2024

Europe - U.S. Symposium on Building the Financial System of the 21st Century

What's Next for the EU Capital Markets Union & U.S. Capital Markets?

U.S. Capital Markets

- World leading in most sectors and most institutions
  - Diverse venues mean competition and greater efficiency
  - USD remains the world's safe asset
  - But concerns about complacency
- Liquidity may be fragile
  - Regulatory burdens disincentivize banks from market-making
  - Who will provide liquidity generally and in times of stress?
  - Asset managers can temporarily exit markets without worrying about customer service
  - Is/should the Fed be "market-maker of last resort"?
- Political cycles and regulatory pendulum as wild cards

EU Capital Markets

- Traditions of bank-based finance
  - EU has long had universal banks (no Glass-Steagall)
  - Increasing recognition of need to encourage capital to move from deposits to capital markets
- Challenges of public markets in Europe
  - Low liquidity in secondary trading
  - Weakness of public markets as an exit opportunity discourages VC, PE
- Cultures of investing
  - Retail investor risk aversion and financial literacy
  - Pension funds highly regulated in risk profile and cross-border holdings
  - Firms also averse to market borrowing for risky investments

Digital Finance and Capital Markets

- Technological potential
  - Blockchain as alternative means of verification and settlement
  - Tokenization likely to become ubiquitous
- Generational change
  - New sources of information – social media as trusted advisor
  - Crypto and apps as entry points
  - Will younger generations in Europe be more open to risk and cross-border investment?
- Trust as central issue for capital markets
  - Trust in capital markets has been premised on regulation, disclosure, intermediaries
  - Surveys show Gen Z mistrust of established institutions
  - Is DeFi and unintermediated finance the answer or just a reminder of the need for trusted intermediaries?

Managing Competition and Fragmentation in EU

- Fragmentation and competition
  - U.S.: diverse venues lead to competition => efficiency
  - EU: diverse venues have led to segmentation and fragmentation
- Causes
  - Promotion of domestic exchanges and home country bias of investors
  - National debt markets remain national
    - Will there be expansion of EU safe assets?
  - Divergence of bankruptcy, resolution, and supervisory frameworks
    - Fundamental change would require treaty amendment and state private law
  - Brexit
- Impacts
  - U.S. and other foreign investors are wary of European markets
  - Lack of diversification and opportunities for European investors

Lessons for Invigorating Capital Markets

- Rules do not create markets, but they can facilitate or hinder
  - Clarification/simplification can reduce obstacles
  - Does promotion work? ESG and digital as stated EU priorities
    - ESG may cut both ways - reduces focus on shareholder value
  - Promoting financial literacy and planning for retail investors
  - Imposing bank-like regulation on non-bank financial intermediaries can hinder capital market development and liquidity
- Where is the supply of capital?
  - Public pensions - regulation and fund management
  - Does EU need to expand defined contribution plans
  - Insurance - are they over-constrained by Solvency II and other regulations?
- Role of private credit - stay tuned for next session

The Role of Banks in Lending and Economic Growth and the Rise of Private Credit

Rise of Private Credit Positive for Growth

- Aligns investor interest with risk-bearing investment
  - Higher risk appetite matches demand for growth capital
  - More flexibility and speed than bank loans or debt issuance
  - Different funding models - maturity transformation vs. investor base
- Diversity of financial institutions is good
  - Private credit key lender in some areas
    - Middle-market
    - Infrastructure and real estate
    - M&A
  - EU should encourage private credit to fill gaps of bank-based finance
- Complementary as well as competing
  - Markets for distressed assets or loan portfolios

Concerns over Rise of Private Credit

- Is it dangerous for financial stability?
  - Interconnectedness - linkages to banking, insurance, private equity
    - Reliance on private ratings
  - Challenges of information - need better data, not just more
    - Do we need same amount/types of data as for banks?
- Is new regulation needed to collect data?
  - Voluntary may be sufficient
    - Supervisors should precede regulators
  - Contagion concerns may be captured by bank reporting
    - Authorities proposing more call report data from banks re exposure to NBFI
  - Must bear in mind that "private credit" is highly varied
    - Stable funding - closed-end, life insurers, pension
    - Contingent funding - leveraged funds, open-ended funds
- Can private credit weather a serious downturn?
  - Where will liquidity come from?
  - Are there opportunities for exit without fire sales?

Maximizing Benefits of Private Credit

- Don't impose bank regulation on private credit!
  - Banks provide key public goods of payments, deposits
  - Need to fit regulatory efforts to funding and function
    - Maturity transformation vs. investor base
  - Don't regulate banks as "proxies" to regulate NBFIs
- Still need supervisors' eyes on risk migration
  - Regulatory arbitrage should not be primary justification for private credit
- Need to prevent "barbell effect"?
  - Middle-sized banks and SME funding most at risk - consolidation of middle-sized banks?
- Access for retail investors
  - Retail investors are kept out of growth opportunities
  - Are entry barriers to private credit the right way to protect investors?

UPCOMING EVENTS

2024

China - U.S. Symposium
June 5-7, Harvard Law School

Japan - U.S. Symposium
November 21-23, Washington, DC

To receive an invitation to other PIFS Symposia,
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Whitney Vasey
wvasey@pifsinternational.org | 857-242-6072
www.pifsinternational.org