FINANCING GROWTH IN EUROPE

TOWARDS A PROACTIVE EUROPE IN 2014-2019

July 2014

FEDERATION
BANCAIRE
FRANCAISE

CONTENTS

ACCOMPANYING THE GROWTH RECOVERY

THE WORK OF THE EUROPEAN LEGISLATURE IN THE BANKING AND FINANCIAL SPHERE during the 2009-2014 cycle involved intensive work to resolve the problems related to the 2007-2008 crisis, and to overcome the resulting crisis in the Eurozone. Europe proved exemplary during this period, seeking resolution through progress in the Union's construction, notably the creation of a Banking Union, and the restoration of the economic area's stability.

FRENCH BANKS HAVE GENERALLY SUPPORTED THE REFORMS, endorsing in particular the need for supervision at European level to restore confidence in Europe's banking sector and attract investors, and the implementation of a crisis prevention and resolution system at international and European level to ensure potential future crises will be managed appropriately.

DURING THIS PERIOD, HOWEVER, THE FBF WARNED PUBLIC AUTHORITIES of the risk that poorly calibrated reforms would pose for financing of the European economy. Everything must now be done to fund Europe's economy, and the FBF will be particularly vigilant concerning the conditions for setting leverage and liquidity ratios.

AGAINST THIS BACKDROP, FRENCH BANKS HAVE IDENTIFIED FOUR PRIORITIES for the cycle ahead with a view to promoting efficient funding of the economy and limiting the distortion of competition. This is all the more crucial given that other key European banking and financial projects for 2014 (European tax on financial transactions and banking structural reform) are posing a threat to the competitiveness of European businesses. The FBF is calling on the members of the new legislature to prevent this.

PRIORITIES FOR 2014-2019: FINANCING THE ECONOMIC RECOVERY

The FBF felt it would be useful to review the priorities of the European banking and financial regulations in the 2014-2019 cycle with a view to referring them to the policy makers, in particular the new European Parliament and European Commission.

Four priorities were identified: better regulation of corporate financing, launch of a global impact study, enhanced security of payment systems, and the bringing of accounting systems into line with real economic situations in Europe.

1. FACILITATE FUNDING OF EUROPE'S ECONOMIC RECOVERY

- **Introduce preferential prudential rules for long-term and infrastructure financing, and quality securitisation.**

The FBF supports the Commission's plans to apply preferential prudential treatment to the funding of long-term infrastructure projects in its White Paper, as was the case for loans to SMEs in the CRR-CRD IV legislation. This will also be useful in funding the energy transition, on which growth in Europe hinges.

Preferential prudential rules for quality asset-backed securities or ABS that meet central bank eligibility criteria is also to be integrated into a future CRR-CRD V. In fact, the current securitisation regulations are punitive. Another area that requires development is the securitisation of mortgage-backed securities. In the US, the securitisation of mortgage-backed securities through government agencies Fannie Mae and Freddie Mac gives US banks a significant competitive edge because it allows them to reduce their balance sheets.

SMEs' REFINANCING THROUGH SECURITISATION

In France, the securitisation of credit claims (which remain managed by the banking groups that granted them), rated by the Banque de France and with a first issue of EUR 2.65 billion could become more widespread if the securities issued were recognised as liquid for the purpose of the LCR.

▪ **Make better use of European savings, the abundance of which is a competitive advantage.**

This would require the maintenance and development of channels and European financial players, as well as appropriate taxation on long-term corporate financing.

▪ **Facilitate corporate financing, including that of SMEs.**

Loans by banks in the Eurozone to non-financial companies fell by 7.4% from EUR 4,700 billion to EUR 4,348 billion[1] between December 2010 and the end of 2013. While this EUR 358 billion decline is almost exclusively due to the decline in lending in Italy and Spain, it should raise questions for Europe's policymakers.

As a result, the FBF is calling for regulations that do not discourage banks from lending to businesses, and more particularly to SMEs which are dependent on banks for funding.

In concrete terms, the FBF supports **the European Commission's project to recognise quality asset-backed securities (ABS) as liquid securities in its Delegated Act on LCR**. This would be an incentive to develop the SME securitisation market, which represents a mere EUR 40 billion compared with the EUR 4,348 billion that banks lend to companies in the Eurozone.

The FBF also supports **the proposal to recognise export financing as a high quality liquid asset (HQLA)**. This funding is considered non-risky because it is 95 to 100% state guaranteed via export credit agencies, as Coface in France.

Furthermore, the FBF is worried about the terms of payment involved in intercompany lending, and the perilous number of cases that do not comply with the 60-day requirement set out in the 2011 directive designed to combat late payments in European transactions.

▪ **Promote and defend the European credit-based funding model and the role played by universal banks within international bodies.**

This should guide positions concerning banking regulation in international bodies (Basel Committee, Financial Stability Board) and during negotiation of the transatlantic trade and investment partnership (TTIP).

TERMS OF PAYMENT

According to the January 2013 report of the Observatoire des délais de paiement (Trade Credit Observatory), one-third of companies pay their bills or are paid after 60 days. The consequences of this are significant since intercompany lending represents EUR 850 billion.

If deadlines were met, this would free up EUR 15 billion of available cash for SMEs and EUR 6 billion for intermediate sized companies.

There is significant scope for improvement among public entities in France to meet the 60-day deadline. By comparison, the average term of payment in Germany is 29 days.

Concerning the aforementioned negotiation between the United States and European Union, the FBF supports the inclusion of cooperation in the area of financial services to promote the convergence of rules, the mutual recognition of regulations, the adoption of common standards, and cooperation between supervisors.

1. *ECB data dated February 2014.*

Accompany the growing disintermediation of corporate financing.

Going to financial markets naturally implies abandoning the draft regulation on structural reform in European banking in order to preserve market making in universal banks and abandoning enhanced cooperation in the area of taxation on financial transactions. These projects pose a major obstacle to the financing of French and European companies.

To enhance their appeal, the European markets also need to implement secure post-market structures (clearing houses, central depositories, trade repositories). A resolution plan must be implemented for clearing houses and central depositories and a specific framework adopted for trade repositories.

The shadow banking system.

Tighter banking sector regulations facilitate development of the shadow banking system.

A high accumulation of risks in this system must be avoided to prevent new funding crises from occurring, hampering growth.

Regulation of the shadow banking system should favour an entity approach so as not to distort competition of banking activities.

2. LAUNCH AN IMPACT STUDY

A global impact study of recent and current regulatory changes related to funding of the economy is vital.

It would give the future European Commissioner in charge of financial services a vital overall perspective from which to prioritise and oversee coherent action.

Pending the results, no other proposals that would restrict funding of the economy should be implemented.

3. HAVE ALL PLAYERS COMPLY WITH THE PAYMENT REQUIREMENTS

Growth also requires security, which is why the FBF wants security and responsibility requirements to apply to all players in the payment process, so as to avoid the creation of a new shadow banking system.

- In the context of the draft PSD II[2], the FBF wants security requirements to apply to third party payment service providers (third party PSP) also, **and to all players in general** to ensure a level playing field. Specific identifiers are needed therefore that differ from those used by the customer in its dealings with the bank. **Authorisation of the third party PSP must be provided by the costumers** and this authorisation must be communicated to their bank for approval.
- Similarly, to guarantee consumers' security, **the third party PSP must be held liable in the event they are responsible for a fraudulent or flawed transaction** (e.g. following an attack on the third party PSP's information system or an execution error by the third party PSP). Moreover, **in such cases, the latter must have the necessary funds** (in the form of equity or escrow) to repay the costumer.
- **The FBF wants the European Commission to be even more ambitious in combating cybercrime**. The FBF commends the action taken over the last year by the European Cybercrime Centre at Europol. The FBF also commends the adoption in August 2013 of a directive to combat attacks against infor-

mation systems, which is to be transposed into legislation by September 2015. The FBF believes the ECB's recommendations following the work associated with the SecurePay Forum (which did not cover all cyber-related issues) must give rise to **harmonised regulations**, or at least be integrated into PSD II for **harmonised application across the European Union**.

- The FBF notes that because internet operators provide unsecure internet access there has been a significant increase in cyber fraud, the consequences of which are mainly assumed by banks. The banking sector wants to see the emergence of a genuinely secure internet and mobile access offering as part of the normalisation work to be carried out at European level.

4. BRING ACCOUNTING SYSTEMS INTO LINE WITH REAL EUROPEAN SITUATIONS

The FBF supports the reinforcement of European sovereignty in the accounting sphere and believes it is vital that the next European Commission implement european accounting reforms :

- The FBF is in favour of implementing the proposals of the Maystadt report[3] to strengthen the authority of European institutions when they adopt IFRS. The FBF believes moreover that the Commission should have the power to modify certain parts of IFRS when European interests are at stake. It already does this when it transposes the Basel Committee standards into prudential law.
- To avoid too late and insufficient loan loss provisioning (banks set aside provisions for loan losses during crisis periods when companies have least access to credit), the IASB[4] will publish a new accounting standard in July 2014 requiring that banks provision for expected losses. The FBF wants the future Commission to transpose this new standard into European law applicable as of 1st January 2018 so that European banks have time to implement it.

2. European payment services directive
3. http://ec.europa.eu/commission_2010-2014/barnier/headlines/news/2013/11/20131112_fr.htm
4. International Accounting Standards Board

VIGILANCE CONCERNING INTERNATIONAL REGULATORY PROJECTS

Too much reform could have a negative effect on banks' capacity to finance their clients' projects.

International bodies are nevertheless pushing ahead with regulatory reform. These projects, which are restrictive for financial institutions, must be seriously assessed in view of the priority of financing growth, by banks, which are now much sounder.

There is a considerable risk that the new rules will handicap continental European banks in particular because they are designed with the US economic model in mind.

New regulations are already being discussed by the **Basel Committee and the Financial Stability Board (FSB)** in relation to:

- the long-term liquidity ratio known as the net stable funding ratio (NSFR);
- the hedging of bank's exposure to interest rate risk in the context of their banking portfolio;
- a trading book review;
- the FSB's proposed new requirement concerning GLAC[5], which at this point is not consistent with the European MREL[6] requirement;
- a framework for the calculation of banks' risk-weighted assets;
- shadow banking regulations;
- banks' exposure to central counterparties;
- the leverage ratio.

These measures are strongly supported within the G20 and the Basel Committee by proponents of the Anglo-Saxon funding model. They are suited for this economic model and US accounting rules but would have negative effects on the continental European banking sector.

5. Gone-concern loss absorbing capacity (GLAC)
6. Minimum requirements for own funds and eligible liabilities (MREL); as provided in the BRRD, calculated for each bank by its national resolution authority based on its size, risk profile and business model.

OVERVIEW OF 2009-2014: A SOUNDER BANKING SYSTEM WORKING TO FINANCE THE ECONOMY

The work of the European legislature in the banking and financial sphere was of unprecedented scope during the 2009-2014 cycle with 20 legislations adopted between the start of 2010 and now.

The reforms already adopted have profoundly changed Europe's banking landscape and funding model.

Work of a similar scale is set to continue for several more years; certain projects are at the discussion phase and will be transposed into European law later.

The impending laws will have consequences for both growth and employment.

1. THESE REGULATIONS MAKE EUROPE'S BANKING SYSTEM ONE OF THE MOST SOUND IN THE WORLD:

- **thanks to banking union**, a plan that places Eurozone banks under one transnational and independent supervisor and creates a single crisis resolution mechanism backed by a fund of EUR 55 billion. The ECB's current asset quality tests coupled with stress tests will enhance the solidity of the Eurozone's banks.
- **thanks to implementation of the decisions taken by the G20** following the 2007-2008 crisis: strengthening of capital and liquidity requirements, adoption of the EMIR regulations to enhance derivative market soundness and transparency; adoption of the banking crisis prevention directive which cuts the link between banking crises and sovereign crises and offers full protection for depositors.
- **thanks to reinforced investor protection**, with the Markets in Financial Instruments Directive (MiFID 2) and the adoption of an information regulation applicable to retail investment products.
- **thanks to harmonisation of the rules governing retail banking**: property lending directive, directive on payment accounts.

The European banking system and the regulations that govern it have been considerably strengthened. Banks today are nothing like they were before the crisis.

2. THE REFORMS ARE IMPACTING EUROPE'S BANKING LANDSCAPE AND FUNDING MODEL:

- Between the outbreak of the subprime crisis in 2008 and 2014, **Eurozone bank capital has been strengthened by 36%, from EUR 1,753 billion to EUR 2,392 billion**[7].

This is largely attributable to prompt action by various banks to comply with the ratio provided under CRR IV. A trend that is set to continue because capital ratios must be brought into line between now and 2019 and asset quality assessments complied with.

- **European banks have also started to adapt their refinancing profile to comply with the short term LCR, with a 26% increase in deposits (up from EUR 6,444 billion in the Eurozone in 2008 to EUR 8,133 billion in 2014), and a decrease in the loan to deposit ratio to 114%**. In parallel, banks' total bond issuance has fallen from EUR 4,873 billion in 2008 to EUR 4,412 billion in 2014, representing a decline of 9%. This trend is also set to continue since European banks have until 1 January 2018 to comply with the rebalancing LCR. Depending on the calibration of the finally-agreed LCR, this could weigh on loan volumes and on companies' and households' financing costs.
- **Banks' refinancing costs have started to increase, and this will amplify with implementation of the banking crisis resolution directive:** the credit spread (difference between a bank's bond rate and the government borrowing rate) now stands at 0.7% in the Eurozone (compared with 0.1% before the 2008 crisis). The implementation of bail-in rules on 1st January 2016 will strengthen this phenomenon.

The possible adoption of the draft regulation on banking structures will also make funding more expensive for entities that have been separated from large banks but also for the main entity that collects deposits (because the balance sheet risk will be concentrated on equity capital and bond debt, deposits benefiting from a preferential treatment in terms of bail-in).

- All of these prudential reforms are changing the funding model of European companies, necessarily giving rise to less intermediation. In France, **bank loans accounted for 63% of companies' debt in 2013** (compared with 73% in 2008). This trend needs to be gradual and to adapt to higher demand for credit on the back of a stronger economic recovery.
- Due to such transformation, there has been a substantial fall in banks' ROE, well beyond pre-crisis levels. Their new target is 10%.

7. Source ECB.

DESIGNED BY THE INFORMATION AND EXTERNAL RELATIONS DIVISION

PRINTED IN JULY 2014

—

WWW.FBF.FR

—

FBFFrance

FEDERATION
BANCAIRE
FRANCAISE