects warrant a realistic assessment of the situation:

i. *Volumes*: The EU's banking sector with 36 trillion Euros in assets is larger than its equity and private bond markets combined (EUR 8tr and EUR 16tr, respectively). New issuance volumes in Europe have been low by international standards, in particular in recent years. Thus, there can be no doubt that the banking sector will and has to play a central role in financing going forward.

ii. *Adjustment*: While the problems in the credit market are real and current, and are set to continue going forward, an adjustment of capital markets to replace any of the potential shortfalls will take a long time. We are talking about a fundamental evolution of these markets, which in continental Europe in particular has been a very gradual process so far.

iii. *Market dynamics*: Most importantly, any such adjustment depends on the dynamics in the markets. Borrowers may find it hard to exchange long-term bank relationships for the more volatile world of capital markets. And for investors, the question arises to what extent they want to commit funds to European markets and at what costs, especially considering the broader economic conditions. However, changes in regulation and the market environment are already pushing both groups to adjust their behaviour according to the new incentives. Thus a diligent evaluation of risks and a proactive attitude to available market information are likely to arise in the longer run. This increase in market discipline will render markets more efficient.

Still, achieving more balanced and sustainable financing structures in the EU will continue to be an important objective for markets and policymakers alike. But it will take realism, patience and a clear regulatory vision to accomplish this.

The role of regulation

Let me now come to the second important question that I would like to address: What role can financial market regulation play in the current environment?

In face of the difficult economic situation in Europe and elsewhere concerns are being raised that financial market reforms may hamper our economic recovery.

I am not convinced of that logic. Poor regulation and supervision were among the reasons for the crisis and the current state of the banking sector, and the financial markets. Keeping this in mind we need to focus on what we want to achieve for the future: Strong and sustainable growth requires stable markets. But stable financial markets need good regulation and effective supervision.

The financial reforms undertaken in the EU, but also in the U.S. and elsewhere, serve this important overriding objective: They provide a stable and predictable regulatory framework for financial markets and, in Europe, support competition by safeguarding and enhancing the European Single Financial Market.

Let me give you a few examples from our experience at ESMA, where – following up on the primary legislation adopted here in Brussels – we try to make a pragmatic contribution to promoting stable markets:

i. *Investor protection*: The peak of the financial crisis in 2008 was marked by an all-time peak in the risk aversion of global investors. Subsequently, risk aversion remained very high and only recently returned to more moderate levels. In addition, the confidence of financial consumers and retail investors in the financial services sector are at very low levels. Good regulation needs to restore trust into financial markets and institutions. ESMA contributes to this target in multiple ways. For example, ESMA has just issued a consultation on guidelines on remuneration practices for entities providing investment services. As we all know, high quality advice can only be given when it starts with the right incentives for the advisor. Our guidelines on ETFs will ensure more transparency on important elements of these products and that efficient portfolio management techniques are conducted in the interest of investors. On another front, our efforts in completing a unique regulatory environment for CRAs with more transparent ratings, reduce information asymmetries and rebalance the relation of issuers and investors. ESMA also strongly supports the universal and stringent use of high quality financial reporting standards. In sum, all those measures promote market confidence as a result of more transparency, better financial services and the right risk-adequate behaviour of market participants.

ii. *Stability of the financial system*: Building on the slowly returning investor confidence ESMA actively promotes a stable and sustainable financial system. For example, ESMA's soon to be completed technical standards on CCPs facilitate the stability and efficiency of derivative markets. Hence, they provide the basis for effective regulation and supervision of these very important market infrastructures. ESMA's guidelines on high frequency trading support a smooth market process and minimize trading distortions. Finally, the earlier mentioned ETF guidelines also support the stability of these investment funds by having requirements for the quality of collateral, securities lending and the use of repo transactions. Hence, our current and future regulation and supervision efforts are aimed to assure the stability of financial markets.

iii. *Single European Market:* The restoration of investor confidence and a stable financial architecture are important prerequisites for the Single European Financial Market. In addition, ESMA conducts an array of policies specifically designed in order to promote this important pillar of the common European House. In particular, ESMA coordinates the implementation of consistent regulations throughout the member states. The general move away from Directives towards regulations and common technical standards importantly contributes to the Single Market. The earlier mentioned guidelines not only help investor protection and stability, but also achieving consistent supervisory practices across the EU. We also closely cooperate and communicate with national authorities in order to avoid and mitigate cross-country differences which would generate regulatory arbitrage and the fragmentation of financial markets. Thus, ESMA helps to sustain the market depth of the European Single Financial Market as well as the related economies of scale and risk absorption capacities.

Conclusions

The European Union indeed faces some tough challenges in the coming years when it comes to financing growth. Finding alternatives for traditional intermediation models will be an important task. Whatever ways the markets may take in this regard, it is essential that we restore investor confidence by having a high level of investor protection. In addition, financial stability and efficiency are necessary prerequisites for economic growth. Efficient and effective regulation and supervision, in turn, safeguard and enhance financial stability and efficiency, in particular through the preservation of the European Single Financial Market. It thereby also promotes economic growth. I hope that – with the efforts I just highlighted – ESMA can make an effective contribution to this important mission.

Thank you for your attention.