20 years ECMI

CLOSING THE FUNDING GAP: Competition at the heart of the single market

Università Commerciale Luigi Bocconi

Jointly organised by the European Capital Markets Institute with Carefin - Università Bocconi and the Belgian Financial Forum

Belgian Financial Forum

Event Report

ECMI Annual Conference 2013
17 October, National Bank of Belgium, Brussels

As a landmark event in Brussels, the 2013 ECMI Annual Conference brought together once again international experts in capital markets from industry, policy-making and academia for a full-day of discussions on October 17th. This year's conference, organised in partnership with the Belgian Financial Forum and Bocconi University (CAREFIN), explained how competition in the single market can help to fill the funding gap. More specifically, it was structured around three sessions on the following topics:

1) **Competition among member states** - Balancing competitiveness and federalism in the eurozone
2) **Competition among financial market operators** - Making pan-European capital markets thrive
3) **Competition among funding sources -** Competition for funding and the role of capital markets





Key takeaways

- *Session 1.* Despite the fact that the eurozone begins to see the light at the end of the tunnel, uncertainty remains on the speed of institutional reform, such as banking union, and greater harmonisation of fiscal policies. More symmetry is needed to implement structural reforms by core countries and to ensure a mechanism of governance that does not create distortive incentives.
- *Session 2*. The financial market is a competitive setting that exhibits characteristics similar to multi-sided platforms. Therefore, it should be subject to ongoing supervision from competition authorities, while financial stability concerns are less significant than some years ago. European capital markets infrastructures need to find a way to succeed in a more competitive environment globally, perhaps by promoting a truly pan-European market architecture.
- *Session 3.* Governance is an essential aspect to ensure greater and better access to finance to corporates. Capital markets are testing several new tools to revive funding for fundamental parts of the economy, such as small- and medium-sized enterprises. The dilemma of promoting the risk-taking needed for growth while deleveraging and de-risking the financial system remains a tough objective to achieve for policy-makers in the aftermath of the crisis.

Session 1. Competition among member states: Balancing competitiveness and federalism in the Eurozone

Keynote speech

- **Thomas Westphal**, Director-General for European Affairs, Federal Ministry of Finance, Federal Republic of Germany

Keynote presentation

- **Andrea Beltratti**, Full Professor of Finance, Università Bocconi, and Chairman of the Board, Eurizon Capital

Panel discussion

- **Marco Buti**, Director-General for Economic and Financial Affairs, European Commission
- **Lúcio Vinhas de Souza**, Managing Director and Sovereign Chief Economist, Moody's Investors Service
- **José Manuel Campa**, Professor of Financial Management and International Economics, IESE Business School, and former Secretary of State for the Economy, Kingdom of Spain
- **Danuta Hübner**, Member of the European Parliament (EPP), and former Commissioner for Regional Policy, European Commission
- **Daniel Gros**, Research Director and Senior Research Fellow, Centre for European Policy Studies

  Moderated by **Freddy van den Spiegel**, Economic Advisor, BNP Paribas Fortis

Keynote speech

Thomas Westphal, Director-General for European Affairs, German Federal Ministry of Finance, opened the first session focusing his keynote speech on the future political challenges that European governments face in order to restore Europe's competitiveness on the global scenario.

"The main problem of Europe not being a federal State is that politicians can win the elections in their national countries on opposite arguments to the policy indications decided in Brussels. As long this will be possible, we will need to set a proper framework of incentives in order to prevent member states from escaping the need to make the necessary structural reforms."

Westphal highlighted how the challenge for a more competitive Europe will call for important reforms like the definition of a common fiscal policy for the eurozone countries. The success of these reforms will be highly dependent on the way in which EU institutions will manage to rebuild a consensus around the European project against the opposition of national interests. A key area in which national governments chronically fail to pursue EU objectives is the EU budget. According to Westphal, the current EU budget looks like a pool of subsidies and is the clearest example of how national interests are prevailing over EU interests, endangering the credibility of the EU's actions in front of the citizens:

"The EU budget should be used to finance EU public goods and the European Parliament should have a higher control over it".

The implementation of reforms requiring member states to give away substantial parts of their national sovereignty is seen by Westphal as a precondition to restore the EU competitiveness. In any event, this does not mean that all countries will have to look like each other; once the institutional framework has been set, the key driver of international competitiveness still remain *Ricardian specialisation*.

Keynote presentation

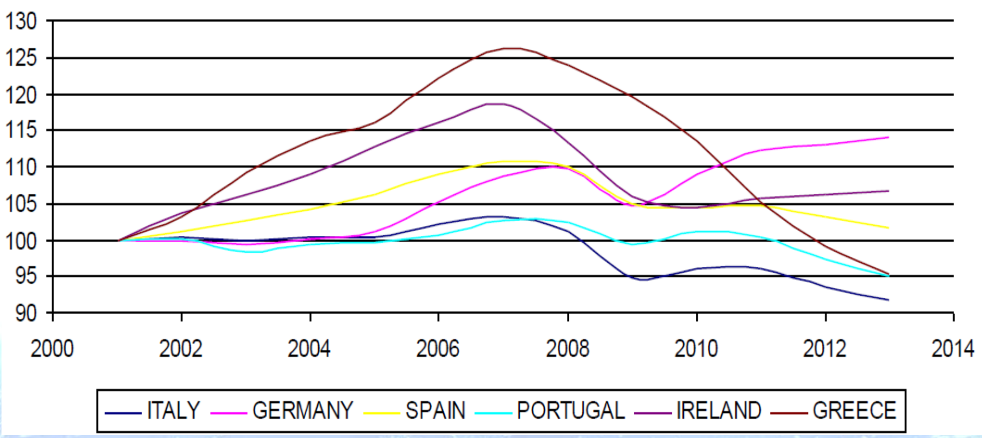
Andrea Beltratti, Professor of Finance at Università Bocconi and Chairman of the Board, Eurizon Capital, gave the keynote presentation of the first session. The first part of Beltratti's remarks aimed at assessing the status of the European macroeconomic environment and of the strategies that European leaders are undertaking in order to restore growth, especially for the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain). From an institutional point of view, he saw positive progress for the development of a common European identity. In this regard, some steps forward have been taken in the form of more coordination at European level of national budgets and, despite the fact that we are still far from a common fiscal policy, all member states are cutting the deficit at the same time. The project of the banking union is another example of this institutional convergence, even though there are still big issues pending, such as:

- The role of the ECB as supervisor and as monetary policy institution,
- The European common deposit guarantee scheme and
- The consequences of bail-in procedures on banks' funding costs, as traditional sources of funding are the deposit base and bondholders.

Beltratti's presentation also included an analysis of the fiscal policy decisions taken by European governments to restore growth in Europe and thus the effectiveness of austerity measures.

"Something has been done on the aggregate supply side but no policy actions targeting aggregate demand have been put in place."

Figure 1. Peripherals' lost decade. GDP per capita, 2000-2014.



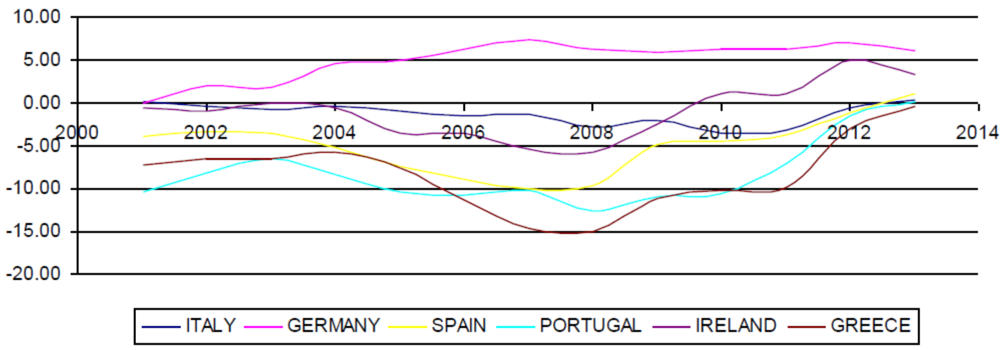
Source: Beltratti from IMF.

The initial response to the crisis has been *austerity* all over Europe. But learning from the experience of Greece and Italy, countries that have maintained fiscal discipline for many years with no positive effects on growth, and building on the new IMF position regarding an income multiplier estimation close to one (if not higher), the number of supporters of big cuts to public expenditures has drastically declined.

"We forgot that, as the Okun's law predicts, a drop in the aggregate output triggers a drop in productivity, which further worsen the competiveness of European economies."

Beltratti noted that the eurozone just returned to a positive growth path after 18 months, and other signals, e.g. the increase in current account surpluses, points at a Europe close to the end of the tunnel.

Figure 2. Current accounts in selected EMU countries



Source: Beltratti from IMF.

Some crucial questions remain: Is this the effect of the strong austerity measures imposed in the years after the crisis, which has cut aggregate demand (imports), or is this the consequence of the easing of such measures in recent months? Can we expect current account surpluses to grow fast enough to have positive effects on demand even when public demand is falling? If the shrinking of the public sector seems unavoidable, how can we avoid the vicious circle triggered by unitary fiscal multipliers? Growth will then have to come from other sources. Beltratti then concluded with some remarks on the EU banking sector:

"To regulate successfully a banking sector, you need one that is alive, and it can be alive if it is profitable."

If we want the banking system to be one of the drivers of European growth, we need to carefully attend to the incentives that regulation is creating for banks. Banks' deleveraging is reducing dramatically credit available to the real economy. We can force bank to be better capitalised, but we cannot force them to lend, as the failure of the UK's Funding for Lending programme witnesses.

The **panel discussion** elaborated on the inputs of the keynote speakers regarding the challenges that European governments will have to face to create a balance between federalism and competitiveness among member states. According to Marco Buti, the "production function factors", both in terms of labour force productivity and the European macroeconomic environment, are areas on which a stronger European coordinated action is required. A more federal Europe, with more national sovereignty to be shared, is necessary to act effectively on those important issues for Europe's competitive position.

In Manuel Campa's view, the policy answers to the crisis made the eurozone countries more balanced generally but much more polarised in terms of foreign assets holdings (FDI), such as banks' holding of sovereign debts, etc. Moreover, Campa claimed that the debate is too unbalanced, especially on what peripheral countries should do while core countries are performing worse than the US, the UK and Japan. Symmetry on the implementation of structural reforms is necessary, as so-called 'virtuous countries' have not done much in that direction. Danuta Hübner, MEP and former Commissioner for regional policies, emphasised the different adjusting mechanisms that each country has, but she argued that a common pathway for structural reform shall be identified and eventually implemented. According to Lúcio Vinhas de Souza, Managing Director and Sovereign Chief Economist at Moody's Investors, peripheral countries are effectively implementing structural reforms and this is witnessed by significant improvements in their external imbalances. These first signs of recovery, anyway, do not have to stop the commitment of these countries in keeping following this reform path as it may take years for these structural changes to be fully received. Daniel Gros pointed that in some areas greater European action is required, i.e. in order to stabilise the financial system, but in others, this is not a priority. We should leave national governments the possibility to make mistakes and to be accountable for these mistakes to stimulate a healthy competition. More long-term political solutions will come once we have ensured that the financial system is stable.

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Session 2. Competition among financial markets operators: Making pan-European capital markets thrive

Keynote speech

- **Joaquín Almunia,** Commissioner for Competition and Vice-President, European Commission

Keynote presentation

- **David Evans**, Executive Director, Jevons Institute for Competition Law and Economics, University College London, and Chairman, Global Economics

Panel discussion

- **Marc Antoine Autheman**, Chairman, Euroclear
- **Mark Hemsley**, Chief Executive Officer, BATS Chi-X Europe
- **Diana Chan**, Chief Executive Officer, EuroCCP
- **Jorge Yzaguirre**, Director of Equity Trading, Bolsas y Mercados Españoles (BME)

  Moderated by **Paul Bodart**, Board Member of T2S project, European Central Bank, and former Executive Vice President, BNY Mellon

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Keynote speech

The second session discussed the state of competition among financial markets operators and was opened by the keynote speech of Joaquín Almunia, Commissioner for Competition and Vice-President, European Commission. Commissioner Almunia gave an overview of what DG Competition is focusing on in the area of financial markets.

"The state of competition in Europe's capital markets is uneven."

Mr Almunia remarked how, thanks to the MiFID Directive, competition in trading and post-trading activities for financial instruments like equities is quite strong while in other sectors like derivatives trading, many things still need to be done. To address this problem, the Commission proposed the MiFID II/MiFIR regulation in 2011 which is at the moment being discussed by the Council and the Parliament.

The second aspect on which the Commissioner focused its presentation is the special-regime of *state aid* that was introduced since 2008 in order to cope with the massive public support received by private banks. This tailor-made regime has been justified with three arguments: to preserve financial stability, to safeguard the internal market and to protect the interests of tax-payers. Since August 2013, a new regime of state-aid for banks, compatible with the developments on the Banking Union side, is in place and includes three main changes. First, before recurring to taxpayers money, banks will be asked contributions from shareholders, hybrid and junior/subordinated debt-holders; second, no state-aid recapitalisation will be allowed before a restructuring plan has been approved by the Commission; third, a cap on executive pay for all aided banks would be introduced.

Commissioner Almunia, finally, discussed the major antitrust investigations that DG Competition is carrying on at the moment in the financial markets area. One of the major cases concerns the possible sanction of main investment banks and Markit for having illegally blocked the entrance of Deutsche Boerse and Chicago Mercantile Exchange in the credit derivative business to protect margins. Another major investigation was launched into the Libor/Euribor manipulations. This investigation is assessing whether major investment banks and some brokers set cartel arrangements in the interbank interest rate. The investigation is at an advanced stage and very soon the Commission will disclose its findings.

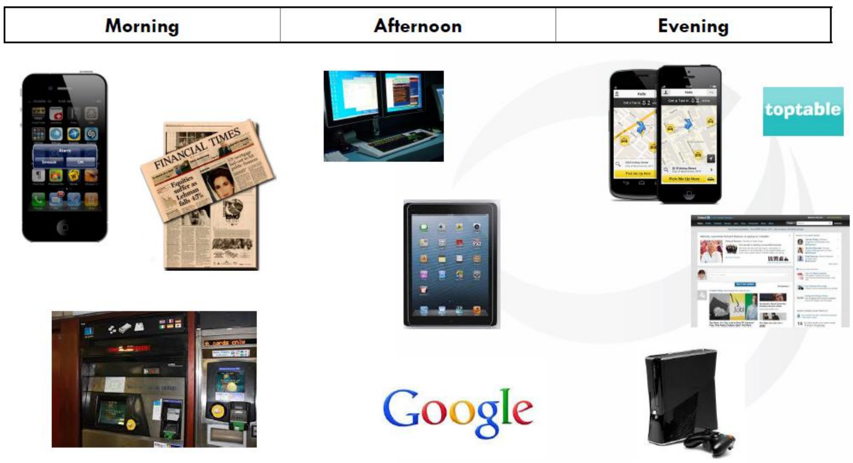
Mr Almunia concluded its remarks by saying:

"Safeguarding competition in this sector remains a top priority. We will spare no effort to make sure that market players abide by EU competition law: from State Aid to merger control, from abuses of dominance to fight against cartels. When it comes to competition control, financial markets are markets like any other. They will not receive special treatment from us, only special attention when financial stability is at stake."

Keynote presentation

The keynote presentation of the second session was given by Professor David Evans, University College London and University of Chicago, introducing the audience to his studies on the competition policy implications of multi-sided platform businesses. Multi-sided platforms coordinate the demand of distinct groups of customers who need each other in some way; the business of running such platforms consists of matching in the most efficient way the needs of these customers, by subsiding access to a category of users from the fees charged on another set of users that need the services provided by the platform. Multisided platforms are present all around us, from payment systems and game consoles to shopping malls.

Figure 3. A typical day of a Londoner



Source: David Evans.

The most pertinent case for the financial markets industry is typically the business of stock exchanges and clearinghouses. According to Professor Evans, there are three basic conditions for the emergence of a multi-sided platform business: 1) the presence of two or more distinct groups of customers (i.e. merchants and customers in the case of payment systems); 2) there are externalities associated with the two types of customers (i.e. a cardholder benefits from a merchant accepting his card and a merchant benefit from the cardholder being able to pay with a card he accepts); and 3) an intermediary is necessary to internalise the externalities created by one group for the other group (i.e. customers are not able to enter in a bilateral transaction).

"Competition authorities need to be particularly aware of the specificities of these kind of businesses as efficient pricing strategies can lead them to charge a price to a particular market side below the average variable cost or marginal cost incurred for customers on that market side."

The key message of Professor Evans's presentation is a warning to competent authorities not to limit the development of such platforms as they are a source of a great social value through the internalisation of externalities among different consumers and through the creation of products and services that could not exist without their role of intermediation.

"There is no basis for asking regulators or antitrust enforcers to steer clear of these industries. An understanding of the unique economic principles that govern pricing and investment in multi-sided markets will lead to discerning and efficient regulation of this important type of business."

The **panel discussion** of the second session focused on the topical issue of open access and interoperability in post-trade market infrastructures. Mark Hemsley strongly remarked how the future competiveness and attractiveness of European capital markets *vis-à-vis* global competitors is highly dependent on the accomplishment of a truly pan-European market for trade and post-trade services. The lack of a pan-European best bid and offer (EBBO) poses a potential obstacle to the creation of a competitive pan-European market. In this regard, Diana Chan explained how interoperability is a service that EuroCCP offers to its clients and that is highly valued by customers, who in fact pay for it. Opposition to offer interoperability comes, in Mrs Chan view, from inside the industry as it is seen as a threat to profitability, rather than as a high-value service to offer. Quite different was the view expressed by Jorge Yzaguirre concerning BME's clearing offer. BME is aiming to strengthen its vertical infrastructure and may soon launch its own clearinghouse in the Spanish market. A potential challenge to address, as Marc Antoine Autheman clarified, is the balance of competition policies' action in order to keep both vertical and horizontal models alive.

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Session 3. Competition among funding sources: Competition for funding and the role of capital markets

Keynote speech

- **Colin Mayer**, Peter Moores Professor of Management Studies, Saïd Business School - University of Oxford, and former Director, Oxera

Keynote presentation

- **Julian Callow**, Chief International Economist, Barclays

Panel discussion

- **Paulina Dejmek-Hack**, Member of Cabinet for Commissioner Michel Barnier, Internal Market and Services, European Commission
- **Mark Cliffe**, Chief Economist, ING Group
- **Stefano Caselli**, Full Professor of Banking and Finance, Carefin Research Fellow and Vice-Rector, Università Bocconi
- **Theo Vermaelen**, Schroders Chaired Professor of International Finance and Asset Management, INSEAD Business School

Moderated by **Thierry Timmermans**, Deputy Director, National Bank of Belgium

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Keynote speech

The keynote speech of the third session was delivered by Colin Mayer, Peter Moores Professor of Management Studies, Saïd Business School at the University of Oxford, who focused on the central role that financial intermediation has in promoting and sustaining economic growth.

Professor Mayer gave some examples of how financial intermediation can be successful and highlighted some common causes at the roots of successful entrepreneurial stories. The business model of the Swedish bank, Handelsbanken, has been used as an example of financial intermediation able to fulfil its role as long-term source of financing for the real economy and, in particular, to improve the access to finance for SMEs as opposed to the traditional UK banking business model. The interesting feature of the Handelsbanken model, which was not affected by the financial crisis, includes a highly decentralised structure where branch managers have complete discretion over each branch activity (from lending decisions to human resources management). As a consequence of this delegation structure, the bank does not have a central financial plan and does not set out long-term goals or a central marketing budget. The alignment of the incentives of executives and shareholders is given by the absence of traditional bonus schemes and the presence of a particular profit-share system: as long as the bank obtains a return-on-equity performance higher than its peer group, which has happened for the last 41 consecutive years, every employee of the bank receives an equal share of the bank's profit, this money is used to buy Handelsbanken's shares which can be accessed by employees only after they have turned 60 years old.

From the analysis of the common features of success stories of financial intermediation and through the comparison with the widespread business model of UK banks, Prof. Mayer drew some general conclusions on a set of priorities that may help the banking system to be a primary source of long-term financing for the real economy:

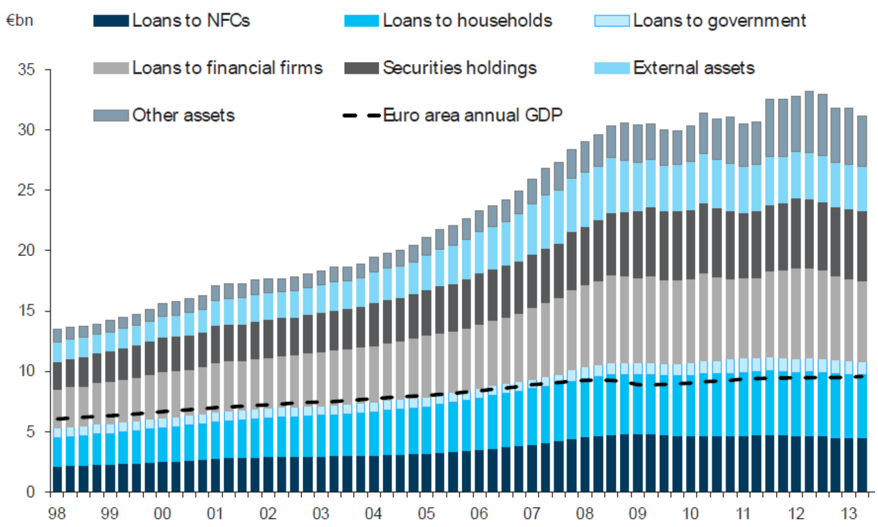
- A need for long-term ownership,
- A stronger focus on corporate financing,
- A deeper industrial knowledge,
- A higher delegation to local decision-making points and
- Long-term measures of performance and incentives.

Prof. Mayer also noted that, in order to revert the actual negative trends regarding the role of banks in SMEs financing structural, changes will have to come not only from 'inside' the banking industry, but also from policy-makers who will have to create more incentives for an active intermediation of banks. In particular, this will have to be done by promoting a more systemic regulation rather than a prescriptive one.

Keynote presentation

The keynote presentation of the third session was given by Julian Callow, Chief International Economist, Barclays. He presented to the audience the latest figures describing eurozone trends regarding the availability of financing sources to non-financial corporations (NFC) and households.

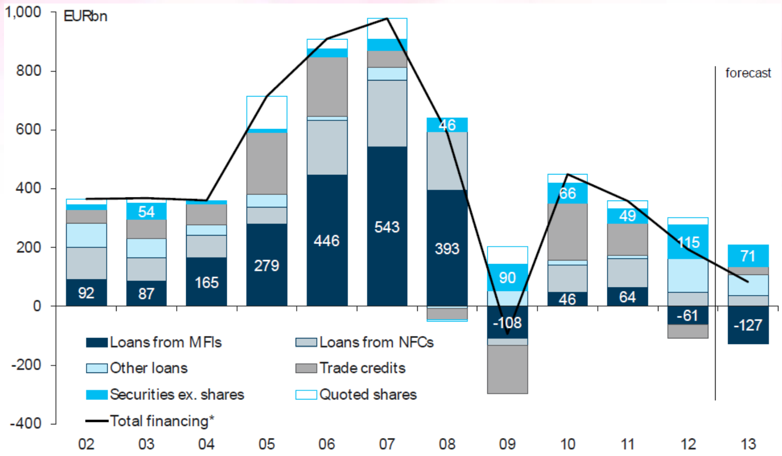
Figure 4. Assets held by euro area credit institutions



Source: Barclays from ECB data.

Data show how *divergent are trends in eurozone countries*: 2013 figures show in countries like France, Germany and the Netherlands positive growth rates of deposits and loans to NFCs and households. Conversely, in all the peripheral countries the same indicators are still facing a large deleveraging of financial institutions exposures towards NFC and households. An analysis of Eurozone banks' balance sheets reveals how, if from the end of the 1990s assets held from credit institutions more than doubled, the largest growth of these assets accounted for loans to other financial institutions, loans to governments and holding of securities while loans to NFCs and households remained grossly stable. In the meantime, non-financial corporations are increasingly relying on securities issuances (mainly debt) in comparison to past years.

Figure 5. Liabilities of non-financial corporations (annual transactions)



Source: Barclays from ECB data.

Other signs point at an *increased polarisation* within the eurozone concerning financing sources and access to credit: data on interest rates applied to new loans to SMEs and on house purchasing show a structural spread between Germany and France versus Italy, Spain Greece and Portugal, while the ECB survey on credit availability show how, again, that German and French SMEs have much lower refusal rate of loan applications compared to their Mediterranean peers.

In trying to show a possible way out from a situation in which bank de-leveraging is likely to continue, and where monetary policies actions are not reaching southern European countries, Mr Callow embraced some of the conclusions of the latest IMF World Economic Outlook, i.e. the *improvement of the securitisation agenda* via:

- The development of the primary and secondary markets for securitisation of SMEs loans,
- The problem of asymmetric treatment of securitised assets vis-à-vis other assets with similar risk characteristics,
- The introduction of governments guarantees for SMEs securitisation,
- The inclusion of SMEs loans in the collateral pool of covered bonds and
- The improvement of risk evaluation for SME securities by regulating and standardising information disclosure.





The **panel discussion** of the third session, elaborating on the two keynote presentations, continued to discuss the possible solutions to the issue of access to finance for SMEs in Europe. Mark Cliffe argued that capital markets can indeed be part of the answer to the sub-optimal financing condition of SMEs, also driven by a strong 'home bias' and fragmentation in the banking sector, but the growth of these markets is driven by investors and issuer demands. Therefore,

> *"Policy-makers have to confront the dilemma of promoting the risk-taking needed for growth while deleveraging and de-risking the financial system."*

The view of the regulator, coming from Paulina Dejmek-Hack, is that indeed market regulation can impose some costs and burdens on market participants and might be seen as harming the development of capital markets, but the correction of market failures that are embedded in such markets lead to an overall 'positive sum' game. Solving the funding gap is a multidimensional problem that doesn't have a single solution. Prof. Vermaelen cautioned about the limited role that governance can have in generating risk-taking behaviours embedding innovation and so contributing to growth. He also warned about the need to avoid unnecessary burdens and to limit policy tools that discourage risk-taking, which is ultimately the only way to generate groundbreaking innovation and renew economic growth. Prof. Caselli, while ruling out highly beneficial developments in the bond-markets for SMEs, brought some examples of interaction between the public and private sector that proved to be effective in improving the access to finance for SMEs, such as the Venture Capital Trust in the UK, the Elite programme of Borsa Italiana and a model of private equity funds developed in the US where the investment in SME equity is done on a shared based between public and private investors and where losses are shared but profits are private (so called, 'crowdfunding').



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