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Unlocking Europe’s economic potential through financial markets

Europe’s financial structure weighs on growth

The Euro area’s recovery from the global financial crisis remains anaemic and, at least in comparison with its Anglo-Saxon peers, Europe’s underlying trend growth rate is modest. Both cyclical vulnerability and secular weakness have been widely blamed (e.g., in the academic literature and among market participants), at least in part, on the structure of Europe’s financial sector

A bank-centred financial system …

Europe’s financial system is centred on banks. To illustrate, banks provide around 70% of European firms’ external financing, with the remainder coming directly from other sources such as securities markets. By contrast, in the US these shares are reversed. Traditionally, European universal banks lent to their customers on a relationship basis, setting aside relatively modest capital when making loans. Leverage in European universal banks has therefore been higher than in their US counterparts.

… under challenge in a new global financial environment

This bank-centred financial model is being challenged by the experience of the global financial crisis and the international regulatory response that has followed it. The crisis itself demonstrated the vulnerability of bank-dependent borrowers to a credit crunch. The strengthening of capital and liquidity regulation that has followed the crisis weighs on banks’ balance sheet expansion. Other things equal, this reduces the availability and raises the cost of bank loans, to the detriment of those companies and economies that are more bank-dependent.

Developing deep, liquid EU-wide capital markets

In response, the European authorities need to create alternative sources of external finance. This would improve the resilience and reliability of credit supply to the real economy, by creating opportunities to substitute out of bank loans. Recently announced initiatives under the umbrella label of ‘capital markets union’ are a step in this direction. Of course, the financial crisis also illustrated vulnerabilities in the pre-crisis off-balance-sheet model of financing prevalent in the US – the underlying mistakes (e.g., complexity and opacity in securitisation markets) need to be guarded against. And capital market initiatives need to be seen as one part of a broader agenda for necessary structural reform in the broader economy.

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Unlocking Europe's economic potential through financial markets

Despite recent upside data surprises, the Euro area's recovery from the global financial crisis remains anaemic, at least in comparison with that seen in its Anglo-Saxon peers (Exhibit 1). And by international standards, Europe's underlying trend growth rate is modest: we estimate potential growth rates over the medium term to be little more than 1%pa (Exhibit 2).

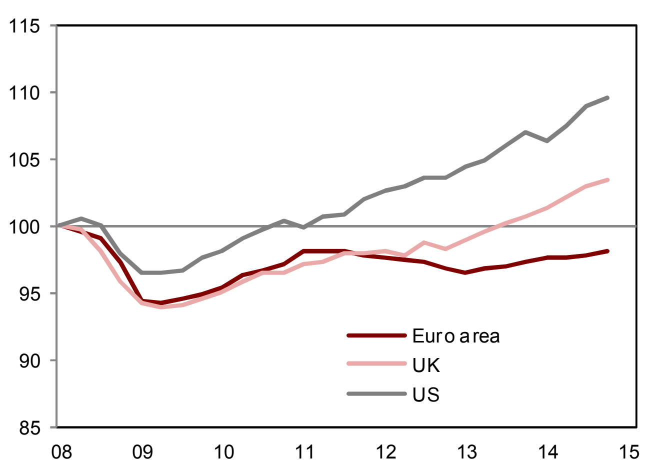
Both cyclical vulnerability and secular weakness have been widely blamed (e.g., in the academic literature, among market participants and in the supervisory community), at least in part, on the structure of Europe's financial sector.[1]

In previous work, we have discussed the role of financial market fragmentation in deepening and prolonging Europe's post-Lehman recession.[2] While all advanced economies suffered a sharp downturn after the failure of Lehman in September 2008, the fragmentation of Euro area financial markets during the subsequent sovereign crisis exacerbated and lengthened the recession. Financial conditions – especially in the stressed peripheral economies – tightened dramatically once concerns about the continued viability of Euro area membership were priced in. Given their close relationship with sovereigns, peripheral banks were particularly adversely affected, intensifying the 'credit crunch'.

This week, we explore the influence of financial structure on the underlying economic potential of the Euro area over the medium to longer term. We argue that Europe's bank-centred financial system may weigh on growth performance in a changing global financial environment.

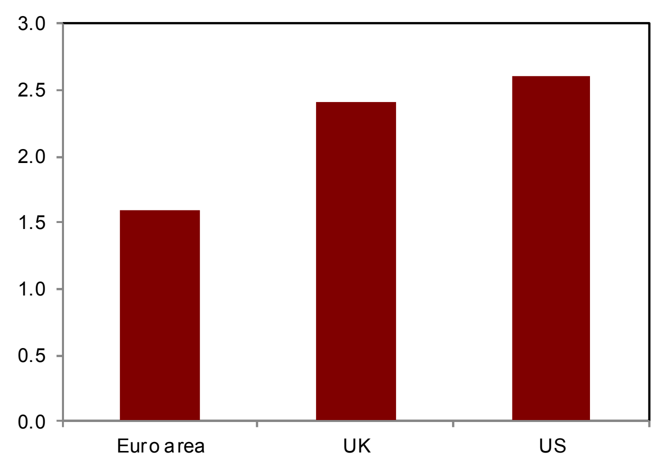
In this context, developing deep and liquid continent-wide capital markets to complement the banking sector would support trend growth in Europe. Such markets can diversify and augment the financing and saving opportunities available to firms and households. By helping channel resources to more efficient uses, a better functioning financial sector (in general, and deeper securities markets in particular) can raise Euro area economic potential, by boosting returns, strengthening investment and accelerating capital accumulation.

Exhibit 1: The Euro area economic recovery has lagged that in the US and UK ...
Real GDP, index 2008 Q1 = 100



Source: Eurostat, ONS, Bureau of Economic Analysis

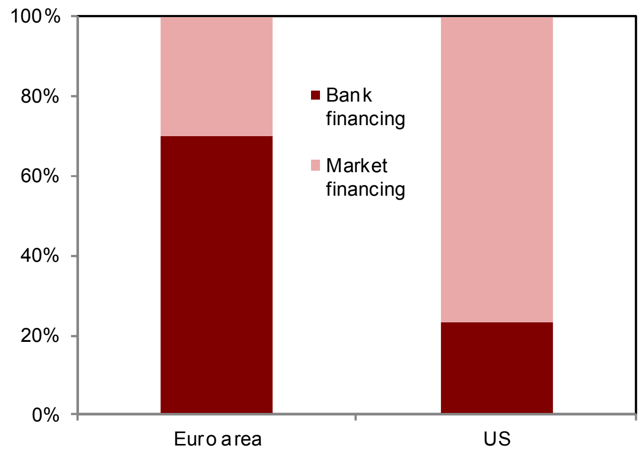
Exhibit 2: ... and IMF estimates of potential growth in the Euro area are lower than in the Anglo-Saxon economies
Steady-state potential growth rate, real GDP, %pa



Source: IMF

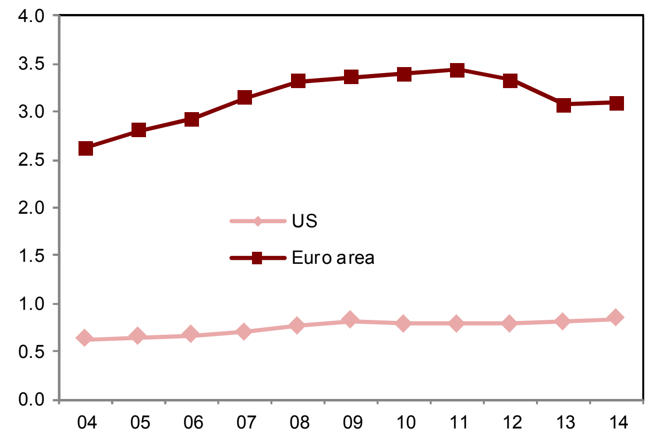
[1] See (e.g.): "Is Europe overbanked?" Reports of the ESRB scientific committee 4, June 2014.
[2] See: "Shocking aspects of Euro area bank lending", *European Economics Analyst* 13/30.

Exhibit 3: Euro area companies rely on bank borrowing to a much greater extent than their US peers …
Financing from banks to total net external financing, non-financial corporate sector, 2014, %



Source: ECB, Federal Reserve

Exhibit 4: … leading to a much larger banking sector in Europe than in the US
Bank assets to nominal GDP, %



Source: ECB, Eurostat, Federal Reserve, Bureau of Economic Analysis

Challenges to a bank-centred financial system …

Europe's financial system is centred on banks. Banks provide around 70% of European firms' external financing, with the remainder coming directly from securities markets (Exhibit 3). In the US, by contrast, these shares are reversed. As a result, the European banking sector is significantly bigger than its US counterpart. Total bank assets sum to more than three times GDP in the Euro area, whereas in the US the ratio is less than one (Exhibit 4). Aside from the role played by banks in corporate financing, this trans-Atlantic difference also reflects the retention of mortgage loans on European banks' balance sheets, whereas in the US loans for house purchases often tend to be sold into the market via agencies (Fannie Mae, Freddie Mac).

Traditionally – and we recognise that this description represents something of a caricature – European universal banks lent to their customers on a relationship basis. With an in-depth knowledge of borrowers' day-to-day business and strategy, the capital set aside when making such loans was modest. Leverage in European banks was therefore high.

This banking model has been challenged by the experience of the global financial crisis and the international regulatory response that has followed it:

- First, there is an obvious **risk in relying heavily on bank finance if the banking sector is itself subject to stress.** Experience during the global financial crisis reflects this. In all jurisdictions, larger companies with direct access to capital markets have performed better than smaller companies that rely on banks and have been hindered by the credit crunch.
- Second, the **regulatory response to the financial crisis** poses further challenges to bank-centred financial systems. The Basel III arrangements require banks to hold more capital and liquidity when conducting their business. Well-capitalised, more liquid and better supervised banks will strengthen the resilience of the financial sector as a whole. But if increasing bank leverage is more costly owing to regulation, other things equal, bank loans will also become more costly – and less freely available. This is particularly the case where leverage ratios do not distinguish among different types of bank assets. European universal banks which start with high leverage ratios as a result of their traditional business model are particularly vulnerable in this respect.

To the extent that extending bank loans becomes more difficult – whether because of crisis-related stresses in the banking sector or because expanding banks' balance sheets becomes more costly for regulatory reasons – this will be to the detriment of those companies and economies that are more dependent upon banks for external financing.

Creating a diversity of alternative financing sources would improve the resilience and reliability of credit supply to the real economy, allowing for substitution that insures the economy against impediments in the banking sector. But, to be successful, the excesses and vulnerabilities that helped contribute to the financial crisis in the US (e.g., mispricing of asset-backed securities stemming from opacity and complexity in securitisation markets) need to be guarded against to ensure capital markets function well.

… serving a corporate sector dominated by SMEs

The high level of bank-dependence in the Euro area also reflects the importance of small and medium-sized enterprises (SMEs) in the European corporate sector. In the EU, half of all workers are employed by firms with fewer than 50 employees, whereas in the US that proportion is only around one-quarter (Exhibit 5). As a rule, small businesses cannot issue directly on publicly-traded securities markets, since insufficient information is available for investors to assess corporate performance and creditworthiness. SMEs are therefore more likely to rely on banks.

Putting these two elements together, European companies tend to be more bank-dependent than those in the US simply because of their average size. If Europe grew more large companies, its financial sector would naturally become less bank-dominated.

But bank-dependence is as much a cause as a consequence of the structure of the European corporate sector. If companies are reliant solely on bank loans, their opportunities to grow may be limited. More diversified funding sources – including venture capital, private equity and private placement opportunities – are important vehicles to allow smaller companies to expand and achieve the scale and financing necessary to gain access to publicly-traded markets.

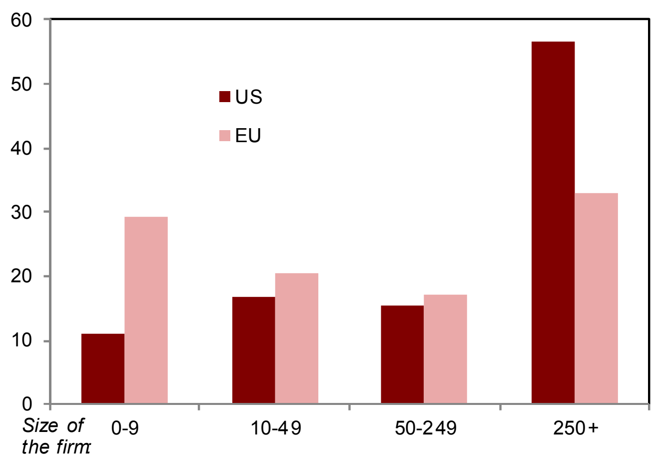
Moreover, creating these alternative financing vehicles for growing smaller companies would diversify the investing opportunities available to households and institutions. While banks are dominant, bank deposits are the principal saving mechanism for households (notably in Germany). The counterpart to the creation of alternative financing mechanisms is the creation of new savings vehicles. Allowing institutional investors such as insurance companies and pension funds to make greater use of such instruments could act as a catalyst for their development.

Yet financial constraints are not the only (or even the main) cause of the preponderance of small firms in Europe. Labour and product market regulation and segmentation also hinder the emergence of larger firms. As an illustration, in those countries where employment protection legislation becomes more onerous above a certain threshold for firm size, there is a clear tendency for firms to cluster just below that threshold. Broadening and deepening the availability of financing sources to SMEs may be a necessary step in reducing bank dependence. But, to be effective, it needs to take place in a wider context of structural reforms to liberalise European economies.

Addressing challenges to the existing framework

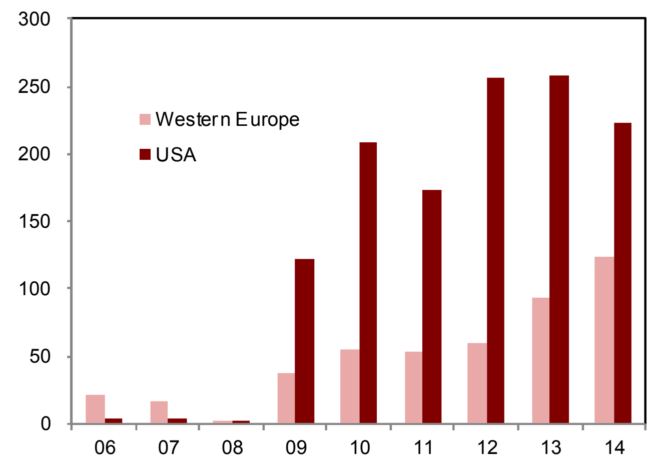
That said, the European financial sector itself needs to evolve to reflect the new global financial environment and the challenges it creates for a bank-centred system. In a jurisdiction that is overly bank-dependent, conceptually one can identify three dimensions along which progress could be made:

Exhibit 5: SMEs are more important in the EU than in the US
Proportion of workers employed, %



Source: ECB, US Census Bureau

Exhibit 6: Despite some progress, European high-yield bonds issuance still lags behind that in the US
High-yield bond issuances, USD mn



Source: Bloomberg

- **Improving the functioning of the banking system** itself.
- **Developing alternative sources of funding** (notably in the form of publicly-traded securities markets) to allow borrowers access to greater diversity and depth of financing, as well as giving investors a broader range of savings vehicles.
- (Building a link between the two preceding themes) **developing securitisation markets** that allow consumers and companies better access to capital via banks, in part by allowing banks themselves access to more diversified sources of funding.

We address each of these three themes in turn.

Banking union promises a more efficient European banking sector. In previous work, we have argued that banking union in the Euro area should strengthen the banking sector.[3] Substantial progress has now been made with the implementation of banking union (and the institution-building that it entails). In the complicated EU institutional environment, this is a significant achievement.

Having discussed banking union at length in the past, we do not dwell on it again here. That said, the ongoing strengthening of European banks' balance sheets (triggered by the ECB's comprehensive assessment and asset quality review), the centralisation of bank supervisory responsibilities at the ECB and the newfound intra-Euro area fungibility of bank capital and bank liquidity should all serve to create a better integrated and more efficient banking system. In turn, this should lead to improved capital and credit allocation, as well as a more efficient banking market structure.

Deeper and more liquid continent-wide capital markets diversify funding sources for the real economy. To complement the banking sector, the development of capital markets could provide a broader range of financing opportunities to companies and savings vehicles to households. Allowing financing to bypass the banking sector entails:

- *Providing small companies that have scope to expand with access to forms of financing that allow them to grow and eventually become large enough to access publicly-traded securities markets*. Venture capital and private equity are important candidates in this regard. Facilitating private placement of debt and equity issues

[3] See: "Banking union at two: Cautious optimism and a cautionary tale", *European Economics Analyst* 14/25; "Liquidity without borders: Eurozone's resolve for cross-border banking", *European Bank Equity Research*, February 25, 2014.

would also support this process. High-yield bond markets offer the opportunity for companies to transition from bank financing to public markets. While progress is being made (for example, as illustrated in Exhibit 6), in general Europe still lags well behind the US in these regards.

- *Providing institutions and households with increased opportunities to invest in alternative instruments*. A pool of saving could be created that can be channelled via the new, non-bank financing mechanisms.
- *Ensuring that the EU-wide infrastructure exists to support well-functioning markets*. The effectiveness of all of these efforts – and other measures taken to strengthen existing publicly-traded markets – crucially depends on the adoption of an EU-wide approach. The benefits of a single market in financial services stem from allocating savings to their most efficient uses on an EU-basis. Standards, rules and legal frameworks – such as bankruptcy procedures and disclosure requirements – need to be applied on an EU-wide basis that supports cross-border activity.

Markets for 'high-quality' securitisation. In the US, securitisation markets worked poorly in the years leading up to the global financial crisis: underwriting standards were poor, and instruments were opaque and complex. The implied mispricing and misallocation of risk, especially in sub-prime mortgage securities, was an important cause and/or propagator of financial stress.

But in a bank-centred financial system, well-managed securitisation can improve firms and households' access to financing by broadening banks' funding opportunities. As argued by ECB President Mario Draghi, to fulfil this role asset-backed securities (ABS) must be transparent and simple (avoiding problems associated with sub-prime instruments in the past) and the originating banks must ensure credit quality. The ECB and Bank of England have recently argued that 'high-quality' securitisation should be encouraged,[4] an initiative taken up by the European Commission in a consultation document published yesterday.[5]

If originators maintain credit standards, household mortgages and consumer loans are amenable to packaging in such simple, transparent high-quality ABS. Such securitisation would improve the availability of mortgage and consumer finance directly. In addition, by removing loans to households from banks' balance sheets, high-quality securitisation has the potential to release spare balance sheet capacity to extend credit to business.

Huw Pill

[4] See: "The case for a better functioning securitisation market in the European Union", Joint ECB / Bank of England discussion paper, May 2014.

[5] See: "An EU framework for simple, transparent and standardised securitization", European Commission DG-ECFIN, February 18, 2015.

Disclosure Appendix

Reg AC

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