bankenverband

Position paper

of the Association of German Banks on
the role of banks in financing the European economy

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Role of banks in financing the European economy

- **The financing of the economy through banks has proved its worth and is already successfully linked with capital market funding.**

  Banks are a **supporting pillar of the European economy**: they perform a key function in financing businesses, thus supporting growth, trade and employment.

  At the heart of **European financial market policy,** as fleshed out in the capital markets union project, is an overarching objective to strengthen the financing of businesses. Europe’s banking sector has a central role to play in achieving this goal. Member states come from very different starting points. In Germany, for instance, both bank-based and capital-market-based corporate financing function extremely well.

- **But the EU’s financial market policy risks draining the economy of funding power.**

  Lawmakers and regulators need to have a clear idea of how much banks can do to provide finance for businesses – even in a changing market environment – and what framework conditions are required to ensure they can operate in an optimal manner.

  Our aim is to present a clear overview of the role of European banks. Banks perform an important, tried and tested intermediation function, especially by analysing and managing risks, not least when capital market funding is involved. This function should not be disrupted by separating banks from the capital markets.

Banks as intermediaries

1. **The economy benefits from a diverse banking landscape.**

   The banking landscape in Germany, as in the rest of Europe, is characterised by **diverse business models**, keen competition, and innovation. This heterogeneous structure has proved beneficial to the equally diverse financing needs of businesses.

2. Businesses expect and obtain a wide range of financial services from banks – over and above credit and loans.

Banks are a **core element of corporate finance** in Europe. In addition to loans, they offer their customers a wide range of modern financial services, especially in the area of payments, export financing, risk management (e.g. of interest rate or FX risk) or in arranging private placements. Globally operating **universal banks** are important partners for internationally active companies. State development funds (from the EIB, for example) can also be delivered most efficiently through the corporate client's principal bank (intermediated loans).

Intermediation function of banks in corporate finance …

- Transformation of maturities, volumes and risks in credit lines and investment loans
- Export financing
- Syndicated and project financing
- Informed requirements analysis and professional risk management
- Holistic support and funding throughout and beyond economic cycles
- Use of derivatives to hedge against risks (of fluctuating interest rates, exchange rates, commodity prices)
- Placing pooled credit exposures with investors
- Growth financing

3. Banks offer businesses long-term support …

Banks normally **have close, long-term business relations** with their corporate clients. This enables them to carry out **informed risk analysis** and cooperate with customers throughout and beyond economic cycles. The bank acts as a go-between and offers support and backup in the form of bespoke solutions for all funding needs. It performs an **intermediation function**.

4. … and are dependable partners.

This includes a willingness to supply long-term funding. The focus is on **stable customer-bank relations** (relationship-oriented) rather than just individual transactions (deal-oriented). For customers, this is often an advantage which is lacking when they tap the capital market (or crowd) directly.

… not least when raising money on the capital market:

- Informed analysis of risks and market developments
- Assistance in equity and debt financing through the capital market
- Arranging private placements
- Often integral part of holistic customer relationship
- Market making: by trading securities and quoting prices banks ensure liquidity, thus making funding less costly; by underwriting, banks provide firms with funding security

5. **SMEs benefit particularly from a customer-bank relationship based on trust.**

   Small and medium-sized enterprises (SMEs) set particular store by a **close relationship with their bank** and, owing to their limited size, rarely have direct access to the capital market. In addition, it is often important to SMEs to avoid divulging information about their company to other investors unnecessarily.

6. **Larger companies are assisted by banks when tapping the capital market.**

   Large companies, which are able to **tap the capital market directly**, obtain extensive and bespoke assistance when they do so. This type of "one-stop" service has proved its worth over the decades.

7. **Banks are comprehensively regulated.**

   Banks are embedded in a robust **regulatory framework**, thus offering clients a high level of transparency and protection.

Banks in a changed environment

8. **European financial market policy has lost sight of the role of banks.**

   Banks' **role as intermediaries** has come **under pressure** in recent years as a result of market developments and regulation. European financial policymakers have set themselves the objective of reducing "dependency on banks".

9. **Risk expertise and long-termism are being pushed aside.**

   The desire of policymakers to reduce risks in the banking sector and distribute them more throughout the market is understandable. But this objective need not, and should not, lead to the role of banks as intermediaries being excessively restricted until it disappears altogether. Banks' core strengths – namely the **analysis and management of risk** and the ability to offer customers **holistic, long-term support** – should not be destroyed.

10. **Regulation generates very high costs.**

    Rising regulatory requirements (especially in reporting) increase the fixed costs of extending corporate loans. Owing to the comparatively small sums involved, this poses a particular challenge to banks when it comes to lending to SMEs. It is true that the growing digitisation of processes allows some room for cost-cutting. Nevertheless, **overall higher costs** are putting a strain on SME funding.

11. Corporate finance is becoming more complex …

Where appropriate, banks already include products and services of non-banks (such as insurance companies and funds) in **holistic funding plans** for businesses in order to broaden their investor base. If a company wishes to obtain long-term capital from the market, it needs the support of its bank.

12. … and requires professional support.

Banks are in favour of a greater diversification of corporate finance in the context of capital markets union where such diversification makes good sense. It is thanks to their role and function that companies are able to obtain stable capital market funding in the first place and banks wish to continue to support their clients in this process. Negative experience in Germany (since 2010) with so-called "SME bonds" has once again shown that **professional support** from experienced banks is the key to success in raising funds on the capital markets.

Appropriate framework conditions for the involvement of banks

13. The European capital market needs an efficient banking sector alongside it.

Banks and capital markets need to **work together**: they do not exist in isolation from one another. The advantages of capital-market-based and bank-based funding are complementary and should supplement one another. Even countries with highly developed capital markets, such as the US and UK, also have strong banks. Whether the financing culture is mainly capital-market based or bank based, banks perform important functions in either case.

14. Coherence and predictability in regulation are indispensable to the efficiency of banks.

The regulatory measures introduced in the wake of the financial crisis have rightly reduced the ability of banks to take on risk and raised the amount of regulatory capital they have to hold, thus enhancing their overall transparency and risk-bearing capability. But the interplay of various individual measures, a general lack of coherence and a degree of overregulation in certain areas have together **significantly undermined the capacity of banks to function** while driving up costs to excessive levels.

Examples

- The **securitisation of loans** plays a major role in financing businesses, infrastructure projects and banks. But the recent renewed significant tightening of the criteria for, and the legal uncertainty surrounding so-called "simple, transparent and standardised" securitisation threaten to put an end to this instrument in certain key areas.
- Hedging against market risk with the help of OTC **derivatives** – arranged via the bank – is highly important not only to large companies, but also to numerous SMEs. An exporting company may want to hedge against fluctuations in exchange rates, for instance. But the interplay between more stringent rules and regulations in various legislative instruments (EMIR, MiFID, Basel) makes these **hedging** practices much more **complex and costly**.
- If a medium-sized business wants to open a **new account** in an emerging country, for example, the bank has to satisfy extensive and recently considerably increased know-your-customer requirements for the purpose of verifying the account holder's identity and preventing money laundering. Though this is undoubtedly a necessary exercise, the costs for the bank (in terms of personnel, IT, processes) have increased substantially. For this reason, opening a foreign account is no longer always economically viable for the bank, and it is now only able to offer this service **in the context of a holistic customer relationship**.

15. The diversity of the banking landscape in Germany and Europe must be retained.

To enable corporate clients to continue using the services of small, medium-sized and big banks, each with their own different business model, it is important for supervisors to differentiate between banks of different sizes and to apply the principle of **proportionality** in an intelligent manner.

16. European banks need to operate on a level playing field – globally …

Both Germany and Europe as a whole need profitable and resilient banks which are located here and can at the same time offer global support. European policymakers need to commit to **globally coordinated financial market regulation** which **takes account of European conditions** and will not disadvantage the European economy. The global playing field should be as level as possible. A situation should not arise where certain financial services can be offered more cheaply outside the EU as a result of different rules and regulations, thus squeezing European banks out of the market.

Examples

- Businesses in Germany carry **comparatively low risks** and can consequently benefit from banks' risk-sensitive rating models. The restrictions on these models envisaged under Basel IV would hit the **bank-based** financing of businesses in Germany and Europe especially hard. Banks in the US, which are geared more to the capital markets, would be much less affected. When implementing the Basel IV standards in Europe, account should therefore be taken of established, tried and tested structures.

- US banks can **earn around 30 billion euros a year more** than their counterparts in the eurozone simply because of the difference in interest rates on deposits at their central bank.

17. … and with non-banks.

The same principle applies when it comes to non-banks: the **same risks should be subject to the same rules**. As long as both sides operate under the same conditions, banks can work in partnership with non-banks to the benefit of the customer. But if banks have to compete with non-banks under unequal conditions, they may be forced to withdraw from certain business segments and abandon them completely. Expertise built up over decades would be lost. These financial services would no longer be available to businesses.