Jacques de Larosière 6th May 2015

Brussels
Better Finance Conference :
" A Capital Markets Union
for growth, jobs and citizens "

If we look at the title of this conference, we see that the basic problem with a number of EU countries is that they have no growth and no job creation. This is not the result of defects in the functioning of the financial markets. It has to do with the loss of competitiveness that many EU countries have experienced since the early 2000s.

Restoring competitiveness by structural measures is the precondition for a resumption of growth.

This being said, the financial system and markets have an important role to play, as the European Commission has rightly stressed in its Capital Markets Union project.

Let me outline three themes on which I would be happy to return in the course of the second round of our panel.

I – Debt versus equity : the wrong incentives

The world has suffered before the crisis - and continues to suffer - from insufficient equity and too much debt.

Many enterprises need more capital to better face the future, engage in innovation, and develop their investments.

But the regulatory and tax incentives go in the wrong direction. Just an example : Under Solvency II, an insurance company that decides to hold equity must, on average, build 29% of capital. If it is a Government " risk free " debt instrument, the capital charge is 0. Taxwise, debt has also the most advantageous treatment (no deduction of dividends, while debt service costs are deducted from income).

This incentive pattern has to be rebalanced if we want more equity.

II – Financial Markets : they should play a bigger role in financing enterprises

With the bank deleveraging that we are experiencing, we need to bolster the role of capital markets in order to finance the " real economy ".

But, in this field also, the incentives are not always right. A few examples :

- Holding long-term assets is discouraged : for insurance companies, Solvency II penalizes, in fact, the holding of long term bonds related to infrastructure projects ; for banks, NSFR makes maturity transformation more costly ;

- More generally, the present regulatory setting has resulted in a significant shortening of credit maturity in the Eurozone ;

- Market making is hampered through increased capital charges on trading books. In addition, short term liquidity requirements (LCR) tend to reduce market making activities (and this, therefore, impacts negatively financial market liquidity) ;
- Securitization is far from being encouraged by present financial regulation.

III – Should one encourage direct holdings of financial assets by households ?

A number of questions have been put to us by Better Finance.

My view is that it would be a good thing to :

- Encourage more direct trading and holding by well informed households, and this for basic citizenship reasons : individuals should feel part of the economic governance. And this has also an educational dimension ;

- Take measures that would standardize financial products and make them more transparent (in terms of information on trade dates, on return, on prices (including fees) ….

But, in some countries, we must recognize that the tax system discourages direct holding and favors collective forms of investment. For example, in France, the favorable tax treatment of life insurance products as well as of regulated savings accounts (Livret A, Plans d'Epargne-Logement …) encourages households to invest a large part of their savings in such subsidized products.

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Conclusion

In conclusion, the problem relates to SMEs. No large investment grade listed company has any difficulty today in getting finance. Such companies have direct access to financial markets, and, in addition, market regulation, de facto, favors bluechips.

But SMEs are still almost completely dependent on banks which are, in a large part of the Eurozone, deleveraging.

This is not a technical observation. It is a fundamental one for " growth, jobs and citizens ". Indeed SMEs are the backbone of employment and growth in the EU (2/3 of new jobs, 60% of value added).

So, in my view, the absolute priority of CMU is to facilitate the market financing (shares, bonds, private placements …) of those enterprises, especially at a time of very low interest rates. Just a reminder : in the US, capital markets play a significantly higher (x 3) role than in the EU[1].

[1] In the US : outstanding bonds issued by non financial corporations = 3,3 trillions Euros
In the EU : " " " " " = 1,3 trillions Euros

The nagging question for European SMEs is captured in the following table :

SME's **(outstanding in billions €)**	Private equity funds	venture capital funds	crowd funding	family, friends	angel investments	total non bank financing	market capitalization **(trillions €)**
US	**59**	**104**	**3**	**371**	**39**	**576**	**19**
EU	**32**	**22**	**1**	**168**	**11**	**234**	**= 10**

Source : AFME – BCE " Bridging the growth gap " Feb 2015

Some of the questions are : why is non bank financing for SMEs 2,4 times more significant in the US than in the EU ? Why has the US a more developed equity network for SMEs ? Are there US best practices that could be adopted by the EU ? How could we encourage SMEs in the EU to become larger ? Could the use of internet social networks in assessing and financing SMEs be developed in the EU as it is in China, for example ?

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