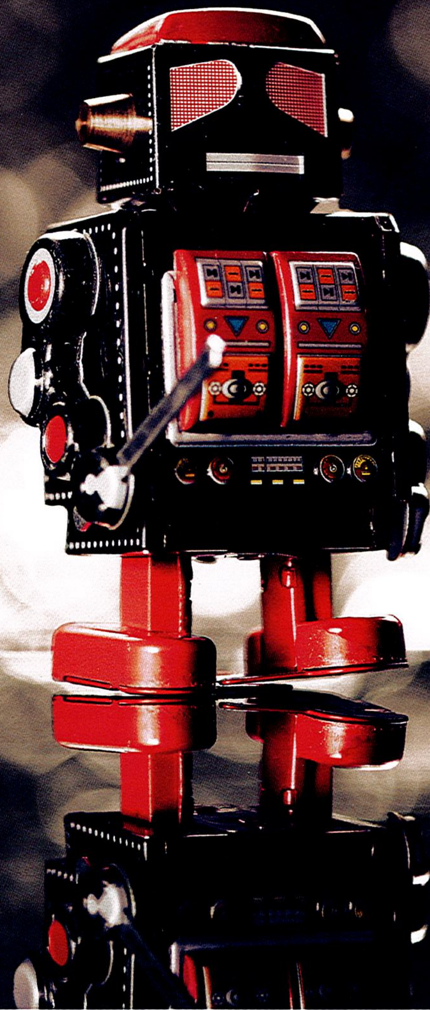

Europe heads back to the future

In February this year, the European Commission (EC) set out proposals to establish a Capital Markets Union (CMU) across its 28 member states; a move that it is hoped will precipitate a major rebalancing of financial intermediation across the continent. But if the EC really wants the idea of a pan-European capital market to become manifest, it had better make sure it considers the powerful role that FinTech might play in making that happen.

Most readers will by now be well acquainted with the story. A global recession combined with a financial crisis, followed by a more localised European financial crisis and recession, led to a deluge of strict banking regulation that stifled the supply bank credit to European firms. As access to banking channels dried up, larger corporates turned to the capital markets and, in unprecedentedly favourable borrowing conditions, drove bond issuance to new record highs. Those companies in the Eurozone that are too small to tap bond investors for funding have not, however, been quite so fortunate.

They are not small in number. A YouGov survey of 218 medium and large European companies and published by the law firm Allen & Overy in 2014, shows that 43% of corporate funding comes from banks, a figure which has changed little from the 44% that was reported when the survey was first conducted five years before. Correlation does not always equate to causation, of course. But the way that a less bank-reliant economy like the US managed to avoid the sustained malaise still affecting Europe has been used by some commentators as testimony that Europe is too reliant on its banking sector for financing and needs to beef up non-bank finance.

A capital markets union

The vision of a single European market for capital did not begin with the ideas set out in the Green Paper 'Building a Capital Markets Union', published earlier this year by the European Commission (EC). From the very beginning, the principle of free movement of capital has been at heart of the European project, shaping the policy agenda. The consultation recently kicked off by the EC, which sets out the case for the creation of a single European-wide capital market, is just the latest hopeful example of its influence on policy.

The first mention of the need to develop European capital markets was actually made in a paper written by Brussels policymakers nearly 50 years ago. It is striking to hear the similarities in language between now and then. "In all the member states, the financing of economic growth is coming to depend more and more on the capital market, and the establishment of wider markets, and close co-operation of economic policies would facilitate this growth," the report declared.

Does it sound familiar? The underlying motivation for pursuing the goal of a pan-European capital market is different, perhaps more urgent, now than it ever was before though. Back then the explicitly stated intent of capital market reform was to lay the groundwork for the unification of foreign exchange markets. Today, the single currency is already a reality. Unfortunately, though the very concept of monetary union is in increasing jeopardy as a consequence of the debt crisis in the Eurozone periphery and a far from convincing economic recovery almost everywhere else. The purpose of CMU now, then, is no longer to pave the way for the euro, but to save it.

Rebalancing finance

Reading the Green Paper it is clear that policymakers have their work cut out if they are to succeed in their ambition. A number of issues are identified in the document. These include the barriers to access the capital market, the need for sustainable securitisation activities, and the differences across legal jurisdictions that continue to impede companies who wish to issue private placements outside of their domestic market.

In a study by the Association for Financial Markets in Europe (AFME) published in February 2015, the latter, in particular, was found to be a significant impediment to investment in European companies. The AFME report, which surveyed global investors holding around €9trn assets under management, revealed that 65% of investors blame market fragmentation (lack of information and understanding of the differences across markets) for holding back investments in Europe. A further 60% cited discrepancies in rules across member states.

In the Green Paper, the EC also cites – albeit briefly – the role that new financial-technology (FinTech) companies can play in driving this integration. If one looks at these areas of focus in tandem with the banking union reforms also currently being implemented, then it quickly becomes clear what basket European policymakers are putting their eggs in. It is not with the bank-dominated financial intermediation.

"The ECB has supported research that concludes that Europe is overbanked," says Nicholas Véron, Senior Fellow at Bruegel, a European think-tank specialising in economics. "It is pretty clear that if you have a deep capital market you can mitigate this vicious circle between banks and sovereigns somewhat because you have an alternative for credit allocation if banks become impaired."

For the corporate sectors of certain countries, like the UK, that have relatively small capital markets these initiatives could be particularly beneficial. It is widely acknowledged, for example, that the UK capital market is not big enough for large UK-based corporates and, as such, many have to look to international markets when they decide to issue debt. That gives companies based in the US, for example, a material advantage when it comes to financing. So CMU, while a very important step, is perhaps more important for some countries than others.

In the digital age

If the EC and ECB are serious about making a success of the CMU initiative, however, the two bodies would be well-served to give more thought to what role new technological innovations might play in all of this. Although, as noted above, the paper did acknowledge that European law has so far "insufficiently (integrated) the benefits of digitisation," solid proposals around how to redress this issue for the benefit of digital innovators were in scant supply.

This shortcoming was highlighted in a paper published this year by the European Digital Forum, a think-tank and policy network led by the Brussels-based Lisbon Council and innovation charity Nesta. "I was really surprised to see that the digital technologies challenge was not fully addressed in the Green Paper," Sergey Filippov, Associate Director at the Lisbon Council and author of the report told Treasury Today. "What we believe, and what we say in our paper, is that it is not really possible to regulate separately for a CMU and to facilitate digital innovations in the European market."

The two ought to go hand in hand, because if the fundamental objective of the CMU is to reduce the European financial system's over reliance on the banking sector then FinTech might have a lot to offer to that end. We have seen how, in recent years, developments in digital technology have led to the emergence of new types of financial service providers and new funding vehicles (see, for instance, the rise of P2P lenders who have had such great success filling the bank void in SME financing space of late). Policy initiatives integrated into the CMU framework that would help such firms grow and intermediate more in such areas – channelling funding to SMEs who have had bank credit lines withdrawn, for example – would, arguably, be very much in accord with the CMU objectives.

As such, The Lisbon Council is calling for a "stronger technology mandate embedded in the forthcoming CMU proposals" and, secondly, for capital markets to be given a more prominent status in the Digital Single Market strategy. "The European Commission directorate-general for financial stability, financial services and capital markets union (DG FISMA) and directorate-general for communications networks, content and technology (DG Connect) should work together energetically to drive a policy agenda forward," the report demands.

Innovators and collaborators

It is important to emphasise that nobody, least of all the EC is suggesting we replace an overdependence on one type of financier (the banks) with another (capital markets investors and FinTech). It is merely that a more diverse financial system with more non-bank funding and more non-bank financial providers will be a safer, more stable system that is better placed to fund growth. The point that the likes of Filippov are trying to make is that capital markets should be for everyone: start-ups and financial services incumbents alike.

Indeed, far from seeing the rise of new digitally-enabled alternative finance providers as a competitive threat, it is becoming increasingly clear that the banking sector – or at least the greater part of it – see opportunities for themselves in the space. Disruption is, increasingly, giving way to collaboration.

"Some banks have swum against the tide, but a lot of the others are actually reacting in quite a positive way," says Filippov. "They genuinely think it is a good thing for the

financial system; they can collaborate with them and access some niche market that is not their market."

We have seen numerous examples of such collaboration of late. One might recall, for instance, that in recent years both RBS and Santander have struck up partnerships with P2P lending firms like Funding Circle which will see them refer customers they have turned down for business loans. But collaboration between banks and FinTech is not stopping at investment into already established innovators. The banking industry has also been investing increasing resources into helping new financial companies with novel ideas get off the ground.

For instance, every year since its launch in 2011, SWIFT's Innotribe Start-Up Challenge has served as a venue through which start-ups can present their ideas to leading banks, financial institutions, technology vendors and other professional services providers to attract potential collaborators. SWIFT rates and screens those start-ups using a network of over 500 volunteers, bankers, consultants, and academics. They also work with a network of approximately 20 industry experts who coach those start-ups in pitching their ideas to banks.

Needless to say, Fabian Vandenreydt, Head of Markets Management, Innotribe, the SWIFT Institute and Partner Management at SWIFT, believes banks and other financial institutions have a big role to play in fostering the innovations being developed by start-ups in the Fintech space. "I think the word 'disruption' is sometimes a bit abused. I don't think many (Fintech companies) are there consciously to disrupt anything. They may facilitate some reengineering of some functions in banking but, as we have seen, many of them are also willing to work with the banks.

"Ultimately, all banks have to comply with regulatory requirements," Vandenreydt says. "They are seeing a changing landscape, however, and in areas where there are themes that they see as important, they want to do something, but often they don't have the internal resources to support it. So instead, many are opting to work together with some of these Fintech start-ups.

The rapid rise in interest in this space has been triggered by the requirements of the end customers – be that individuals or corporates – for transparent rapid, and low cost solutions," he adds. "I think what the Fintech companies do is they make building blocks that can then be assembled to address some of those requirements for the end-customers. If you take, for example, big data or distributed systems, or P2P lending, these are all building blocks that when assembled may make the life of the end-user easier. Now, whether these will be revolutionary remains to be seen. But P2P lending, clearly is starting to have traction, to the point that a lot of banks are wanting to be part of what is going on the space as well."

Many of the large international banks have also established their own FinTech accelerators. Back in 2011, for instance, Citi was one of the first to launch such a service with creation of various Innovation Labs (which now number five globally). Like SWIFT's Innotribe, the ultimate objective is to explore new ideas and service concepts and collaborate with start-ups (and the bank's corporate and institutional clients) to develop, test, pilot and launch new solutions.

"One way to think of the digital challenge is as a threat," says Rajesh Mehta, Managing Director, EMEA Region Head, Treasury and Trade Solutions, Citi. "But the other way, the way we prefer to look at it, is as a massive opportunity to provide more value added services and products to our clients. Clients are increasingly becoming more digitally savvy. Because of this, we need to consider how we can use and develop new capabilities that will benefit corporate treasurers and CFOs. Many of these clients are commenting on the dichotomy between their personal financial lives and the way their institutional banks still operate. We are working to bridge that gap."

Baby steps

Predicting the future is always a risky undertaking, but can we determine, on the balance of probabilities, the extent of the change we are likely to witness in Europe over the coming years?

AFME, who in November 2014 published a report outlining potential objectives for a future pan-European capital market, is among those who caution that the road to CMU will be a long one. Some of the issues highlighted in the EC's paper such as tax, insolvency reform and securities law will need to be negotiated with member states. This can take some time, says Paul McGhee, AFME's Director of Strategy. "It has identified some issues that are really long term. For example, in the case of withholding taxes and the taxation of debt interest relative to equity, member states are responsible for those levers. So there are going to be some big political challenges ahead."

If it were easy to reach the sort of agreements between member states then a CMU might have been accomplished nearly half a century ago when the idea was first mooted. Had that been the case the financial history of Europe might have been very different. Perhaps, as a deep, pan-European debt market developed, companies would have had a much more diverse set of funding sources to choose between. That was not to be, however, and instead Europe continued, right up until the financial crisis, to become more and more bank dominated.

Other experts agree that the rebalancing of financial intermediation in Europe will be a gradual process. "Financial intermediation changes very slowly," says Bruegel's Véron. "The dominance of the banks in Europe is so extreme that even if it was massively corrected over the next five years it would still probably be excessive. There is no way that in the course of just a few years you could have the same level of capital market activity that we see in the US, because the EU is probably the most significant bank dominated economy in the world."

But gradual though it may be, change will eventually come. Part of this transformation is likely to be policy-driven, as evidenced by the proposals set out in the EC's recent Green Paper. But part of it will also be organic, coming, as we are already witnessing, from a burgeoning FinTech sector ready to fill the void left as banks retreat from certain, no longer profitable, segments of the market.

It doesn't mean that the bankers will find themselves in any way redundant in the future European financial market. But that the sector's role will change. Just as banks play a vital role in the functioning of capital markets – as book runners or lead arrangers on behalf of issuers, to name but one example – they are, through accelerator programmes and other forms of collaboration, also becoming increasingly important to the nascent FinTech sector.

In the end, the degree to which Europe can rebalance financial intermediation will largely depend on the extent to which legislators are able to agree new rules consistent with a vision of Europe in which the free movement of capital is a central, indisputable principle. That was the vision European policymakers had for the future European financial system back in the 1960s. It remains the vision today. ■