Financing European growth: a new model

Essays and discussion from a Brussels symposium

Including contributions from
Michel Barnier
Steven Maijoor
Elizabeth Corley
John Llewellyn
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Join the debate:
email comments to economy@afme.eu
Mathias Dewatripont, Executive Director of the National Bank of Belgium, chairs AFME symposium on 'Financing European Growth'
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Financing European growth

Introduction

Gaël de Boissard
Chairman, Association for Financial Markets in Europe
After three years of market turbulence, there are welcome signs that Europe is starting to tackle the root causes of the euro crisis and to lay the foundations for renewed economic growth.

The readiness of the European Central Bank (ECB), in the words of its President, Mario Draghi, to do “whatever it takes” to save the euro is one positive sign. Another is the serious effort now under way to create a banking union in Europe, starting with unified supervision arrangements under the ECB.

While the outcome of both these moves remains highly uncertain, they at least give grounds for hope that the euro break-up feared by the markets may not come to pass, and that the EU is equipping itself to address the financial fragmentation that has so destabilised its economy.

Even though the crisis is far from over, this seems a good time to look beyond it and ask some searching questions about Europe’s economic future. Policymakers and industry agree that a key focus should be “growth”. How are we going to get the European economy growing again and, as importantly, how will we finance investment and job creation when it does?
The Association for Financial Markets in Europe, which represents a large number of European and global banks, is as concerned about these issues as anyone, and that is why we decided to publish this booklet and, with it, to launch a debate about the future of Europe’s financial system.

In these pages you will find reports and speeches from a high-level symposium convened by AFME in Brussels on 18 September 2012 entitled “Financing European Growth: the challenge for markets, policymakers and investors”.

With EU Internal Market and Services Commissioner Michel Barnier as keynote speaker and dozens of senior officials, regulators, parliamentarians, academics and representatives of the financial sector in attendance, the meeting considered the prospects for the economy and investment over the next decade, and asked whether the financial system as currently constituted is best placed to play a proper role in supporting growth. The answers were far from reassuring. The health of banks is inextricably bound up with that of the wider economy. And as the Llewellyn discussion paper prepared for the meeting and reproduced here makes clear, in today’s Europe that is a sobering thought.

In Europe in particular, the required fiscal austerity is a brake on growth, while new financial regulations - justified as they may be in the long run - are increasing recessionary forces in the system. Indeed, the wave of deleveraging and restructuring driven in part by regulation means Europe’s banking sector is ill-equipped to play its traditional role as motor of investment: on the contrary, there is a strong risk that much of the necessary deleveraging can only take place through reduced lending.

The IMF suggests euro area credit could drop by anywhere between $100bn and $400bn in the coming years, with the axe falling especially hard on countries already struggling with relatively high interest rates such as Spain and Italy. Another recent report from the IMF examining deleveraging under way at the 58 largest banks in Europe estimates that tighter regulation will result in their total assets falling by $2.6trn or 7% of balance sheets from Q3 last year to end 2013.
What makes this problem especially acute is that Europe has traditionally depended far more than, say, the US on bank lending to fuel growth, and Europe’s banks, with their relatively high loan-to-deposit ratios, depend heavily on capital markets to fund themselves.

In the US, deep and liquid bond and stock markets provide significant financing for corporations; in Europe, finance through the securities markets is much less well developed. Of total non-financial corporate debt outstanding in the euro area and the UK in 2011, bank loans and other advances accounted for 85%; non-financial corporate bonds just 15%.

Moreover, corporate bond and stock issuance face significant headwinds in current conditions, and securitisation activity in the euro area has fallen sharply since 2008. As a result, in the short term Europe faces a corporate funding gap. According to Standard & Poor’s, the euro area and the UK have $8.6trn of corporate debt that needs to be refinanced in the next five years, and will need $1.9trn-$2.3trn in new financing in the same period. Even assuming, as S&P does, that sufficient liquidity will be available to help companies refinance maturing debt, those figures could imply a need for net new corporate bond issuance on a scale at least double the highest level Europe has seen in the past decade.

While global companies will have no problem accessing the bond markets for their needs, the worry must be that small and medium-sized companies – the kind that generate most of the jobs – will struggle to fund themselves. The UK’s recently completed Breedon Review focused on improving access by SMEs to sources of finance other than the banking system. Other European countries are worrying about the same issue, and it is bound to feature in the European Commission’s deliberations as it prepares to publish a Green Paper on long-term investment before the end of 2012.

In the longer term, the problem is even more serious. Prolonged deleveraging could severely curtail economic growth, as happened in Japan in the past 20 years as its banks restructured their own balance sheets and reduced lending. So even if Europe follows through with the steps to overcome the euro crisis that were recently initiated, the economy still faces very difficult and complex issues.
This goes well beyond the current constraints of austerity. When confidence starts to return, we will need a banking system sound enough to fund investment and jobs. But we know that the formal banking sector will be constrained by the burden of new regulation and the need to deleverage.

Two questions therefore arise. First, in the wave of regulatory reform prompted by the financial crisis, has the right balance been struck between growth and financial stability, and are there better ways of managing the trade-offs? Change was needed: at issue is the pace, volume and cumulative impact of change. Policymakers need to look carefully at the effect of multiple layers of new regulation. They should ask whether this has added to procyclical tendencies and if so, how to undertake a course correction. That it has certainly created additional procyclicality was one of the key conclusions reached by our symposium, although speakers differed as to whether this was something that urgently needed redressing or simply a painful but necessary cost incurred while making the system safer.

Second, we urgently need to consider how to develop alternative ways of channelling Europe’s savings into long-term investment. It is becoming clear that we need a new model for our financial system to enable it to support the economy more effectively. The system needs to change, from one predominantly reliant on the big banks to fund investment to one with a greater focus on capital markets. A broader corporate debt market, capable of funding a larger swath of the corporate landscape, including middle-market names, would be a welcome development for corporates and investors alike.

That would be a change to Europe’s financial system almost as profound as the arrival of the euro itself. But it is one I believe policymakers will find themselves forced to contemplate as part of the process of structural reform.

What I am suggesting, in essence, is that it is time to refocus the conversation between regulators and the regulated. In addition to focusing on the detail of how the financial system can be made safer, we need to consider how individual institutions and the financial system as a whole can best meet the longer-term needs of the real economy.

“Change was definitely needed: at issue is the pace, volume and cumulative effect of change”
And that requires all of us – policymakers, market users and participants alike – to develop a broader understanding of the way the system now works, and the impact that the massive changes in the legislative and regulatory framework are having on its operations.

As several speakers at our conference pointed out, we tend to look at the financial system in silos. This is often true of regulators, preoccupied with addressing a specific flaw in the previous “light-touch” regime but less able to spot unintended consequences of their actions. But it is also true of those of us who work in the capital markets. We tend to focus on the parts we know best and pay less attention to the rest. This booklet, and the discussion it records, mark an attempt to take a broader, more holistic view of the system and how it serves, or should serve, the economy.

We need a vision for developing deep and liquid capital markets in tandem with a restructured banking system. We need a clear idea of where the blockages and misalignments currently lie and of what new financial products and services the market requires.

The subject is huge and highly complex, and this booklet certainly does not pretend to present any definitive answers. Instead it seeks to identify the right questions for policymakers and market participants to ask. Over the course of the next year, AFME will be returning repeatedly to the subject. We will commission further research on some of the issues identified here, and we will work closely with the buy-side to come up with recommendations to assist policymakers as they work to shape a financial system fit for the future. It is an effort of vital importance to everyone who works in wholesale banking and the capital markets – and arguably to anyone with an interest in seeing Europe return to soundly financed economic growth.

I would like to thank all those who participated in our symposium. My particular thanks go to our speakers, Commissioner Barnier, Steven Maijoor and Elizabeth Corley, and our conference Chairman, Mathias Dewatripont of the National Bank of Belgium, for ensuring that the discussion was both wide-ranging and to the point. We look forward to working with all participants and other interested parties to take the issue forward in the coming months.

“We need a vision for developing deep and liquid capital markets in tandem with a restructured banking system.”
Llewellyn report

Financing European growth: the challenge for policymakers, markets and investors

John Llewellyn
Partner, Llewellyn Consulting

Bimal Dharmasena
Economist, Llewellyn Consulting
There are many hurdles to achieving sustainable economic growth. One major issue for markets, investors, and policymakers is how to finance this growth as European banks restructure.

- Financial systems around the world have evolved rapidly, becoming larger and more complex
- Europe is particularly dependent on banks: stock markets and corporate bond markets are smaller and less developed than in the US
- Europe’s banks are likely to be constrained as the European banking sector restructures and strong pressures to deleverage continue
- This presents markets, policy and investors with a number of significant challenges, including a potentially large corporate funding gap
- Policy instruments, capital markets, regulation, the negative feedback loop between banks and sovereigns, and changes in financial structure are important interrelated issues that warrant further discussion.

01. Introduction: slow growth ahead

Europe and the West face slow growth and weak investment. GDP in the euro area has yet to return to its pre-crisis level. US GDP has, in contrast, attained its pre-crisis level, but even there investment has rebounded weakly.
Meanwhile, the US fiscal position is deteriorating and, in aggregate, is weaker than that of the euro area and most other major economies. Europe and the West need an economic recovery. And to be sustainable, that recovery must be investment driven, if not investment led. If this is not achieved, and confidence in the efficacy of policy continues to diminish, slow growth risks becoming self-perpetuating.

The share of investment in GDP is below 1980 levels in Europe and other major economies. Investment/GDP ratios fell post-crisis and have rebounded little. The large pre-crisis rises in countries such as Ireland and Spain have corrected sharply - Ireland now has a relatively low share, at around 11%. The UK and US have ratios of just 15%-16% of GDP. The euro area as a whole, and its major economies, have ratios closer to 20%. Japan’s relatively high share of investment has declined since the early 1990s.

**The broader policy context: demand and supply-side constraints**

It is hard to know whether an observed level of bank lending is the product of banks being unwilling to lend more, or of the private sector being unwilling to borrow more. The factors that determine companies’ desire to borrow to finance investment are controlled neither by banks nor policymakers. Animal spirits are weak across the Western world: and there is no policy lever that can directly address this. Until investors come to believe, as they look into the future, that the Western economies are a place in which to invest, the demand for credit is likely to remain subdued.

This will take time: on average, after a financial crisis it takes seven quarters for GDP to rebound. But it can take many years, especially when many countries are afflicted, so world demand and trade are sluggish. Particularly challenging is the simultaneity of the deleveraging pressures on banks and sovereigns. Sovereign indebtedness is at peacetime highs. Consequential fiscal consolidation depresses demand, especially when it happens across countries.

This can be amplified by simultaneous deleveraging in the banking sector. Moreover, fiscal contraction can accelerate bank deleveraging by contributing to a shortage of collateral. Policy can, therefore, exacerbate market pressure to deleverage. At some point, however, the demand

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for borrowing will recover: and it is vital that, when it happens, the mechanisms are in place to ensure that the desired investment can indeed take place. The non-financial corporate sector in Europe depends on banks for finance. Restructuring of the banking sector could take many years, and potentially lead to a large corporate funding gap. It is not clear how this would be filled.

02. The evolution of the modern complex financial system

Over the past decade, the financial system has changed fundamentally. The range of services it offers has expanded, and the provision of services has changed profoundly, particularly because of the fusion of banking and capital markets. The way credit is intermediated today is very different; collateral is vital to the system, and the shadow banking system is more important.

The financial system has become far more complex and interconnected - and less well understood. Banking and capital markets have become intertwined(2) through the growth of private markets, over-the-counter (OTC) derivatives, securitisation, and banks as intermediaries in capital markets. Even the most limited forms of commercial banking involve hedging of risk in interest-rate and foreign-exchange markets. Wholesale loans to medium and large companies lie at the intersection of retail and wholesale/investment banking.

The financial system has also become more interconnected in general. Firms are linked by markets and infrastructure through a network of contracts covering derivatives, repos and securities lending, clearing and prime brokerage services, and more.

Collateral is central to the functioning of the system.(3) Money creation and collateral are inseparable. Just as short-term credit is normally extended by private agents against collateral, so does the re-use of pledged collateral create credit in a way that is analogous to the more traditional money creation process based on central bank reserves.

The “velocity of collateral” has become analogous to the more traditional “velocity of money”. The velocity of collateral is a function of rehypothecation, reflecting the number of times a unit of collateral is used.


Haircuts on collateral are equivalent to the reserve ratio, preventing the repledging of collateral from going on forever, and the number of times collateral is repledged is comparable to the money multiplier. Good-quality collateral is like high-powered money. The most valuable collateral is that which can be re-used time and again, potentially creating longer and more complex collateral chains. The corollary is that a sudden lack of good-quality collateral in the system can cause large funding stresses.

Complex universal banks dominate the global financial system. These are large users of wholesale funding, and through their activities and operations they have significant interconnectedness with the rest of the financial system.

The assets of many such banks are larger than host-country GDP, and the banks are large holders of government bonds. These banks are responsible for the bulk of collateral intermediation: according to the IMF’s Manmohan Singh there are 10-14 banks active in collateral management globally. Dealer-banks intermediate collateral to provide funding, settle trades, hedge counterparty risks on OTC derivatives, and enhance returns for clients.

The central collateral desk is an important node in these institutions’ structure, linking everything from demand for funding and collateral to investment strategies and trading flows. The corollary is that dysfunctions in repo/secured funding markets can have far-reaching effects. At the end of 2007, the largest banks globally received about $10trn of pledged collateral. Primary source capital was about $3.4trn, implying a re-use of collateral rate of around three.

The shadow banking sector has become increasingly important. (4) Shadow banks, like traditional banks, intermediate credit in the economy (directly and indirectly). However, they are funded mainly through secured funding markets (particularly repo); they have no (institutionalised) access to central-bank backstops; and are largely unregulated. They are an important source of credit and liquidity for the corporate sector (financial and non-financial). Shadow activities, directly and indirectly, impact the liquidity and stability of financial markets and funding to the real economy. Activities that act as important sources of funding include securitisation, securities lending, and repos. A large part of financial innovation also occurs in the

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(4) The material in this section draws on Pozsar, Z et al. (2010), Shadow Banking, Federal Reserve Bank of New York Staff Report no. 458, July; ECB (2012); and Tucker, P (2012), Shadow banking: thoughts for a possible policy agenda, speech given by Paul Tucker, Deputy Governor Financial Stability, Member of the Monetary Policy Committee and Member of the Monetary Policy Committee and Member of the Financial Policy Committee, at the European Commission High Level Conference, Brussels, 27 April.
shadow sector. Separating ‘good’ from ‘bad’ is not easy: but it is necessary, because the term has become pejorative. Some activity has little purpose other than regulatory arbitrage, including various off-balance sheet accounting practices that can be traced back to the originate-to-distribute\(^{(5)}\) banking model.

Much however is driven by gains from specialisation and comparative advantage over traditional banks. Pozsar et al. (2010) defines this type of shadow activity as belonging to the ‘parallel banking’ system. Credit intermediation outside the formal sector can help to increase efficiency, and make the system more resilient. The sector can diversify risk away from the formal sector, and provide the economy with an alternative source of funding. This is particularly important if or when traditional channels become impaired. The shadow sector can also increase access to finance for those not served, or not served well, by the formal sector.

Shadow activity can, however, be a major source of systemic risk. Leverage can build up unseen and deposit-like funding structures can be subject to “runs”. In times of stress, liquidity can dry up instantly.

Shadow bank failures can also contaminate the formal sector. This can be due to loans, credit enhancements and liquidity lines provided by the formal sector to the shadow sector, and the potential fire sale of assets. Given the scale of the global shadow banking sector, it has important implications for global liquidity and financial stability. Complex lending chains, linking the shadow sector, the formal sector, money market funds and hedge funds are an important feature of modern systems. The lack of transparency and understanding of the sector is a major issue.

The asset management complex can be an important driver of the banking system. Asset managers provide significant short-term funding to the banking sector by transforming long-term savings into short-term assets - now commonly referred to as “reverse maturity transformation”\(^{(6)}\) - a process driven by asset managers’ demand for safe, short-term, liquid instruments, or non-deposit money-claims. Hedge funds, pension funds, insurance companies and the like are an important source of collateral and funding. Such institutions serve as source collateral (‘mines’) for the shadow banking system, with the formal sector


receiving funding through the re-use of pledged collateral. The routine lending of securities is thus a major driver of collateral-based systems; asset managers are increasingly important sources of funding for banks via the shadow banking system; and the asset management complex has increasingly displaced households as key creditors to banks.

**Procyclicality and the money markets**

Money markets are important because they: contribute to market efficiency and discipline; affect financing conditions in the economy; act as an initial link in the monetary transmission mechanism; and affect overall financial stability.

Money markets, both secured and unsecured, have become crucial funding markets for financial institutions. Wholesale funding markets, rather than traditional deposits, are now a more important source of bank funding. Bank wholesale liabilities are several multiples of GDP, particularly in countries with international financial sectors. In 2010, wholesale liabilities were particularly large in: Ireland (682% of GDP), the UK (318%), Switzerland (274%), Austria (248%), France (244%) and the Netherlands (235%). And wholesale liabilities are much larger than retail deposits in a number of cases: Ireland (3.6x); France (2.5x); UK, Finland, and Sweden (2.2x); and Italy and Austria (2.1x).

**Wholesale liabilities and retail deposits, 2010**

![Wholesale liabilities and retail deposits, 2010](chart)

<table>
<thead>
<tr>
<th>Country</th>
<th>Wholesale Liabilities</th>
<th>Retail Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>682%</td>
<td>208%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>274%</td>
<td>108%</td>
</tr>
<tr>
<td>UK</td>
<td>318%</td>
<td>126%</td>
</tr>
<tr>
<td>Austria</td>
<td>248%</td>
<td>151%</td>
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<tr>
<td>France</td>
<td>244%</td>
<td>135%</td>
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<tr>
<td>Germany</td>
<td>120%</td>
<td>120%</td>
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<tr>
<td>Netherlands</td>
<td>108%</td>
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<tr>
<td>Spain</td>
<td>96%</td>
<td>96%</td>
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<tr>
<td>Denmark</td>
<td>92%</td>
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<tr>
<td>Sweden</td>
<td>86%</td>
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<tr>
<td>Italy</td>
<td>84%</td>
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<tr>
<td>Austria</td>
<td>82%</td>
<td>82%</td>
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<tr>
<td>Germany</td>
<td>71%</td>
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</tr>
<tr>
<td>Norway</td>
<td>69%</td>
<td>69%</td>
</tr>
<tr>
<td>USA</td>
<td>64%</td>
<td>64%</td>
</tr>
</tbody>
</table>

Source: Nomura

(7) Source for data Nomura.
A large part of the intermediation in money markets takes place at the interbank level. The repo market is central to the functioning of more collateral-based systems; and government bonds are an important source of collateral for repo transactions. Developments in these markets can affect the stability of the financial system and financing conditions for households and non-financial corporations. They are an essential source of bank funding, and thereby influence the size of bank balance sheets and the amount of credit extended. If liquidity dries up in money markets, it can oblige banks to deleverage; how they do so has important implications for economic growth.

The procyclicality inherent in financial systems leads to asset bubbles. Credit extended to the private sector has grown since 1980. Countries in which credit grew sharply saw asset-price/real estate booms - these included Japan, the US, the UK, Ireland and Spain. The increase for the euro area as whole was less pronounced than in the US, particularly after 2002.

Money markets are a key transmitter of procyclicality and leverage cycles. In times of optimism, high asset valuations, low haircuts and abundant liquidity can spur more leverage and credit expansion. However, when confidence weakens, asset prices fall, haircuts increase, and liquidity can dry up. This can oblige the banks to deleverage, affecting the supply of credit to the economy: or it can force banks to shed assets, potentially imposing externalities on others through contagion and fire sales.

In credit systems with conventional deposit-taking banks, and where collateralised money and credit are more important, there is a clear tendency towards procyclicality. The velocity of money and collateral, and the cost and availability of credit, are procyclical.

High levels of activity increase the liquidity of all forms of collateral, foster over-optimistic expectations, and create asset price bubbles. When the bubble bursts, however, money-like collateral shrinks, and the velocity of collateral falls. Less debt is available, its value falls, haircuts rise, and loan-to-value ratios fall. In modern financial systems, this is tantamount to a monetary shock. 

(8) The material in this sub-section draws on Credit Suisse (2012), When Collateral is King, Global Strategy Research, March.
Negative feedback loop between banks and sovereigns

Negative feedback on banks:
- Losses on holdings of sovereign debt
- Reduction in the value of collateral
- Potential credit rating downgrades
- Reduced value of explicit or implicit guarantees

Banks weakening

Sovereigns weakening

Negative feedback on sovereigns:
- Deleveraging pressures detrimental to real activity
- Bank failures reduce investor base
- Increase in sovereign outlays, actual and potential liabilities

Source: OECD, Schich and Lindh (2012)

“Three years after a crisis debt has increased, on average, by 86% in real terms”

Banking and sovereign risks are inseparable. Sovereign risk feeds back to bank balance sheets, and vice versa. Financial sector deleveraging can constrain real activity, and financial crises damage sovereign balance sheets. Government debt typically increases, often substantially, following a crisis. Reinhart and Rogoff’s study of major banking crises, *This time is different*, calculates that three years after a crisis debt has increased, on average, by 86% in real terms. Concerns about sovereigns also harm banks: given their significant sovereign debt exposures, sovereign credit risks multiply concerns about their liquidity and solvency. Collateral issues are of particular importance. The feedback loop is complicated by European institutional arrangements: development has not kept pace with financial integration.

03. The European financial system in international context

Financial systems have become more complex and larger in relation to GDP. Their evolution has varied by country, and there are important differences between the US and Europe, and within Europe itself.

Formal banking sector
Europe’s (formal) banking sector is large relative to GDP. For the euro area as a whole, bank assets total around 250% of GDP; for the EU they are closer to 300%. In Japan, the total is around 200% and in the US it is just under 100%.

(9) Refers to central government debt.
**European banking sectors, % of GDP**

- **Europe's formal banking sector is large relative to GDP. For the euro area, bank assets total around 250% of GDP.**

### 25 global banks' balance sheets, % of host-country GDP, 2010

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<td>Bank of America</td>
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</tr>
<tr>
<td>Wells Fargo</td>
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<tr>
<td>Fannie Mae</td>
<td>6</td>
<td>8</td>
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<td>12</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: IMF GFSR April 2012


- Luxembourg: 556
- United Kingdom: 479
- Ireland: 368
- Denmark: 366
- France: 344
- Austria: 334
- Netherlands: 329
- Belgium: 313
- Portugal: 298
- Euro area: 254
- EA17: 242
- Spain: 208
- Finland: 204
- Japan: 199
- Canada: 194
- Greece: 191
- Germany: 186
- Italy: 158
- Sweden: 152
- United States: 99
Banking sectors are particularly large in countries with international financial centres. In the UK, bank assets are more than five and half times GDP. In Ireland, bank assets are approaching five times GDP. In Denmark, France, Austria, the Netherlands, Belgium and Portugal the figure is between three to four times GDP.

Europe is home to some of the world’s largest banks, many of which have assets greater than host-country GDP. In Switzerland, the assets of UBS and Credit Suisse alone were nearly 6x the country’s GDP in 2010. In the UK, RBS, Barclays and HSBC totalled 3.4x GDP; and in France BNP Paribas, Crédit Agricole and Société Générale totalled 2.4x GDP.

Loans and other advances make up a small part of the overall balance sheet of banks in many European countries, while interbank liabilities, sovereign bonds and derivatives are significant. In the US, by contrast, the balance sheets of larger banks appear smaller. The assets of JP Morgan, Citigroup, Bank of America, Wells Fargo and Fannie Mae collectively totalled less than 0.6x US GDP in 2010, while Japan and China had no banks with assets over 0.5x host-country GDP.

**Shadow banking sector**
The US has a relatively large shadow banking sector - substantially larger than the formal sector pre-crisis, and still much larger than the formal sector in recent years. In the US, the shadow sector measured $20trn-$25trn\(^{(10)}\) before the collapse of Lehman Brothers. By 2010, the US shadow sector had become significantly smaller but, at between $15trn and $20trn, was still larger than the formal sector, US GDP and the euro area shadow sector. In the euro area, the shadow banking sector was estimated at around €11trn in 2011, less than half the size of the area’s formal sector, and similar to its GDP. The euro area’s formal banking sector accounts for around half of the area’s total financial assets. The shadow sector accounts for around 20%.

Of the total shadow banking activity across major jurisdictions, the US accounts for almost half; the UK is next with 13%; Japan and the Netherlands are also significant,\(^{(11)}\) each with around 8%. In the euro area, the Netherlands, Luxembourg, Ireland and France together hold three quarters of total shadow banking assets.

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\(^{(11)}\) See Financial Stability Board (2011) *Shadow Banking: Strengthening Oversight and Regulation: Recommendations of the Financial Stability Board*, October. The 11 jurisdictions are the US, the UK, Japan, the Netherlands, France, Canada, Germany, Korea, Italy, Spain and Australia.
This is partly the result of the growth of US banks’ off-balance-sheet liabilities; in Europe, for example, more derivatives are held on balance sheet. Constrained from expanding their balance sheets by a regulatory leverage limit, US banks sought higher returns on their equity by increasing the riskiness of their asset pool – hence their moves into subprime and leveraged lending, and various securitised products, much of which was held off-balance sheet in special purpose vehicles.

The US shadow banking sector was heavily involved in lending to the private sector. An important difference between the US and Europe is that, due in large part to Fannie Mae and Freddie Mac, only around one quarter of US mortgage debt is on the balance sheet of banks in the formal sector: this compares with 85%-odd in Europe. Securitisation activity in Europe never reached US levels, although it grew significantly pre-crisis, spurred by increasing house prices and mortgage activity. Securitisation issuance in the euro area was lower than in the US pre-crisis: €462bn compared with $1.7trn, or around 5% and 12% of GDP respectively. Asset-backed commercial paper and asset-backed securities (ABSs) are the main forms of securitisation in Europe; over half of all securitised products are residential mortgage backed securities. The majority of assets underlying ABSs are loans (65%), followed by deposits (16%) and securities other than shares (11%). Most are financed by issuing debt securities.

Securitised loans are originated mainly by banks; 72% represent borrowing by the household sector, while just 24% are to the corporate sector. Consumer loans account

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(12) There is a lack of convergence between US and IAS accounting standards, with implications for policymakers in comparing bank balance sheets and leverage ratios in Europe and the US.
for just 10% of outstanding securitised loans in the euro area; home mortgages account for the vast majority.\(^{(14)}\) This supports the argument that securitisation spurred credit growth, especially for mortgage loans, pre-crisis.

Recent estimates of the size of the US repo market put it at around $12trn in 2010 (over 80% of GDP). Official data on the size of the euro repo market are not yet available. The December 2011 ICMA survey put the gross value of repos outstanding of 59 financial groups in the EU at €6.2trn, equivalent to around two thirds of euro area GDP. Government bonds account for around 80% of EU-originated collateral in repo transactions. An increasing share of repos is cleared via central counterparties (CCPs) in Europe; the share was 32%, according to the ICMA survey. CCPs’ share of the euro repo market is larger, at around 50%. The rest is accounted for by bilateral trading, clearing and settlement modalities (40%) and triparty repo (10%).\(^{(15)}\)

European money market funds (MMFs) are much smaller than those in the US, where they originated largely as an alternative to bank deposits, in order to circumvent regulatory caps that kept bank interest rates artificially low. By end-2008, assets under management by US MMFs totalled $3.8trn (around one quarter of GDP), about 65% of which was accounted for by institutional investors, the remainder by retail funds.

US MMF assets have slumped from peaks in 2008, but remain far larger than in Europe. In the second quarter of 2011, the balance sheets of euro area MMFs totalled around €1.1trn (around 12% of euro area GDP). However, activity differs across countries and, given the close ties to the banking sector, provides a strong link between shadow and regulated sectors. In the US, MMFs have strong links to other shadow institutions, for example securitisation vehicles, often funding them through short-term debt.

**Bond and stock markets**

European equity markets are small compared with the US and Japan. In 2010, stock market capitalisation was $17.3trn in the US, significantly larger than Japanese equity markets ($4.1trn), euro area equity markets ($5.7trn) and EU equity markets ($10.1trn). Euro area market capitalisation was around 50% of euro area GDP, lower than Japan (70%) and the US (120%). Luxembourg, the UK and Sweden

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have relatively large stock markets, equivalent in size to 190%, 160% and 130% of GDP respectively. Stock markets in most other European countries are significantly smaller.

European bond markets are smaller than in the US. In 2010, outstanding public and private debt securities totalled $32.4tn in the US compared with £31.1tn in the EU, $24.7tn in the euro area and $14.1tn in Japan. Euro area bond markets were equivalent to just over 200% of GDP, lower than in the US (220%) and Japan (260%).

Private debt markets are relatively large in Ireland, the Netherlands and Denmark. In Europe, interbank liabilities constitute a large proportion of outstanding private debt securities. Corporate bond markets are much larger in the US. At €2.2tn, the eurobond corporate securities market is currently only about half the size of the US market of €4.5tn.\(^{(16)}\)

**04. The constraints faced by Europe’s banking sector**

European banks are relatively highly leveraged, particularly large euro area banks, which are more leveraged than banks in the UK, the US and Japan. Whereas large European banks pursued a high-leverage strategy, their US counterparts pursued a high-risk strategy. Since the start of 2009, when leverage ratios aligned more closely, large banks in the US and the UK have reduced their leverage more than their euro area counterparts have.

**Leverage of domestic banks**

European banks have relatively high loan-to-deposit ratios: hence the greater reliance on wholesale funding. Large euro area banks have higher loan-to-deposit ratios than banks in the US, the UK, Japan and the emerging markets, leaving them more exposed to cyclical and structural deleveraging pressures. In the US, the extent of intermediation outside the formal banking sector means the value of loans on US bank balance sheets is significantly lower than it would otherwise have been.

In Europe, the loan-to-deposit ratio has not fallen post-crisis as it has elsewhere. European banks’ ratio of (typically illiquid) loans to (stable) retail deposits rose to 130% in 2008, and remained about the same in 2011. In contrast, banking systems in the US and Japan in 2011 reported a loan-to-deposit ratio of around 75%, having fallen post-crisis.

European banks have lower stable funding ratios – the proportion of retail and long-term funding in total funding – than banks in the US, Japan and the emerging markets. This suggests that maturity transformation on the balance sheets of European banks is substantial. As liquidity risks materialised in 2011, the loss of access to funding markets by euro area banks, particularly those in countries with powerful negative sovereign-bank feedback loops, prompted, inter alia, the ECB’s Long-term Refinancing Operations (LTROs).
At the end of 2011, the ECB provided €489bn at an interest rate of 1% to 523 banks in its first three-year LTRO. The second round followed in February 2012, totalling €529bn, and spread across 800 banks.

The LTROs significantly eased the short-term pressures in bank funding markets, helping most banks to meet their wholesale funding requirements in 2012. However, the sovereign-bank negative feedback loop remains strong.

An unbroken negative feedback loop between sovereigns and banks will constrain banks. The crisis and the policy response have tied banks (including central banks) and sovereigns even closer together. Moreover, new regulations and more central bank intervention in bond markets could see this develop yet further. Credit rating agencies are also adding to pressures on banks and sovereigns. Breaking this loop is a major challenge.

**Bank funding**

Central bank funding to the euro area banking sector remains high. How the ECB will exit from its interventions is unclear. If, as seems likely, it will be years before bank funding heals, a central question is what the role of central banks in the money markets should be.

European bank funding faces severe constraints. The key developments affecting bank funding in the US have been tensions in secured funding markets, particularly repo markets. In the euro area, the key trends have been a shift from unsecured to secured funding, as well as money market fragmentation along national lines, exacerbated by sovereign debt worries.

In the US the “run on repo” was key to the collapse of the shadow banking sector in 2007/08, prompting the Federal Reserve to take on risk exposures that made it a “liquidity backstop for the emerging new market-based system”, according to Professor Perry Mehrling. It also made emergency liquidity programmes available to the formal banking sector.

Such actions raise questions about which institutions/activities should receive access to central bank backstops, and how this should be regulated. In Europe, unsecured and secured market financing have been constrained since 2008.

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(17) See Mehrling, P (2011), *Three Principles for Market-based Credit Regulation*, prepared for American Economic Association meeting, Chicago, 7 January
Liquidity stopped moving from cash-rich banks to cash-poor banks, and central bank liquidity has replaced interbank lending.

The share of interbank liabilities in total assets has declined since 2008. Recourse to central bank funding by banks averages around 5% of total deposit liabilities, higher than after the collapse of Lehman Brothers.

There has been a wide dispersion in banks’ access to funding, with banks in countries where sovereigns are under pressure facing major constraints to accessing even secured funding markets. The euro repo market has also been under stress, experiencing declining volumes, a shrinking pool of eligible collateral and the exclusion of counterparties due to increased haircuts and margin requirements. More recently, volumes have increased, reflecting the shift from unsecured to secured funding.

Demand for good-quality collateral is rising in order to access funding markets, encumbering bank assets in the process. Demand has increased due to stresses in unsecured funding markets, obliging banks to pledge more assets as collateral to access secured funding markets. These assets are unavailable to the holders of unsecured debt in the event of failure, making collateralised debt even more attractive to investors, and continuing the cycle. When private funding withdraws from markets, banks also use collateral to obtain official support, further encumbering their assets. It has been estimated that 20% of European bank assets were encumbered in 2011. Asset encumbrance reduces the ability of the system to absorb shocks, because more pledged assets make banks more vulnerable to margin calls if collateral depreciates. Covered bond issuance in particular can encumber a sizeable proportion of bank assets by making them unavailable to senior unsecured creditors and depositors in the event of insolvency. This is of concern to unsecured creditors as well as to regulators. Higher covered bond issuance leads to wider unsecured bank spreads, and the differential may have permanently widened relative to pre-crisis levels.

There is a global shortage of good-quality collateral. The supply of high-quality primary collateral has fallen, due to a major reduction of “safe assets” in the global financial system. AAA-rated ABS and MBS in particular

(18) BIS (2012), Annual Report.
have dissipated. Initially, AAA-rated sovereign issuance increased to offset this. But now fiscal policy is tightening across the major economies and sovereigns are losing their risk-free status. As a result, the issuance of AAA-rated securities has fallen. Sovereigns’ loss of risk-free status undermines financial stability. Risk-averse private agents and financial intermediaries are deprived of valuable collateral, and governments are less able to provide a reliable backstop for the financial system. The global pool of “safe” government bonds has shrunk just when demand has risen due to a flight to safety.

Increasing the amount of good-quality collateral in the system would ease the pressures on bank funding. This creates an argument against tightening fiscal policy too quickly: fiscal consolidation can be thought of in this context as also a tightening of monetary policy. The blurring of the lines between fiscal and monetary policy is a challenge for policymakers, not least in Europe.

The velocity of collateral has fallen since 2007. Market tensions and question marks over the health of bank balance sheets have reduced the onward-pledging of collateral. With fewer trusted counterparties in the market, this can lead to stranded pools of liquidity, incomplete markets, shorter collateral chains, idle collateral, missed trades and deleveraging.

The ratio of pledged collateral to underlying assets decreased from 3 in end-2007 to 2.4 by end-2010. The figure did not rebound in 2011. Global collateral flows have fallen since the end of 2007 by an estimated $4trn due mainly to shorter collateral chains and idle collateral. This will affect the cost and availability of credit.

**Challenges of regulating modern financial systems**

The evolution of the financial system has made it more difficult to implement appropriate policy. Important trade-offs, both political and economic, have to be managed, not least between the near term and the long term.

Swift and substantial regulatory reform is necessary, but it is important to consider the cumulative effect of new regulations. Balancing economic growth and financial stability is the biggest challenge.
Basel III is pressuring banks across the globe to improve their capital positions. Its new rules include a leverage limit, a capital surcharge for systemically important institutions and a countercyclical capital buffer. Banks are also under pressure to improve their liquidity positions. Two rule changes are particularly important: the liquidity coverage ratio (LCR) and the net stable funding ratio. These could constrain bank activity significantly in the near term. New European regulations are impinging on the entire financial sector. The Capital Requirements Directive IV intends to implement Basel III faster than in the US.

Banks should have met the European Banking Authority’s 9% Tier 1 capital target, which is likely to become permanent, and will also be affected by developments such as the Markets in Financial Instruments Directive II, the Markets in Financial Instruments Regulation, Crisis Management and Resolution, the Liikanen review, the green paper on shadow banking and Solvency II.

Country-specific regulation can have a transnational effect, particularly if it emanates from countries with international financial centres. For example, the US Volcker/Dodd-Frank regulations could also have a significant global impact.

The reform agenda will have unintended consequences and the restructuring of universal banks will affect the entire system. Reforms of the formal banking sector are likely to push more activity into the shadow sector: this provides some benefits, but also carries inherent risks, not least because the sector is poorly understood. Regulation of the non-bank sector could have effects on the banking sector. Plans for the shadow banking sector will affect the formal banking sector, and vice versa.

Constraints to the provision of funding could be significant. Large sovereign debt issuance, and regulation that requires financial institutions to hold more government bonds, could crowd out bank funding. Insurance companies, pension funds, investment funds and others may be less willing, or less able, to provide liquidity and capital to the banking sector.

The regulatory response is adding to procyclicality. On the one hand, policymakers are asking banks to lend more to support economic recovery. On the other hand, banks are
being obliged to improve their capital and liquidity positions, substantially and quickly, in an unfavourable environment.

This is the schism at the heart of the debate about economic growth and financial stability. Collectively, policymakers must avoid worsening the near-term economic outlook while they pursue a safer medium-term configuration for the financial sector. Tackling the procyclical nature of the system is in its early stages. Countercyclical rules that temper the system’s creation of large booms and busts are far from coming into operation.

New regulations will amplify the collateral shortage. Greater standardisation and central clearing of trading towards CCPs are likely to increase the demand for collateral substantially. The IMF’s Manmohan Singh judges that the widescale shift of OTC derivatives transactions to CCPs will elevate collateral demand by $200bn. Morgan Stanley and Oliver Wyman have put the figure at $500bn-$800bn, while Finadium puts it at $1trn.

Moreover, the requirements of the new Basel III LCR alone could raise demand for safe assets by $2trn to $4trn globally, equivalent to 15%-30% of banks’ present sovereign debt holdings. (19) Regulations will affect banks’ ability to fund, now and in the future, and the resolvability of financial institutions, particularly those that are systemically important and operate cross-border, will become more important.

The use of bail-in mechanisms as part of bank resolution will have huge implications for price and availability of bank funding. While estimates of the effect of implicit guarantees of bank funding are to be treated with caution, various studies suggest that the reduction in funding costs could be substantial, (20) particularly for Germany, France, the UK, Italy and Sweden. (21)

The effects of a banking union are hard to evaluate. Common supervision that leads to a better allocation of capital across banks could be a positive for bank funding, but ex ante funding of resolution and deposit insurance, as well as a minimum amount of bail-in liabilities, could be detrimental.


(20) Haldane, AG (2010), The $100 billion question, Comments by Mr Andrew G Haldane, Executive Director, Financial Stability, Bank of England, at the Institute of Regulation & Risk, Hong Kong, 30 March 2010, BIS Review 40/2010, estimates a funding cost reduction of more than £100bn for 2009 for 13 banks in the UK. Sveriges Riksbank (2011), estimates that the average yearly reduction in funding costs for the four largest Swedish banks amounts to SEK 30bn from 2002 to 2010.

**Bank restructuring**

Cyclical and structural pressures from the markets and regulators are strong. Structural risks on bank debt are increasing due to factors such as asset encumbrance, depositor preference, and plans to bail-in bonds in resolution. The financial sector is set for an extended period of widespread and comprehensive restructuring. The banks stand to be constrained, including importantly in their ability and willingness to provide credit to the economy, for many years.

**IMF estimates of European bank deleveraging are large**

Many of Europe’s largest banks plan to sell collectively around $2trn in assets over the coming two years. Areas that will be the most affected include: trading within investment banking; corporate banking; retail banking; and non-bank and shadow bank assets. The structural drivers of evolving bank balance sheets are finishing the clean-up and shedding of legacy assets, better capitalisation and reduced reliance on less stable sources of funding.

Structural and cyclical forces - including funding conditions for banks and sovereigns - will shape the extent of bank deleveraging. The IMF estimates European bank deleveraging will range from $2trn-4trn, depending on the extent of cyclical pressures.
Deleveraging is expected to make banks more reluctant to lend on unsecured terms, at longer maturities. The risk is of a further pullback of bank credit and cross-border lending in particular.

The IMF suggests euro area credit will see reductions of $100bn to $400bn. Credit supply shocks are expected to be largest in high-spread countries, notably Italy and Spain, where domestic bank balance sheets are dominated by bank loans.

05. The challenge for markets, policymakers and investors

Japan’s experience over the past 20 years has highlighted two principal lessons:

- The supply of loans will be a problem until the banking sector has been addressed; and
- Longer term, if firms’ expectations have adjusted to lower growth, the demand for loanable funds can be a problem, even when conditions ease in the banking sector.

When Japan’s crisis began in the early 1990s, credit growth was initially constrained by banks’ reluctance to lend. However, credit growth following the Miyazawa proposal in 1992 was weak, due largely to companies’ reluctance to borrow. As fiscal policy contracted, Japan’s economy plunged into recession in 1997. During the late 1990s credit crunch, credit fell, again constrained by banks’ reluctance to lend.

Following two large capital injections, financial conditions eased, but credit continued to fall. Smaller companies were, for some time, constrained by the banks’ reluctance to lend, while large companies were unwilling to borrow. It took around 10 years for credit to start growing.

Today in Europe the risk is that low growth will become similarly self-perpetuating. A more aggressive clean-up of the banking sector in Europe - including credible recapitalisations, writedowns, and other restructuring of insolvent institutions - could prevent a self-perpetuating situation in which large “zombie” banks stifle growth.
Europe’s non-financial corporates depend on banks for debt finance. Corporate bond markets are a much larger share of total debt outstanding in the US. Of total non-financial corporate debt outstanding in 2011, bank loans and other advances accounted for 85% in the euro area and the UK; non-financial corporate bonds just 15%. In contrast, US non-financial corporate bonds made up 47%, with bank loans and other advances accounting for the remaining 53%.

Non-financial corporate bonds are a small proportion of the total in Asia’s largest economies, accounting for 8% and 16% in China and Japan respectively.

### Total nonfinancial corporate debt outstanding

<table>
<thead>
<tr>
<th>Region</th>
<th>Nonfinancial Corporate Bonds (%)</th>
<th>Bank Loans and Other Advances (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro area and UK</td>
<td>85</td>
<td>15</td>
</tr>
<tr>
<td>US</td>
<td>84</td>
<td>16</td>
</tr>
<tr>
<td>Japan</td>
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<td>16</td>
</tr>
<tr>
<td>China</td>
<td>85</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: S&P (2012) and IMF WEO April 2012

Standard and Poor’s (S&P) estimates that corporate financing needs are likely to be $43trn-$46trn globally between 2012 and 2016. This comprises $30trn of outstanding non-financial corporate debt that must be refinanced and $13trn-$16trn of new commercial debt financing:

- The euro area and the UK will account for around a quarter of the total: $8.6trn in refinancing needs and $1.9trn-$2.3trn in new financing needs, equivalent to around 75% of GDP.
- The likely US total is similar: $8.6trn in refinancing needs, and $2.5trn-$3trn in new financing needs, equivalent to around 75% of GDP.

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(22) The US is also commonly cited to have a 70:30 split between corporate bonds and bank loans in total nonfinancial debt outstanding. This is due to the exclusion of the farm and small-unincorporated sectors of the economy. Using the broader definition gives the 47:53 split quoted in the text. See Barclays (2012), *There must be some way out of here: can European bank funding be fixed?*, Barclays Equity Research, March 2011, and Standard & Poor’s (2012), *The Credit Overhang: Is a $46 Trillion Perfect Storm Brewing?*, Standard & Poor’s, May, for more information.

(23) The $30trn estimate assumes total nonfinancial corporate debt outstanding matures on a roughly pro rata basis over an average seven-year period, and that three quarters of the total would come due between 2012 and 2016. See Standard & Poor’s (2012), *The Credit Overhang: Is a $46 Trillion Perfect Storm Brewing?*, Standard & Poor’s, May, for more information.
• In Asia, corporate financing needs are estimated to be much larger in relation to GDP. In China, the projected total is around 220% of GDP, and in Japan around 100%.

Europe has a potentially large corporate funding gap to overcome. Its banking sector is disproportionately large, and dominated by big, complex banks that are set for a more constrained future. New financing is, therefore, likely to face the largest constraints.

Non-bank sources of funding will help to limit the effects of bank deleveraging on economic growth. S&P expects that sufficient liquidity will be available to help companies refinance maturing debt, although European companies will almost certainly face larger challenges than those in the US and Asia.

New corporate financing, however, is likely to prove more problematic, especially in Europe.
• In the US, the bond markets have provided $400bn annually in new corporate funding over the past years, and the economy’s mature debt markets are well placed to make up any potential shortfall.
• Assuming that European issuers need to tap the bond market for half of new funding (up from 15% historically), net new issuance amounting to $210bn-$260bn per year is implied. Issuance on this scale could be a challenge, given that it has exceeded $100bn only twice in the past 10 years.

Direct funding from outside Europe’s formal banking sector will be important. Corporate bond markets, stock markets, the shadow banking sector, private equity, venture capital, family offices, insurance companies and pension funds are all potentially important sources of alternative funding.

Longer term, there are structural challenges to face. When demand for investment returns, supply must rise to meet it. Moreover, Europe needs a system that is robust in the face of shocks. This will require the development of diverse financing channels, covering banks, bond markets and stock markets.

European bank funding is a broken model. A recent report by Barclays(24) discussed four potential solutions: prolonged balance sheet shrinkage; a permanent role for the ECB in bank funding markets; a Fannie/Freddie structure for Europe; and disintermediation.

(24) See Barclays (2012), There must be some way out of here: can European bank funding be fixed?, Barclays Equity Research, March 2011.
• Prolonged deleveraging could severely curtail economic growth, as happened in Japan, as loan-to-deposit ratios plummet. Private bank funding might eventually return, but the costs could be difficult to bear.

• Emergency ECB funding could become the norm, but this raises institutional considerations. If a private-sector funding model cannot be sustained, any permanent role for the ECB in bank funding markets would need to overcome political hurdles. Moral hazard concerns would necessitate strong conditionality and oversight.

• A Fannie/Freddie structure in Europe could lower loan-to-deposit ratios by an estimated 30%. However, government-backed lending has structural implications for the public sector balance sheet.

• Disintermediation could reduce dependence on banks. If corporate bond markets in Europe deepened, along US lines, loan-to-deposit ratios could fall by around 15%. Disintermediation is likely, in part due to bank funding costs now being higher than corporates’, but policy could also help to spur market developments.

Attracting fixed-income investors back to banks will be difficult. Structural risks on bank debt are increasing; and sovereign debt issuance, up from around €200bn pre-crisis to €550bn today, could crowd out bank debt. Unless the structural problems are tackled, bank funding seems unlikely to revive, and ECB funding could become the norm.

Broad reforms must address structural design flaws. Nicolas Veron argues that Europe has to build a fourfold union that will allow executive decisions to be made. The four components are: a banking union; a fiscal union; a competitiveness union; and a political union, i.e. institutional reform to embed democratic accountability more solidly in the decision-making.

The first two of these are the most important from a banking perspective: restoring, deepening and sustaining the integration of markets across borders is essential.

Key in this regard will be decisions about banking union and extra-territoriality. Even in the best-case scenario, however, it will certainly be some years before health is restored to bank funding markets. Developing bond and stock markets will be important in financing future growth. In the US, where these markets are most developed, the

(25) See Barclays (2012), There must be some way out of here: can European bank funding be fixed?, Barclays Equity Research, March 2011.

existence of multiple avenues of financial intermediation proved effective during the credit crunch of the late 1980s, when capital markets froze in 1998 following Russia's default, and also in the recent crisis.

This “spare tyre”\(^{(27)}\) of financing is an important difference between the US and Europe and an important similarity between Japan and Europe. A more diverse financial system in Europe will foster growth in the near term and, in the long term, will be more robust.

Recent developments

European corporate bond markets had started to replace bank lending but faltered. A survey by Fitch found that corporate bond funding increased relative to bank debt after 2008. Outstanding euro area debt securities issued by non-financial corporations rose from €652bn in early 2008 to €777bn in October 2011, 90% of which were long-term securities. Higher rated companies account for the most outstanding volume.

In 2011, however, corporate net issuance fell and spreads widened, particularly for high-yield bonds. In Europe, the speculative-grade market has struggled to secure a foothold. Although 2010 was a record year, with $58.6bn issued, volumes fell somewhat in 2011. This compares with $41bn in 2009, $3bn in 2008, and $24.5bn in 2007. Speculative grade issuance in the US was higher at $218.3bn in 2011, compared with $163.5bn in 2009, and $69bn in 2008.

European equity markets, like many other markets, faced severe headwinds in 2011. Many planned IPOs and secondary offerings were postponed or cancelled due to market conditions. Although the situation has eased since 2008/09, the ability of equity markets to provide funding to the non-financial sector, as well as the financial sector, remains limited.

The issuance of convertible bonds\(^{(28)}\) has hit new lows, although demand among investors is strong. So far this year, just 8.7% of funds ($27bn) raised in equity capital markets were through convertible bonds, the lowest since 1995, and far below previous peaks of around 50%. In Europe, there is little activity in this market at present. Only a few high-grade European issuers have issued convertible bonds so far this year.\(^{(29)}\)

\(^{(27)}\) See Remarks by Former FED Chairman Alan Greenspan before the 1999 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia, 19 October 1999.

\(^{(28)}\) Bonds that pay a fixed income but convert into equity at an agreed price.

\(^{(29)}\) See Financial Times article, Fund risk as convertible bond issues falls, 11 July 2012.
Securitisation issuance in the euro area has plummeted since 2008, with particularly large falls in 2011. Asset-backed and mortgage-backed securities issuance remain subdued. Eligible securitised products can serve as collateral in Eurosystem credit operations, and there is evidence that, of the securitised products that have been originated recently, European banks have retained the majority on their balance sheets. Covered bond issuance, while over €100bn in 2011, has also fallen compared with recent years.

**Small and medium-sized companies**

Bond markets have, temporarily at least, become a somewhat viable alternative for larger non-financial corporations, but smaller companies, which are vital to growth and job creation, continue to face severe financing constraints. The availability of finance is largely a function of firm size:

- Large companies can choose from the full range of financing options.
- Mid-sized companies have more limited options: equity markets and private placements are largely closed off to mid-size companies and corporate bond and commercial paper markets are not an option.
- Small companies only have bank lending. They have limited access to equity markets, and private placements, commercial paper, and corporate bond markets are closed to them.

Countries around the world are targeting small and medium-sized companies with policy; success could help to spur future growth and job creation. New infrastructures for issuing and trading corporate bonds are being developed, and this may open up access to markets for mid-sized companies. For example, German exchanges have launched trading platforms for mid-sized companies, such as Deutsche Börse’s ‘Entry Standard Anleihen’. Targeted companies are not required to have a listing or comply with normal accounting rules. Issues range from €25m-225m, and 60%-75% is held by institutional investors. Increased capital market access for medium-sized companies is needed because potential issuers have high financing needs and the banking sector is restructuring. While such new infrastructures are important, issuance and trading volumes remain relatively small.
Non-traditional sources of finance could help to fill the gap for small companies. A recent report by London’s Centre for the Study of Financial Innovation surveyed around 50 internet-based non-bank sources of funding for smaller companies. These included debt funding, equity-based and “business angel” initiatives alongside niche providers of working capital. The survey documents internet-based attempts to provide online hedging, to use debentures for sustainable energy projects, and even to restart the bill of exchange. And, behind many of these initiatives, there are equally innovative data collection tools that can quicken the credit process. Many such initiatives will fail. But those that survive could spur growth.

Conclusions and issues to consider
The complex financial system, the dominance of banking in Europe and the constraints that the sector will face present major challenges to sustainable growth. The challenges are cyclical and structural, and complicated by political and institutional constraints. Five main issues in particular warrant attention.

Economic policy instruments:
- Macroeconomic policy is at or close to its limit.
- The lines between fiscal and monetary policy have become blurred.
- Tackling the procyclical nature of the system is in the early stages.
- Countercyclical rules that temper the inherent nature of credit systems to create asset bubbles are far from being in operation.
- New regulations and fiscal policy settings add to procyclicality.
- No policy can operate directly on animal spirits, but progress towards dealing with the euro area’s structural design flaws would hasten their return.

Supply/demand factors in capital markets:
- The banking sector is restructuring, and European banks’ deleveraging amounts to trillions of euros.
- The non-financial corporate sector depends on banks for finance; bond and stock markets in Europe are relatively small.
- Demand for non-bank sources of capital and liquidity is set to increase. It is unclear what will fill the hole left by the retreat of the banks.
There is a potentially large corporate funding gap that will need to be filled over the coming years. Small and medium-sized companies, which are vital for growth now, face the biggest constraints. If the challenge is not met, the risk is of good companies going bankrupt, and of new investment being foregone.

The cumulative impact of regulation:
- Widespread reform is necessary to create a safer, more robust financial system.
- The unintended consequences of reforms will need to be managed.
- Near-term, regulatory push is adding to procyclicality, and this will lower growth.
- New rules will heighten demand for collateral substantially and, at a time when the supply of good-quality collateral is shrinking, this could lead to large shortages.
- Managing the trade-off between near-term growth and medium-term financial stability is a key challenge.

Breaking the negative feedback loop between banks and sovereigns:
- The negative feedback loop between banks and sovereigns adds to cyclical pressures in the euro area.
- A more aggressive clean-up of the banking sector could prevent slow growth from becoming self-perpetuating.
- Plans for a banking union are in the early stages, and there is much uncertainty.
- Breaking the negative feedback loop would help alleviate near and longer term constraints to investment.

Changes in financial structure
- Europe is dependent on its banking sector, and on its universal banks in particular.
- The financial system appears not to serve small and medium-sized companies well.
- Fannie- and Freddie-type structures could alleviate near-term pressure on the banks, but this would merely transfer risk on to sovereign balance sheets and could prove politically difficult to unwind.
- The shadow banking sector will grow as the formal sector shrinks. Which institutions/activities should receive access to central bank backstops, and how this should be regulated, are paramount.
- Developing deeper and more liquid corporate bond and stock markets will be important.
Perspectives on achieving European growth

Michel Barnier
European Commissioner for Internal Market and Services
I would like to thank AFME for inviting me to contribute to this important debate.

I’m glad that we can join various parties, including the European Parliament and Finance Watch, in discussing intelligent regulation and supervision of financial markets.

There are a lot of dense and complex issues under discussion, each of which have great consequences for all of our activities.

I’m pleased that AFME is leading this open, transparent and frank exchange, perhaps more open than would have been possible in previous years.

**Ending the cycle**

Despite reduced market volatility, adverse links between the difficulties encountered by banks and excessive sovereign debt have been very much in evidence recently. Certain European banks are experiencing new recapitalisation needs, while market fears, exacerbated by speculative behaviour, have led to an increase in spreads - which have briefly exceeded 500 basis points in Italy over the summer.

But amid the concerns, there are reasons to be optimistic. It looks like there may be an end in sight to this prolonged period of market instability. Why? Because Europe has, for the first time, come up with a plan to unite the 17 economies
in the eurozone in a response to the global crisis. The foundations have been laid for a comprehensive plan to end this vicious cycle between banks and governments, by ensuring a balance is found between greater solidarity within the eurozone and greater government accountability.

In June, the European Council opened up the possibility for the European Stability Mechanism (ESM) to recapitalise banks directly, in exchange for a single banking supervision mechanism. This is an essential step towards a banking union, and ultimately, towards the creation of genuine economic and monetary union in Europe.

The President of the European Central Bank, Mario Draghi, explicitly stated on 6 September the possibility of unlimited bond purchases in the secondary market, as long as the countries in question require the assistance of the European Stability Mechanism (ESM) and comply with its terms, particularly concerning budgetary consolidation. This will have an impact on the economic and political landscape.

These measures should ease the pressure on governments while strengthening the stability of financial institutions. However, we must acknowledge that it is a fragile stage and I don’t want to be over-optimistic about what may happen in the weeks or months to come. Five years after the start of the financial crisis, the economic situation in Europe remains fragile: zero growth is expected in the EU this year, unemployment is more than 11% in the eurozone, with youth unemployment rates of more than 50% in Spain, while many companies are still struggling to find the money they need for new projects.

The financial sector, where the crisis began, has a key role to play in establishing economic growth, particularly by supporting the projects of entrepreneurs and SMEs, and by providing the long-term financing of infrastructure needed to ensure Europe remains competitive.

**Twin targets**

We must focus on twin priorities if we are to succeed: restore stability to the financial sector and ensure that new regulations do not harm growth.

Over the past three years, we’ve introduced a number of measures to meet the first objective.
We have created the European Supervisory Authorities (ESAs) for banks, financial markets and insurance and pension companies.

We have closed ‘regulatory loopholes’ by regulating stakeholders such as hedge funds and credit rating agencies. And we are taking measures to regulate bonuses and salaries. The level of remuneration is sometimes unjustifiable given that the financial sector was bailed out using taxpayers’ money and our fellow citizens continue to suffer from the after effects.

In addition, we have implemented regulations on short-selling and credit default swaps, which played a significant role in speculation against sovereign debt in summer 2011.

New regulations on supervising over-the-counter derivative products, which account for $700,000bn worth of trade a year, with a complete lack of transparency, have also recently come into effect.

**Banking union**

European banking union is cornerstone of our drive to support a more stable financial system. We are laying the groundwork, which is based on four fundamental rules: greater protection of savers’ deposits, through the interlinking of national deposit guarantee funds; CRD IV, which lays down common regulation in terms of equity and liquidity for all European banks, in accordance with Basel III; a European framework for banking crisis resolution to ensure that supervisory authorities have the necessary resource to resolve the collapse of a bank without taxpayers’ money; and the concept of a single supervisory mechanism.

It is essential that the European Parliament and the Council of the European Union quickly adopt these fundamentals. This is all the more important since the implementation of a single supervisory mechanism is a condition that would enable the European Stability Mechanism to directly recapitalise the banks.

That said, the stability of the financial sector is not an end in itself. By making institutions and financial markets more stable, transparent and accountable, our primary objective is to ensure they give back to the real economy and create growth.
Regulation and growth
The scale of reforms in such a short time frame is unprecedented. It is normal and understandable that there is some reluctance, particularly from financial institutions, which fear that a system of regulation that is too ambitious will reduce their ability to invest in the real economy and ultimately hinder growth.

But we cannot forget that it was a lack of regulation that hindered growth, and led certain financial institutions to the path of excess that we see today.

Besides, our proposals do take into account the risks that overly strict regulations would impose a significant burden on the financing of the economy. For example, our proposal aimed at increasing the capital requirements of banks, in accordance with Basel III, has been carefully fine-tuned to avoid the consequence of banks reducing their lending to the economy and in particular SMEs, which rely most heavily on bank financing.

Lastly, one of the key features of our regulation programme is channelling savings towards leading sectors with balanced growth rather than towards risky investments. For example, our proposal of a European passport for venture capital funds will attract savings towards innovation and SMEs.

Future focus
Beyond the banking system, we must ensure that the financial system in general is capable of channelling savings towards long-term projects. It is a financing condition for large energy and digital networks and the ecological transition.

The Commission’s green paper expected before the end of the year will allow us to discuss ways to encourage this type of investment, particularly by finding a balance between the need to strengthen prudential regulations and the need to avoid penalising investments in projects of general interest.
Reforming the structure of the banking system is also a key priority. This is the subject of work conducted by the Liikanen Group, who must identify if the current structure carries instability risks, for example due to the size of banks, and if the banking system is capable of fulfilling its key role in the financing of the economy.

At present 30 million consumers in the EU still do not have a bank account, including six to seven million who have been refused by a bank. We want to improve access to retail banking services, by making sure all Europeans have access to a necessary prerequisite for life in society: a basic bank account.

We also want to make it easier for consumers to change banks. According to a recent study by the Commission eight out of 10 mystery shoppers wanting to change banks experienced difficulties.

These measures are numerous and varied. Each is aimed at restoring confidence and stability to the financial sector, so that growth returns. To succeed, we must seriously consider the effect of our reforms - this means continuing to conduct in-depth impact assessments and adapting our regulations if necessary. In doing so we will ensure that Europe has a competitive and efficient financial sector, and one that plays a full role in contributing to the real economy.
The roles of banks and capital markets

Steven Maijoor
Chairman, European Securities and Markets Authority
Safe and sustainable financing is a key precondition for the growth of our economies. It promotes investments and enables innovation.

This vital link is underlined by the findings of the report by John Llewellyn and Bimal Dharmasena. In particular, the report highlights a crucial problem we face: the financing gap left by the struggling banking sector, particularly in the EU. The future of the European banking industry, and its role in financing and investment, is a crucial issue, and it’s clear that much needs to be done to bring the industry back on solid ground.

But another question arises in the wake of this situation: which part of the non-bank financial sector could fill this potential gap? Alternative ways of funding of investments and businesses are a natural place to look, and securities markets in particular may well play a role, but there are three areas that need to be considered.

**Capital market financing**

Equity and bond financing are the two most important alternatives to the traditional credit channel. Together, the two markets represent a key source of funding in the US and contribute substantially to funding in many emerging economies.
In continental Europe, where bank finance has been the most common source of funding for decades, equity and corporate bond markets have made important strides since the 1990s. Credit funding remains the dominant source of private sector funding in the EU, so there is ample space for securities markets in the future.

Shadow banking
Shadow banking has come to be recognised as an important part of the financial system and a significant source of intermediated funding for the financial and non-financial sectors. The sector is estimated at €1trn in the eurozone, which is about one-third of the conventional banking sector. The problem in shadow banking though is the shadow.

As important as its intermediation function may have become, the sector has retained a tainted image because of its role in the crisis, its inherent complexity and the many critical risks involved.

These risks still need to be understood better. There is no doubt that the sector will continue to have the full attention of regulators and supervisors, and in both the EU and the US, steps have been taken to not only cast a light across the sector, but to make it safer. Those efforts mean that most shadow banking activities are now addressed by existing regulation, with further regulation in the process of implementation. Now the attention of the regulator shifts to optimising the regulatory framework.

We need to ensure that shadow banking activities and those of traditional banks are not exposed to incentives for regulatory arbitrage between the two. Rather, shadow and traditional banking and also their regulation should complement each other.

Financing of small and medium-sized companies (SMEs)
SMEs have been most reliant on bank funding and find it particularly hard to access conventional capital markets, owing to low issuance volumes and market liquidity. However, the emergence of trading venues and platforms targeted at SMEs is encouraging. Given the pressure in conventional credit markets, they may play a more prominent role in the future, just as specialised private equity funds may become a richer source of capital-raising.
Realistic assessments

Capital markets, shadow banking, and new forms of SME financing may indeed play a vital role in alleviating potential credit-funding gaps, but they do not come without caution. The extent to which we can rely on any of these funding channels in the EU is open to debate. There are three main factors at play:

Volumes: With €36trn in assets, the EU's banking sector is larger than its equity and private bond markets combined (€8trn and €16trn, respectively). New issuance volumes in Europe in recent years have been low by international standards, so there is no doubt the banking sector must continue to play a central role in financing.

Adjustment: While problems in the credit market are real and current - and set to continue - an adjustment of capital markets to replace any of the potential shortfalls will take a long time. We are looking at a fundamental evolution of these markets, which, based on the evidence in continental Europe, will be a very gradual process.

Market dynamics: Most importantly, any such adjustment depends on the dynamics in the markets. Borrowers may find it hard to exchange long-term bank relationships for the more volatile world of capital markets. And for investors, the question arises as to what extent they want to commit funds to European markets and at what cost, especially considering the broader economic conditions.

Yet changes in regulation and the market environment are already pushing both groups to adjust their behaviour. A diligent evaluation of risks and a proactive attitude to available market information are likely to arise in the longer run. This increase in market discipline will render markets more efficient.

Achieving more balanced and sustainable financing structures in the EU is an imperative for markets and policymakers alike. To succeed, it will take realism, patience and a clear regulatory vision.

The difficult economic situation has raised concerns that financial market reforms may hamper recovery, but I am not convinced of that logic. Poor regulation and supervision were among the reasons for the crisis and the current state of the banking sector and financial markets.
We need to think about how we will achieve growth. Strong, sustainable growth requires stable markets; these stable markets need good regulation and effective supervision.

The financial reforms undertaken in the EU, the US and the rest of the world serve an important overriding purpose: they provide a stable and predictable regulatory framework for financial markets, and in Europe, they support competition by safeguarding and enhancing the single European financial market.

**ESMA’s approach to stable markets**

At ESMA, we try to make a pragmatic contribution to promoting stable markets. This can be seen in what we do to protect investors.

The height of the financial crisis in 2008 saw an all-time peak in risk aversion among global investors. That risk aversion remained high until recently when it returned to more moderate levels. Good regulation needs to restore trust in financial markets and institutions. ESMA has just issued guidelines on remuneration practices for entities providing investment services.

High-quality advice can only be given when it starts with the right incentives for the adviser. Our guidelines on exchange-traded funds (ETFs) will ensure greater transparency and that efficient portfolio management techniques are conducted in the interest of investors.

We are also working on a unique regulatory environment for credit rating agencies (CRAs) with more transparent ratings. We strongly support the universal and stringent use of high-quality financial reporting standards.

We are close to finalising a set of technical standards on central counterparties (CCPs) to facilitate the stability and efficiency of derivative markets, which will provide the basis for effective regulation and supervision.

ESMA’s guidelines on high-frequency trading support a smooth market process and minimise trading distortions, while the ETF guideline supports the stability of these investment funds by requiring quality of collateral, securities lending and the use of repo transactions.
The restoration of investor confidence and a stable financial architecture are important prerequisites for the single European financial market. ESMA has introduced a number of policies to promote this important pillar of the common European House, and we also coordinate the implementation of consistent regulations throughout member states.

The move away from directives and towards regulations and common technical standards makes an important contribution to the single market. Our guidelines help investor protection and stability, and encourage consistent supervisory practices across the EU. We closely cooperate with national authorities to avoid and mitigate cross-country differences that would generate regulatory arbitrage and the fragmentation of financial markets. We want to sustain the market depth of the single European financial market, as well as the related economies of scale and risk absorption capacities.

Confidence and protection
In financing growth, the European Union faces tough challenges. Finding alternatives for traditional intermediation models is vital, but whatever direction the markets take, we must restore investor confidence through a high level of investor protection. Financial stability and efficiency are necessary prerequisites for economic growth. Efficient and effective regulation and supervision, in turn, safeguard and enhance financial stability and efficiency, in particular through the preservation of the single European financial market. All of which promotes economic growth.

I hope ESMA can effectively contribute to this important mission.
The need for deeper, broader markets

Elizabeth Corley
CEO, Allianz Global Investors
How can we achieve sustained economic development in Europe? This is an important topic, and this meeting is a really positive contribution to the debate.

There’s absolutely no doubt, to paraphrase Wolf Klinz, an MEP for whom I have enormous respect: we will not achieve sustained economic development by making a prison of Europe, by having regulation which cuts us off from the rest of the world.

Consequently, I was delighted that David Wright, Secretary General of IOSCO, is among many global representatives at the symposium. I represent a global investment manager that happens to be headquartered in Europe. We look for investment opportunities around the world just like any other asset manager or insurance company.

Any piece of regulation or market structure that prevents the free flow of capital finding those investment opportunities will prevent free flows of capital in the medium term coming back into Europe to stimulate responsive growth. So anything that is preventive - and we have regulation ahead of us that could be - should be resisted strongly until not just the eleventh hour, but until the last second of the eleventh hour.
When I was given the opportunity to speak at the symposium, I promised not to spill any blood or to pull any punches either in speaking on behalf of all the clients that invest with asset managers, the members of pension funds, and insurance companies.

An asset manager is only really an agent and that’s both good and bad news. It used to be said that if you’re an agent, you’ve got no skin in the game. That is changing dramatically because of the pace of change, of regulatory development and the personal accountabilities for any principal or any risk-taker in a financial institution. This is a good thing.

What isn’t so good is that many people who might have grown up in banking or securities can’t always distinguish between the responsibilities of the fiduciary – acting on behalf of others – and the principal – acting largely on their own behalf or on their shareholder’s behalf.

As a shareholder in some of those large financial institutions, I’m not here to complain, but it’s a very important distinction to draw before we even start. The term “shadow banking” is not helpful. It is not broadly or well understood, and is burdened by read-across effects from banking terminology. Moreover, when you define something by what it’s not, you can end up with a big problem.

To find supporting evidence for this, one need only think about how the Republicans responded to President Obama’s healthcare plan by referring to “death committees” as opposed to “policy committees”. We need to be very careful when we enter into this debate. It was very honest of a number of speakers to admit what we don’t know. We don’t know precisely what the implications of shadow banking are.

**What clients want**

One of the ways to think about how we might diversify our sources of funding is to consider our clients. They are asking for real returns, yet the investments that many of them are making – in cash, bonds, gold, real assets, real estate – do not necessarily reflect a full appreciation of financial repression and its consequences.

“The term ‘shadow banking’ is not helpful. It is not broadly or well understood”
At one level, clients are conscious of the fact they need real returns to match real liabilities, yet this does not seem to have fed through into the investment decisions being taken to meet that desire. They are looking for new asset opportunities, whether that is infrastructure or other areas, but at the same time they are looking for proven track records before they move.

With every opportunity, clients are looking for reduced costs and greater transparency of those costs, which is really important for AFME members. The days of describing costs as an “annual management fee” or a “premium charge” are fading into the distance. Clients will wish to see the underlying transactional costs, and somehow see the extent to which these frictional costs are eating up real returns in a low-yield environment. The current discussion around threats to money market funds is only the most pointed example.

This is something to consider when we discuss collateral transformation and substituting for stock lending, which has clearly shrunk. So we, as asset managers and insurance companies and pension funds, will place these costs under greater scrutiny.

At a time when we’re looking for deeper, broader markets, we get less liquidity, more fragmentation and less transparency. This is partly because of the huge swing away from equity investing, in the knowledge that bond markets are nowhere near as efficient and transparent. However, it is also because of the fragmentation of capital largely in response to what has been happening over the past five years.

Clients know they will live for a long time, they know that state pension schemes will not fund their retirement, they know that healthcare is going to come under enormous strain as costs go up, so they’re looking for long-term income and long-term retirement provision. Yet they are coming out of equities. There was an interesting comment both in the paper and at the symposium about looking for diversified sources of long-term funding. In the United States, which could be considered the capital of equity investing in the world, retail investors withdrew $80bn from equity funds and corporates bought back $200bn of equities in a 10-month period during 2010.
Everybody knows the result of de-equitisation: we tilt the world’s capital structures. This is happening partly because we have procyclical capital regulation. It’s also because we have increased risk aversion; secular risk aversion that is making people very concerned about anything that brings volatility to underlying capital.

I wasn’t going to comment on bank equity, until reading the Llewellyn report. Most asset managers I talk to in Europe could almost have written this passage: “A more aggressive clean-up of the banking sector in Europe, including credible recapitalisations, writedowns and other restructuring of the insolvent institutions, could help to avoid a situation in which large zombie banks continue the self-perpetuation of slow growth.”

Regulators and central bankers need to take that to heart. Markets are not stupid, they price in risk even if it’s not visible, even if we’re told that testing has been done.

Currently in Europe we have the basic issue of what property rights are for individual investors, whether it’s sovereign debt, or whether it’s financial institution debt. Everybody knows that you do not get sustainable economic growth if people cannot trust in the long-term rights of property and in the long-term rights of a return on investment. Until we get through the resolution mechanisms, it will be a drag; it will be a sea anchor on what’s happening in terms of the recapitalisation of European banks.

**Consumer choice**

We should also think about consumers. Most people who save for the long term are getting older and are moving from an accumulation stage in their lives to a decumulation stage.

There are fewer people who are continuing to generate earnings that will be available for future investment, and therefore have an insurance against capital loss. As people move to a decumulation phase, they look for safety. And that changes the underlying investment appetite.

We have done a lot of work on the subject of behavioural finance, during which we have found that as individual consumers age, as risk-takers age, risk aversion begins to set in.
By the time people reach their sixties and their seventies, they have often become absolutely averse to risk. We can look to Japan, as the Llewellyn report does, to see what that does to available economic activity in the market.

So what can we do? The first thing to say is that there’s a very helpful shake-up happening in the industry. Clients are now paying for real alpha (as opposed to dressed-up beta); for real returns. The second very helpful thing is that there is huge demand for good-quality corporate bonds and well-underwritten and credible high-yield bonds, and this will continue. So the demand for securitised assets does exist.

There is certainly demand for complementing these with small and mid-cap investments. Anything that can be done to stimulate the way in which small and medium-size enterprises can move into the capital markets is very powerful because there is enormous demand to “season” those lower risk returns that are available elsewhere.

Developing a joined-up approach
In conclusion, now is a time to be joined up globally, not erecting barriers or pursuing narrow avenues. Greater cooperation and coordination of the challenges we share should extend not just to regulation but to political, social and economic policies.

That is the wonderful thing about this initiative: it takes a broad approach, covering economic policy, political responses, regulatory response and the social environment within which we’re all working.

The development of more cohesive policy - including good-quality, predictable regulation - is in Europe’s best interests and should allow a credible and sustainable growth agenda to be formed.
Debating the issues

A summary of the symposium discussion

Simon Lewis
CEO, Association for Financial Markets in Europe
Amid the complexities of Europe’s financial and economic crisis, there is one thing everyone involved can agree on: there will be no long-term solution without renewed economic growth.

It is perhaps a measure of the importance of this topic that so many senior policymakers and market users and participants wanted to participate in our Brussels symposium “Financing European Growth” on 18 September 2012.

The conference attracted more than 50 high-level figures from the European Commission, European Parliament and other EU institutions; senior regulators from EU member states and international organisations; academics and opinion leaders from universities and think tanks; and top executives from large European and global banks as well as from a number of buy-side firms.

Under the expert chairmanship of Mathias Dewatripont of the National Bank of Belgium, the group discussed the difficulties facing investment for growth in Europe following the financial crisis. It was a rich and diverse debate, and a rather sombre one. What follows is an anonymised account of the discussion, written in accordance with the Chatham House rule, under which comments made during the symposium can be quoted but speakers and other participants should not be identified.

“It was a rich and diverse debate, and a rather sombre one”
The discussion started with a sobering reminder of the depth and complexity of the crisis.

Even the financial part of it is, a speaker said, actually three crises in one: the 2008 “trading book” crisis crystallised by the collapse of Lehman Brothers; the traditional, even “old-fashioned” banking crises in countries such as Ireland and Spain; and of course the crisis of the euro and of sovereign debt for a number of EU states.

It is, to put it mildly, difficult to deal with all three at once, not least because the correct policies to each of these problems need to be different, and there is a danger of simply piling new regulations on top of one another without taking account of their macroeconomic consequences. There are no easy choices, and the difficulties are especially acute in Europe given its dependence on bank-based as opposed to market-based finance.

So Europe needs its banks, but they need to deleverage as a result of the financial crisis and will therefore be constrained in their ability to lend to the economy in coming years. This will leave a gap and we need to consider the role that disintermediated market finance can play in filling that gap.

This is not an “either-or” choice: we need both bank finance and market finance. Creating the right balance in the system that would both generate growth and protect taxpayers from the consequences of systemic failure is the most critical task for political decision-makers and regulators.

These opening observations prompted some sharp debate about whether, and to what extent, increased regulation is at least in part responsible for Europe’s current economic woes. On the one hand, as several speakers observed, there could be no doubt that regulation had in the short term at least added to the procyclical forces in the economy, intensifying the downturn. This is ironic, to say the least, at a time when politicians and regulators had been speaking for several years of the need to counter the procyclical effects of Basel II. The countercyclical tools being created under the new macroprudential framework are still in their infancy, and the authorities need to think a lot more seriously about introducing automatic stabilisers into the system.

“This is not an ‘either-or’ choice: we need both bank finance and market finance”
On the other hand, this short-term procyclicality was a direct consequence of moves to make the banking system safer, a goal that the governments globally are united in pursuing and which cannot be achieved without a degree of pain.

The consequence, all could rapidly agree, is intense pressure on the banks to restructure, and in many cases to shrink. As one bank representative pointed out, just to contemplate the scale of European banks’ already-identified needs for capital and collateral over the next few years is to realise they would not be able to raise more than a fraction of such amounts from the markets.

Some said this potential shrinkage was no bad thing. After all, observed one speaker, had the recent crisis not proved that our economies have become over-supplied with finance - with a banking sector way larger than would strictly be required to support growth in the real economy?

A counter-argument was that big banks are still vitally needed to finance companies, and it would serve no useful economic purpose if banks were to shrink too far. It is a false assumption, said a bank executive, that banks should shrink for the good of the economy or that smaller banks are a good thing *per se*. Big companies need big banks to serve their financing needs. And Europe needs big banks to continue to punch its weight in the global competition with the US and Asia-Pacific.

More than one speaker from the world of finance pointed out the sheer scale of private sector financing needs in Europe over the next few years and expressed doubt that the system would be able to meet them under current circumstances. Others warned that the overwhelming focus on safety is leading to a fragmentation of the financial system, both within Europe and at a global level, and that this too could have negative economic effects.

Would these arguments be sufficient to deflect the authorities from their current course and persuade them to contemplate a loosening of the regulatory approach? Many around the table were doubtful. A speaker from the financial world said the direction had already been set and an overall assessment of its implications would only come much later.
As one academic speaker said, it is not the size of banks that is the issue but the risks banks had run with excessive leverage, and the over-reliance of the system on unstable market funding rather than more stable retail deposits. To fix those problems, the overall sector would have to shrink. If that created a period of “capital rationing”, it would not be surprising given the shock to which the system had been exposed when the financial bubble burst.

A regulator intervened on the “size” issue. Regulators are not trying to regulate the size of banks as such: they are focused on leverage, and on improving the health of banks - although in some countries the aggregate size of the banking system in relation to their GDP is a real issue, not least for their taxpayers and voters.

In general, he said, there is a pervasive lack of confidence in Europe’s banks, as testified by the fact that in aggregate the market values their equity at only 50% of book value. He pointed to the experience of Japan in the past two decades, and the role that weak banks had played in prolonging that country’s economic woes by pouring money into keeping troubled firms afloat rather than funding vibrant new activities. “The idea that you can postpone making the banking sector healthy and in the meantime it will continue funding the economy is a very difficult concept,” he said. “You need healthy banks to grow the economy.”

However, there was also a recognition in the regulatory community, said another official, that big banks could entail big risks - hence the imposition of the capital surcharge for global systemically important banks (G-SIBs) and the importance attached to the issue of making banks resolvable and thus shielding taxpayers from in future having to pick up the bill for the problem known as “too big to fail”.

A similar scepticism greeted arguments that the regulatory system is being made impossibly and counter-productively complex, as argued by Andy Haldane of the Bank of England, in his recent speech entitled The Dog and the Frisbee. The problem, as one central banking speaker observed, is that “we have a frisbee that is trying to escape the dog”. Reality is complex in the financial system, and we are deluding ourselves if we think it could be simplified.

“Reality is complex in the financial system, and we are deluding ourselves if we think it could be simplified”
The ground of the debate then shifted from the banks to the cumulative impact of regulation on the system as a whole. Several speakers from banks and other financial companies spoke of the huge additional compliance burden under which their organisations are labouring - from new rules on capital, leverage and liquidity through new risk weights under Basel III to Dodd-Frank and Volcker.

But they also focused on some of the unintended consequences of regulations aimed at one sector on other parts of the system. One example is the way regulations on bank liquidity are affecting asset markets; another is the impact of the Solvency II insurance directive on the worlds of securitisation and of bank debt. These measures, said one banker, are being introduced on such a demanding timetable that the procyclical effects are being intensified, and no one in authority is focused on the cumulative impact.

This complaint was repeatedly echoed around the table, and as the debate continued it grew into a broader call for policymakers and those in the financial sector to develop a “vision” for how Europe’s capital markets are going to develop in the coming years. One bank representative put it most starkly. “We stand on the edge of a violent contraction in credit supply at a time when credit is violently needed,” he said. “How profound is the evident lack of vision about the sources and uses of capital. We should be moving beyond the phase of retribution (against finance) and into the phase of strategic design.”

“Any recovery will require more investment, that investment will need to be financed, and it’s not clear where that finance is going to come from,” said another speaker from the buy-side. “What seems to be lacking is [debate on] who is going to step into the gap. What kind of financing landscape do we want to see? I don’t hear politicians and regulators asking questions like where we are trying to get to, how we want our infrastructure funded and so forth.”

We need to remember, said one speaker, that the point of capital markets is “to connect capitalism and capital” - and that means looking at the whole investment chain from the sources of funds to their application, and not just at the intermediaries in the middle. It means, specifically, interrogating the lack of demand for finance at one end of the
chain and the apparent dearth of funds for certain kinds of investment at the other. Taking a holistic view is important, agreed a regulator, since we have to recognise that the world at large is becoming more dependent on market financing and Europe cannot stand aside from this development.

Many emphasised the especially acute and urgent issue of funding for small and mid-sized enterprises (SMEs), on which innovative thinking is required. One speaker with knowledge of this subject said SME finance is the heart of the matter. It is a problem both of supply and demand: what he called “an unsatisfactory equilibrium between the lack of appetite to provide finance and a lack of confidence among SMEs to take it on”. This is the most vulnerable sector of the economy and the most difficult to finance outside the banking sector. Government intervention would be needed during this period of transition to ensure it did not suffer undue damage through withdrawal of financing or failure to launch growth projects for lack of funds.

Others took the theme further. We need a campaign for capital markets in support of growth, with a particular focus on access to finance by SMEs, said one. We need to find ways of reopening equity markets to small and mid-cap companies and reverse the downward trend in new primary listings. A lot can be done to make bond markets more liquid and transparent; we need to combat the current trends of fragmentation and extreme risk aversion.

A banker pointed to the role that securitisation could play in kick-starting funding for SMEs, as highlighted in the UK’s recent Breedon Review. Another speaker from the financial markets called for a renewed focus on the primary market after a period of intense focus on the costs of secondary market trading. Many of Europe’s smaller stock exchanges are struggling to maintain liquidity as activity becomes more concentrated in London; the number of smaller companies covered by stock analysts is in secular decline. “Equity risk has become the first casualty of the search for safety,” commented another figure from the markets. This is a real problem with the investment ecosystem, said another speaker from the markets. Companies need positive reasons to list their shares on public markets, and instead they are being deterred by the additional costs of regulation.
The conversation moved to the broader context of negative investor sentiment and macro policy. There could be no disguising the intensity of risk aversion surrounding Europe, said one banker. “Clients are concerned about political risk and their expectations in terms of returns are extremely low. So it’s frankly not surprising that they seek safety and security and stay in cash.” The regulatory uncertainty is set to continue with protracted debates ahead about banking union, notwithstanding the “extremely aggressive” timetable EU leaders have set for reaching agreement on it.

“Our cross-border problems are deterring investors from putting money into Europe,” said another. “This is a global phenomenon, not just a European one.”

A bank executive noted that investors are looking for safety and real returns - but that assets considered safe are delivering negative returns, which is a thoroughly distorted set of incentives for savers. He also called for more study of the interaction between the impact of regulation on the one hand and that of current unorthodox monetary policies on the other: both are in uncharted territory but the two seem to be pulling in diametrically opposite directions.

As the debate moved towards a close, the regulators in the room were directly asked how they responded to the points that had been made. One said he felt the calls on the authorities to take a broad view of the cumulative impact of regulation were somewhat “naive”. “The reason we have all this regulatory activity is that the system didn’t work before. If the financial system starts to deliver what it needs to deliver, then government attention will reduce.”

Another appeared more conciliatory. The authorities are constantly considering whether particular regulations need recalibration to make them less procyclical. But on the whole, he added, the fundamental fact we are dealing with is that investors lost confidence in the market as a result of their losses, and our task is to restore confidence. Regulation is not responsible for the problem, but is part of the answer.

In conclusion, participants were invited to reflect again on the multi-dimensional nature of the crisis as an explanation for the current mood of risk aversion. In fact, Europe is still grappling with an even larger number of crises than remarked
at the outset: the crisis of trading and overleverage crystallised by the collapse of Lehman Brothers; the crisis of governance in the euro; and the banking and sovereign debt crises in eurozone countries. Beyond that there is the longer-range challenge of adapting to demographic change, competition in the global economy and Europe’s changing place in the world. This adds up to a large need for structural reform, and a lot of resistance to implementing it.

Against that backdrop, it is important to identify priorities, starting with resolving the design flaws of the euro and restructuring the banking sector. We need both healthy banks and deeper capital markets, but achieving both will take time. In the meantime, policymakers need to get smarter about understanding the effects of decisions in one area on other parts of the system, and to investigate more fully the real problem areas for funding. System incoherence and “silo thinking” are clearly identifiable problems - but so too is the natural human tendency to seek simple or formulaic answers.

Delegates were reminded how conventional wisdom had changed over the decades: in the 1980s, the most widely admired model was long-term, bank-based financing as practised in Germany and Japan; in the 1990s everyone looked to the US market model. Now we are searching for a new model that will be different again and involve elements of both. This is difficult, but achievable if everyone involved focuses on the big picture and is prepared to learn from his or her mistakes.

This was an appropriately constructive note to end on, marking a recognition that this discussion has a very long way to run. We may not have resolved any of the issues, but I would like to think we made a start towards refocusing the debate around Europe’s economy and the role of the financial system in supporting it. The challenges are enormous and highly complex - but resolving them is a vital precursor to renewed economic growth.

At AFME, we look forward to playing our part in the continuing debate. I would like to thank everyone who contributed to the discussions and invite readers to respond. If you have any comments on the views expressed in these pages, please send them to economy@afme.eu