FINAL 09.04.15

Institute for Law and Finance (ILF) Conference

House of Finance, Westend Campus, Goethe University, Frankfurt, 18 March 2015

"European Capital Markets Union, a viable concept and a real goal?"

Panel: What can the capital markets deliver?

Opening Remarks

Anshu Jain, Co-Chief Executive Officer, Deutsche Bank AG

Is European Capital markets Union a viable concept? Certainly. Harmonisation of Europe's Capital Markets is potentially a highly important and positive step. Nonetheless, it is vital to consider not only whether such a step is viable, but also, how Europe can reap the full benefits of such a move. To answer that question, we need to consider the dynamics of Europe's capital markets as they stand today, in the context of wider challenges faced by Europe's economy.

The capital markets and Europe's growth imperative

The short answer is: developing Europe's capital markets is critical to spur the growth which Europe's economy so urgently needs. We are living in a three-speed world and Europe is falling behind. Over the next 5 years, until the end of 2019, the world's emerging nations will grow by around 30% - that is, more than three times as fast as the Eurozone, which is forecast to grow at 8% over the same period. The United States economy is forecast to grow around 15% - not as fast as leading emerging market economies, but double the speed of Europe. Since the crisis, Europe's recovery has not been strong enough, and structurally weak growth in the Eurozone has significant consequences. Most notably, it keeps unemployment from falling – particularly, and tragically, among Europe's younger generation. In some peripheral Eurozone economies, youth unemployment stands at historically high levels of between 30 and 50%. The implication is clear: stimulating growth is our overriding priority. To enable that growth, robust, diverse and well-balanced sources of financing will play a crucial role. Let's first consider where we stand today.

Currently, business in the Eurozone remains highly dependent on bank lending. Today, banks provide more than 70% of debt for European firms. However, bank lending to the private sector in the Eurozone has decreased substantially since the crisis. Partly as a result of bank-dependent business funding, access to financing for Europe's businesses today is highly uneven. Crucially, this problem is felt most acutely in precisely those areas where financing is most needed: in Europe's peripheral economies, and in our small and medium-sized enterprises or SMEs.

Economies in the Eurozone's periphery are worse-hit than core nations. Lending remains 29% below its peak in the periphery; by contrast, in core countries, it has fully recovered. 17% of Spanish SMEs and 14% of Italian SMEs, cite access to finance as their most pressing problem. This compares to only 9% in Germany. Additionally, SMEs are harder-hit than large corporations. In the Eurozone, loans smaller than EUR 1 million, which are most common for SMEs, carry an average interest rate of 3%. In this environment of record-low interest rates, this is the lowest level on record, but it is almost double the average interest rate of 1.63% for loans above EUR 1 million. Furthermore, the gap is getting wider: interest rate 'spreads' between European large-caps and SMEs have widened by almost half, or 47% since 2008. Experience tells us that economies which are dependent on bank financing have a harder time recovering from recessions than more capital markets-driven economies like the US, particularly when the preceding economic downturn is accompanied by a banking crisis.

To return to a path of sustainable growth, companies in the Eurozone, especially SMEs, need access to financing. However, in the post-crisis world, it is unlikely that the financing needs of Europe's economic recovery can be met by bank financing alone. On the contrary, traditional bank lending will likely remain constrained as banks continue to repair their balance sheets and meet the demands of new regulation on capital adequacy. The implication is clear: in order to overcome potential financing constraints, Europe's economy needs to reduce its traditional dependence on bank financing and deepen its capital markets. To assess the prospects for this development, we need first to ask: *where do Europe's capital markets stand today?*

Europe's capital markets: significant scope for development

Today, capital markets in Europe are underdeveloped, especially in comparison to the US - even allowing for the fact that the Eurozone economy, at around $12.9 trillion, is smaller than that of the US ($16.8 trillion). Europe's capital markets are considerably smaller than their US counterparts. Eurozone equity market capitalisation, at around $ 7.5 trillion, is a third the size of US equity markets at. $22.3 trillion. The Eurozone debt market, at around $22.5 trillion, is smaller by a third than the US at $37 trillion. The Eurozone market for asset backed securities, or ABS, excluding mortgage-backed securities, was already small compared to the US and has shrunk significantly since the crisis. Today, at $646 billion, it is barely half the size of the $1.3 trillion US market.

There are several reasons for the difference. In the case of securitization markets, structural factors play a role. The US market for mortgage-backed securities, or MBS, dwarfs its European equivalent, primarily because an implicit 'government guarantee' via Fannie Mae and Freddie Mac creates conditions for a securitization market which now covers some $9 trillion in assets and accounts for around 90% of all US securitization *(Source: SIFMA).* By contrast, in Europe, mortgages remain on bank balance sheets to a far greater extent. In addition, the US asset-backed securities market enjoys far greater availability of underlying assets eligible for securitization, such as student loans and automobile loans. This segment is virtually non-existent in Europe, compounded by regulatory constraints on demand in a key investor segment – insurers, who have reduced ABS holdings.

In equity markets, cultural and historical differences partly explain the gap between the Eurozone and the US. Europe does not have an equity culture comparable to the US, partly because, as America industrialised, its banking system remained relatively small as capital markets expanded. That difference is important to this day. In 2014, US companies excluding financial institutions raised around $150 billion in IPOs and additional offerings - nearly double the amount raised by their Eurozone counterparts. Furthermore, whilst European stocks are up around 15% this year, market participants are in large measure institutions and foreign investors – so a substantial proportion of the wealth created by market performance does not flow through to Europe's retail savers and investors.

Potential areas of focus

In other words; significant scope exists to develop and deepen Europe's capital markets. In considering how we can achieve this, I believe several tools are available to us. Let me focus on two areas which are particularly important in the short term: strengthening the securitization market and access to capital markets for SMEs.

Turning first to securitization; we have just discussed how the size of Europe's ABS market remains significantly below its potential. Developing this market would help make the corporate loan market more liquid, spread risks more widely across investors and provide a vehicle for the ECB to support corporate lending. Policy makers could do much to overcome structural hurdles to the growth of this market – for example, by reducing lower capital charges for securitization. Here, differences are significant. AAA senior securitization, for example, carries a risk weight of 11% and AAA mezzanine securitization a risk weight of 63%; this compares to risk weights for covered bonds of just 4% and for corporate bonds of 5%. In this regard, US banks, and thus issuers, enjoy competitive advantages: US banks benefit from lower risk weightings for securitization and are precluded by Dodd-Frank from using external rating agencies, and thus use a less onerous 'Simplified Supervisory Formula Approach'. By contrast, European credit rating agency requirements make it more expensive to issue structured finance assets.

We have other tools at our disposal. Identifying high-level principles of 'qualifying securitization' would add investor confidence and increase liquidity. In addition, harmonised of accounting treatments would undoubtedly contribute. In Europe, differences across jurisdictions still exist, whereas US banks reporting under Generally Agreed Accounting Principles (GAAP) are more incentivised to issue securitization due to the potential for off-balance sheet treatment of certain structured finance instruments.

We must also confront a second, crucial challenge: widening capital market access for Europe's SMEs.

SMEs are a critical sector of the European economy. They account for 58% of EU GDP and 67% of employment. At the same time, they are hit much harder than large corporations from the retreat in bank lending and face more difficult access to the capital markets. Several measures would help improving capital market access for SMEs. One such is to lower a key barrier: the cost of market access. This cost is still relatively high – driven in part by the need to provide investors with adequate information. SMEs vary widely in their business prospects and risks, particularly when compared across countries and transparency for investors is thus an important step. In addition, more can be done to promote equity financing by SMEs. SMEs have traditionally shown a strong preference for debt over equity, even though high debt ratios may put off lenders. Promoting a culture of equity involvement could be a step in the right direction – for example, via the development of private placement markets or more support for venture capital.

In this context, let us now consider the question of Capital Markets Union.

Capital Markets Union: an important step forward

While the concept for the Capital Markets Union is still being developed, it is certainly a step in the right direction. The Green Paper currently under review outlines a number of positive steps. The focus topics included at this stage are the right ones, especially deepening EU capital markets and supporting SME growth and long term finance. These are critical to our efforts to set Europe back on the path to growth. Very importantly, Capital Markets Union is potentially of particular benefit for Germany. Improving access to funding for SMEs is good news for the *Mittelstand* which, as we all know, forms the 'backbone' of the German economy. Regulatory stability, deeper capital markets and encouraging seamless cross-border business, lending and borrowing will benefit an export-oriented economy like Germany.

However, as we have seen, it is imperative that we see Capital Markets Union as part of a wider effort to deepen Europe's capital markets. Additional measures, such as those we have discussed, are vital – for example, the harmonisation of rules to make securitization less onerous in terms of risk-weightings for banks operating under strict capital discipline. In addition, it's important to recognise the role of the banking sector in enabling the development of deeper European capital markets. The banking sector remains a vital transmission mechanism - not only as providers of credit to SMEs, but also as intermediaries providing essential market-making and capital market liquidity.

Finally, we must recognise that time is of the essence – particularly as economies in other parts of the world are already expanding faster than Europe. It is now vital that we prioritise the most pressing topics and find practical solutions quickly.

In conclusion

Europe urgently needs to find the path to a sustainable growth. This growth will depend critically on robust and well-diversified sources of funding. We cannot afford a long, drawn-out process or solutions that are impractical to implement. Harmonisation of Europe's capital markets is certainly important and right; but our overriding goal must be wider: to accelerate the development of deep, liquid, transparent, well-regulated and well-diversified capital markets in Europe. That is in the interest both of Europe's businesses, and Europe's savers and investors. It is also in the interests of millions of young people across Europe who need and deserve prospects for their future.