The overall impact of the legislative proposals in the financial sector: Balancing between policies and growth

The aim of this briefing is to discuss the interplay of macro-economic growth policies and the regulatory reform effort in Europe. It focuses on the particular impact of reform on demand and supply of credit in the EU. It also elaborates on the policies that need to be implemented in the financial sector over the coming years and how this complies with some of the economic goals of Europe. Regulatory bottlenecks – concrete implementation issues that need to be addresses at the level of the financial institution- have societal impact and will also be discussed. Concerns about how to address the funding gap are touched upon. As a conclusion, this briefing presents some suggestions from the financial services sector's point of view about how to steer Europe to growth.

The rocky road to growth

Lacklustre growth following the 2008 financial crisis has brought discussions to the fore as how to bring about sustained, productive and consistent long-term growth supporting both competiveness and job creation. All this takes place against the backdrop of bank deleveraging in order to meet Basel III capital requirements by 2018 and heightened regulatory scrutiny of the most appropriate way of regulating non-bank providers of finance. Structural reform of financial sector and government austerity policies might resolve into that neither financial institutions nor public authorities will be able to provide the level of credit supply needed to meet ambitious targets for long-term financing. This is a global issue but is particularly relevant in Europe given the strains of the Eurozone crisis on both banks and sovereigns and the high level of bank-driven intermediation in Europe as opposed to other jurisdictions such as the United States.

Europe strives to hold its position in the world next to the US and Asia, but this will not come easy. Many EU countries have high levels of private and public indebtedness. Society has become more risk aware and risk averse. There is a lack of trust in the financial sector and government bodies. This inhibits the resilience of Europe.

Five years of economic and financial crises in the EU have left their mark. After focusing on containing the (financial) crisis, Europe now turns to policy aimed to stimulate growth and create jobs.

In recent years, global, European and domestic legislators and authorities have introduced a large number of new legislative regulatory initiatives aimed at addressing weaknesses in prudential regulation for banks as well as promoting financial stability in areas of non-bank market finance (so-called "shadow banking"). Although the impact of separate proposals is usually quite clear, there is a lack of insight into the combined cumulative effects of all these proposals. For an integrated overview and the effects of regulation on the real economy, the combined and cumulative impact of all new and proposed regulations must be considered. In the end new regulation is designed with a socio-economic objective to change existing practice and behavior and ultimately will impact the degree to which financial intermediation facilitates economic growth and will be able to fit the credit demands.

Regulatory reform has targeted banking and the role of banks rightly remains at the forefront of policy makers' thinking. However, the European citizen saving for life's eventualities and retirement should also be central to policy makers' thinking in all financial services legislation. Calibrating policy-making in the next five-year mandate towards dealing with Europe's demographic challenge would send a signal that Europe is alive to the very real social, economic and fiscal consequences of a phenomenon it will face for many years to come as well as to the priority to re-vitalising European growth. In this climate it is a challenge for the EU to simultaneously realize economic growth and create jobs, while stabilizing the market and making the financial system more secure and stable in order to restore the trust of society in the system.

Pressures on the system

New legislation (addressing structural reform of banking, capital requirements, bank recovery and resolution, deposit-guarantee schemes and domestic ban taxes) has put significant pressure on the ability of banks to finance" the real economy". It is important that legislators take into account the cumulative effect of all these measures on the financial markets when adopting new rules for the sector.

By way of a case study, research by KPMG[1] on the Dutch financial sector shows that the combined estimated effect of these measures applicable to banks implies that, without adjustments to the business model of banks (products and services offered, operations etc.), the Dutch banks will not be able to comply with the regulatory and/or market-imposed (minimum) requirements set for 2015 merely by cutting costs. It is being calculated that banks in this situation cannot distribute dividends to their shareholders. At the same time, it is very difficult (if not impossible) to find new shareholders in the current market conditions. Therefore, banks have to take measures such as re-pricing new loans, attracting long-term financing to replace so-called unsecured short-term financing, and shrinking the total bank balance sheet.

The aim to have a more stable financial sector is fully supported by the banks. As stated, in order to comply with all legislation (especially Basel III) it is inevitable that banks have to deleverage. Eurozone banks already have shrunk by EUR 2.9 trillion since May 2012, leaving approx. EUR 32 trillion on their balance sheets[2]. Further deleveraging of EUR 3 trillion is needed in order to comply. Also, banks are withdrawing from foreign markets and moving back to their home markets which leads to fragmentation of the Single Market. Furthermore, the cost of capital is rising, which is, for example, also reflected in the price of bank lending and its reduced volume. Thus, it becomes increasingly difficult for companies to attract desired funding.

Financial regulatory reform also fundamentally impacts insurers, asset managers and the ultimate end-investor. For the so-called 'non-bank' financial entities, there is a significant amount of concern where there are instances of regulatory frameworks appropriate for one sector of the financial sector (i.e. banking) applied to other sectors (such as asset management, insurance or the pension fund industry). Insurers are concerned about the various policy trends that could reduce the flow of premiums available and could create disincentives to long-term investing. These concerns arise in a range of policy areas, such as prudential regulation, taxation, accounting and macroeconomic policy.

[1] KPMG: The cumulative impact of regulation, 2012

[2] RBS, The long way to deleveraging: We are only halfway there, 2013

Bridging the funding gap

The objective of economic growth does not always match with the objective of reforming the financial sector. Balance should be sought between economic growth and stability of the banking system. The deleveraging, plus estimated amounts needed for economic growth, will lead to an estimated funding gap of EUR 4 – 5 trillion in the period 2013-2016[3]. This gap needs to be financed either through reducing the impact of new regulation on the balance sheet of banks (by striking a better balance between rule and principle based regulation) or promoting a greater role for other 'credit suppliers', like insurers, investment management firms, pension funds and direct capital market financing, but also for new initiatives like crowd funding.

In this setting, equity will become of more important. Specifically for high risk, high potential businesses this is, from a risk perspective, a better source of funding for (start-up) companies. Compared to (bank) debt, equity has always been quite expensive. Due to current all-times low interest rates, debt has long been the preference of companies. Now that financial institutions start to translate the increased capital costs and the increased risk (stemming from the economic downturn) and the costs of the implementation of policies in their pricing, it is assumed that debt will become more expensive and scarcer. In other parts of the world, for example the US, the use of equity has always been a lot more common than in Europe.

Long-term financing is the bedrock of the EU economy but will come at increasing cost to the real economy. There is decreased ability in the banking system (as a result of the new regulations) to supply long-term financing (short-termism) and finance high risk activities. It is a challenge for local and EU governments together with the financial sector to find ways to match demand for financing (from private and public sector, SME's and large corporates, short and long-term maturities) with the supply by different parties. Therefore, diversifying funding for the economy with the potential for more consistent growth and greater resilience to market volatility will be achieved if the needs of end-investors are taken into account. This means understanding the various liquidity and investment needs of investors in the context of their short and long-term liabilities.

It is important that EU policy makers keep the ambition to regulate Europe's financial sector in a way which strengthens and takes due consideration of the diversity of its financial sector. Growth can partially be funded outside of the banking system, for example via non-bank financial entities. Non-bank financial entities provide a valuable alternative of complement to bank funding and support real economic activity. The 1-million euro question is: will it be enough?

At the steering wheel

Financial institutions do understand the move to more regulation and increased governance in order to accomplish a more stable, resilient and safe financial sector which should (re)establish trust. For financial institutions to be able to stimulate growth, regulatory certainty is fundamentally important.

A further step in accomplishing a more efficient financial sector is the establishment of the Banking Union at its centre. The Single Supervision by the ECB should lead to more harmonized application of rules in practice, thereby getting closer to a true single market for financial services. National discretions, which lead to inefficient allocation of capital within banking groups, are to be abolished. This will empower banks to make better use of funding provided to them throughout the Eurozone, supplying it to consumers.

Policy makers also need to recognise the key role banks will continue to play in originating and underwriting risk, and public authorities and public investment banks in structuring deals and providing credit enhancement. Neither should policy makers underestimate the continued role for liquid public markets to provide capital for long-term financing.

Finally, it should be noted that there is a natural lag between implementing all measures and the public noticing the (positive) changes. Therefore it remains of great importance to act and communicate in a transparent and open way about the topics that the financial sector is working on.

[3] Insurance Europe, Funding the Future, 2013

Overall, we see a willingness amongst all parties involved to move in the same direction and make the effort to finance growth in Europe. Europe though cannot be seen separate from the rest of the world. Global developments need to be constantly considered, while taking the right measures within the EU.

Coming back to the rocky road to growth, the greater the policy focus is on delivering a supportive regulatory framework, the greater investors' ability will be to invest in long-term assets. It is important to assess the consistency of other reform proposals with the objective of ensuring a balance between stability and the stimulation of growth. Similar to regulatory disincentives, the financial sector also faces pervasive tax disincentives when investing in long-term equity or corporate bonds. New taxation schemes should be judged first and foremost in terms of their impact on the incentives to invest.

In this context, one cannot but come to the conclusion that the proposed Financial Transactions Tax (FTT) would be detrimental to long-term finance. A Financial Transactions Tax could undermine the ability of capital markets to assist in meeting European financing needs.

Businesses thrive in an environment where outcomes are predictable. Investors, like policy makers and regulators, value transparency of data and market liquidity. Strategies for growth must include a careful examination of regulation to avoid over-reporting and inappropriate regulation.

The European Commission is currently working on an assessment (both qualitative as well as quantitative) of the cumulative impact of the main measures on the economy, in the short run and in the long run. The results of this study are not only important for the banking sector, but also for policy makers.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Secretariat or the Chair of the Financial Industry Committee.

Chair of the Financial Industry Committee
Guido Ravoet, EBF Chief Executive
Avenue des Arts 56, B-1000 Brussels
Tel: +32 2 508 37 11 / Fax: +32 2 502 13 30
E-mail: g.ravoet@ebf-fbe.eu

Secretariat
Catherine Denis, EPFSF Director
Avenue des Arts 56, B-1000 Brussels
Tel: +32 2 514 68 00 / Fax: +32 2 514 69 00
E-mail: cdenis@epfsf.org