Yves Mersch: Finance in an environment of downsizing banks

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Shanghai Forum 2014 "Asia Transforms: Identifying New Dynamics", Shanghai, 24 May 2014.

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Ladies and gentlemen,

Thank you very much for inviting me to speak today.

Europe and Asia have an increasingly symbiotic relationship. In 2013 total EU trade with Asia reached €1.25 trillion, almost double the value recorded a decade ago and representing over one-third of total EU trade. At the same time, the EU accounted for almost 30% of Asian trade last year, far ahead of any other trading partner, including the United States. The EU is also a major investor in Asia, and vice versa. Around 20% of EU outward investment goes to Asia, while 20% of inward investment originates in the region.

In other words, the economic situation in Europe today has important consequences for the growth trajectory of Asia – and this is a relationship that will likely only increase in strength in the future. I would therefore like to use my remarks to discuss developments in Europe as part of the growth equation for Asia. Asian policy-makers know best the domestic challenges that face them and the types of solutions that are needed.

The European situation is no doubt a complex one, but if there is a common factor in the crisis and its persistence, it is the difficulties of the euro area banking sector. The sector is in a phase of downsizing and structural change that will inevitably affect financial intermediation going forward. To think about how this will impact European and global growth, I think it is useful to recall an ancient Chinese fable.

The fable is about a boy who lived near China's northern borders, and whose horse one day wandered off into the territory of the northern tribes. Everyone commiserated with him for his misfortune. But not his father, a well-practiced Taoist. "Perhaps this will soon turn out to be a blessing," he said.

Then, a few months later, his horse returned, accompanied by a fine horse from the north. Everyone congratulated him for his luck, but his father was more sanguine. He remarked, "Perhaps this will soon turn out to be a curse". The boy quickly became fond of riding the fine new horse, then one day out riding, he broke his leg in a nasty fall. Everyone again commiserated with him. But once more his father disagreed. "Perhaps this will soon turn out to be a blessing," he said.

Soon after, the northern tribes invaded the border regions. All able-bodied young men took up arms to fight the invaders, and nine out of ten died. Due to his broken leg, however, the boy did not join in the fighting. He and his father therefore survived.

This fable, known as "blessing or curse", is essentially about how the true significance of developments is often not immediately apparent – and how the wise observer therefore pays due attention to unintended consequences, both positive and negative. In my view this describes rather well the situation in the euro area financial sector today.

The euro area banking sector has suffered a substantial shock that has triggered widespread deleveraging, and on the face of it this is a negative development: it harms economic growth and constrains access to finance. Yet, it is also clear that before the crisis the European banking system had become unhealthily large. It was too leveraged, too big relative to the size of national economies, and perhaps too dominant relative to capital markets. Thus, the effect of a downsizing banking sector might in fact be a blessing in disguise – that is, a shift towards safer banks and a more balanced financing mix.

Yet, we have to be careful that this too does not turn out to create problems. For example, the transition to a new financing mix may favour some jurisdictions over others, thus reinforcing imbalances. A shift from bank to non-bank financing may create new sources of systemic risk in less transparent sectors. In other words, the challenge for policy-makers in Europe today is to capitalise on the potential positives from the situation that has befallen us, while making sure that we do not simply end up creating new problems for the future.

Let me begin my discussion on how to achieve that by looking at the current trend towards bank downsizing in the euro area.

The trend towards downsizing banks

Financing of the real economy in the euro area has historically taken place through banks. The euro area therefore requires and has a large banking sector. The aggregate balance sheet of euro area banks is around 270% of GDP, whereas in the US, where capital markets are deeper, it is only around 70% of GDP.

The euro area banking sector, however, expanded rapidly in the years before the crisis from already high levels. From the start of the expansion in 2005 to its peak in 2012, banks assets increased by more than 60 percentage points of GDP. This was associated with the development of unsustainable bank business models. Banks relied too much on debt to finance their lending, and that debt depended too much on wholesale market funding and too little on deposits.

The crisis has brought those business models to an end and triggered a process of structural change in the banking sector. European banks have entered a period of secular deleveraging and restructuring. Bank balance sheets declined by around 20 percentage points of GDP in 2013 alone. Loan-to-deposit ratios fell from 142% in the first quarter of 2008 to 117% at the end of last year, and I expect these ratios to continue to fall. Credit growth has consequently been very weak.

This trend towards a downsizing of the banking sector has both positive and negative aspects.

The negative aspects are mainly *cyclical* and relate to the current situation. A deleveraging banking sector implies lower credit supply, which is problematic for a recovering euro area economy. While the early stages of recoveries do not depend on credit as firms tend to draw down internal funds, when credit demand picks up it needs to be matched by credit supply for a sustainable recovery to take hold. The typical lag between credit growth and the economic cycle is around 3 to 4 quarters.

The recovery in the euro area began not yet a year ago, and we are seeing tentative signs from survey data that credit demand in the euro area is starting to pick up. The latest euro area Bank Lending Survey (April 2014) shows that net loan demand has turned positive for all loan categories. So, we need to make sure that the banking sector is strong enough to meet that demand. A car can run on low fuel for a while, but at some point it needs to fill up otherwise the engine will stall. At this stage of the recovery it is clear: There needs to be sufficient fuel to rev up the engine.

This is one reason why the ECB has been putting so much emphasis on its on-going comprehensive assessment of bank balance sheets in the euro area. Our aim is to ensure that banks are sufficiently capitalised to once more start originating loans and taking risk. So far, the mere "shadow" of the exercise has had a catalytic effect on banks' asset valuations, provisioning and capital raising.

That is not to say that we expect a surge in aggregate credit growth as the exercise reaches its completion with the publication of the results later this year. Rather, our expectation is that new finance should be available for firms that need it. In Spain, for example, the banking sector restructuring programme since 2012 has not yet led to an increase in overall credit.

But loans of less than €1 million to non-financial corporations – which are associated mainly with small- and medium-sized enterprises (SMEs) – have shown a notable recovery in recent months.

The positive aspects of a downsized banking sector are mainly *structural*.

Some research suggests there is a threshold beyond which the positive effect of finance on growth diminishes.[1] For example, information rents in the financial sector might be generated by complex financial products or opaque banking organizations, allowing – at least temporarily – for higher salaries and bonuses to be paid. This attracts talented individuals away from productive sectors.

Alternatively, too-large banks may start expanding into less productive types of lending. If a housing bubble is fuelled by aggressive lending, it is often the residential construction industry that initially benefits. But the construction sector is typically characterised by low productivity growth compared to manufacturing. Indeed, the proportion of housing loans as a percentage of total loans in the euro area increased from around 50% in 1990 to more than 70% today, which is a type of lending that tends to be associated with lower growth.[2] Structurally, a smaller banking sector could – at least in theory – help to avoid those negative effects on growth and insulate the euro area from some of these risks.

Still, a smaller or downsized banking sector is no guarantee for lower overall risk. The business models, risk attitudes and profitability of the banks need to be taken into account as well. Likewise does geographical expansion into foreign markets when it is not accompanied by local knowledge.

Another aspect is that a downsized banking sector provides impetus for capital market development in Europe – after all, if savings are not being intermediated through banks, they must be being intermediated through capital markets. I see this as central to a more balanced and contested financing mix in the euro area.

Contrary to the trend in most advanced economies, the relative importance of bank versus non-bank financing in the euro area has actually increased in the last two decades – from already high levels – and this may have given banks excessive market power. Recent research looking at the pre-crisis period suggests that where banks face limited competition in their domestic markets, and firms are more dependent on them, financing constraints for SMEs have been higher.[3]]

Matching credit supply and demand

We are already seeing signs in the euro area that a rebalancing towards capital market financing is taking place: as bank credit to corporates has fallen, it has been approximately matched by issuance of corporate bonds. It would nonetheless be naïve to expect this transition towards a new financing mix to occur seamlessly. While on aggregate, euro area credit supply might be sufficient to meet credit demand, I see two factors that might lead to an imperfect match between supply and demand for certain firms. They are the *location* of those firms and their *size*.

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1 See for example Arcand, Jean-Louis, Enrico Berkes, and Ugo Panizza (2012). “Too much finance?” IMF Working Paper No. 12/161, or Manganelli, Simone, and Alex Popov (2013). “Financial dependence, global growth opportunities, and growth revisited.” Economics Letters, 120(1), 123–125.

2 OECD (2014). “The role of the financial sector for economic growth in OECD and G20 countries,” internal paper prepared for the Economic Policy Committee.

3 Ryan, R., O’Toole, C. and McCann, F. (2014), “Does bank market power affect SME financing constraints”, Journal of Banking and Finance, January.

Location

In terms of *location*, the cost of and access to finance in the euro area remains strongly based on national conditions. For example, the average cost of borrowing for non-financial firms in Portugal is more than 5% per year, whereas the equivalent for French firms is around 2% per year.

One would imagine in this situation that a Portuguese firm would seek out a French bank, but the euro area banking market does not facilitate such arbitrage. Direct cross-border loans to firms account for just 7.5% of total loans to firms. And local affiliates of foreign banks represent on average only around 20% of national markets, and much less in larger countries. Thus, firms depend heavily on the health of their domestic banks.

Moreover, while corporate bond issuance has partially substituted for bank lending, it is strongly concentrated in non-distressed countries where there has been no decrease in the net flow of bank loans. The net issuance of debt securities, quoted shares and bank loans in non-distressed countries was plus €66 billion in 2013, whereas it was minus €93 billion in distressed countries.

Of course, in principle firms from distressed countries can issue securities in non-distressed countries. In practice, however, it is legally complicated due to issues of different governing law, especially when securities are traded along a chain of financial intermediaries.

This analysis points to two missing pieces in the euro area financial market: lack of retail banking integration and lack of capital market integration.

The low level of retail banking integration reflects several factors, but diverging approaches to supervision and resolution are certainly among them. For one, the persistence of national borders in a European financial market has in the past created compliance costs and reduced the synergies of banking integration. A European Commission survey in 2005 found that opaque supervisory approval procedures were a major deterrent to cross-border banking M&As.[4]

Moreover, national considerations may have reinforced the fragmentation of retail markets during the crisis. For example, some commentators have argued that supervisors erected *de facto* "internal capital controls"[5] within the euro area, which restricted the flow of funds between banks and within cross-border banks.

A similar pattern can be observed in how national authorities in the euro area have dealt with failing banks. In general, non-viable banks were merged with other national banks, rather than being wound down or broken up and sold off. Thus, what could have been an opportunity to increase foreign competition in domestic markets, and indeed to work through the crisis more quickly, in some cases ended up increasing national concentration. To give a comparison with the US, the FDIC has resolved around 500 banks since 2008, mainly by selling parts of banks to other banks, whereas the equivalent figure for the euro area is around 50.[6]

All this suggests that the move towards a genuine Banking Union in the euro area could help create the conditions for deeper retail banking integration. A Single Supervisory Mechanism (SSM) should lead to harmonisation of rules and standards, and also remove distortions created by national borders. And a Single Resolution Mechanism (SRM) should ensure that

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[4] See ECB Report on *Financial Integration in Europe*, March 2007.

[5] An example of this view is Véron, N. (2013), "Banking nationalism and the European crisis", October.

[6] Sapir, A. and Wolff, G. (2013), "The neglected side of Banking Union", note presented at the informal ECOFIN 14 September 2013, Vilnius.

banks are resolved from a European perspective and according to least-cost principles, which should in principle open the door for cross-border resolution strategies.

In this way, even though the banking sector on aggregate is downsizing, credit allocation across the euro area may become more efficient. Banking Union is key part in ensuring that location becomes a diminishing factor in access to bank finance.

While Europe is and will remain a bank-based economy, adding the second missing piece of the euro area financial market – deeper capital market integration – is key to ensure that firms in all jurisdictions can use capital markets as a "spare tyre" when banks are not lending – and not only those in larger countries with more developed bond markets. Within a single currency area, there is no reason in principle why firms should not be able to tap a European pool of savings. What prevents this in practice, however, is regulatory heterogeneity across the euro area.

Europe has made some good progress in tackling this issue in recent years, in particular in harmonising the rules needed for the transparency and integrity of securities markets. Nonetheless, obstacles remain.

One is legal uncertainty for cross-border holding and issuance of debt and equity securities – for example, different national definitions of securities ownership.[7] Another is differences in national insolvency laws, which make it difficult for investors to properly evaluate the risks they assume when investing in securities in other jurisdictions. Still another is the transaction costs that investors face when engaging in cross-border securities trading due to divergent corporate governance and tax regimes.[8]

In other words, building a truly integrated capital market in Europe requires further efforts and new legislation extending far beyond Banking Union. It is essential that the progress we have made on the banking side does not cause us to lose reform momentum here. And this is not a case of politics directing markets; it is about policy creating the pre-conditions for markets function properly.

Firm size

The effects of location on access to finance are exacerbated by *firm size*. While firms are in general more credit-constrained in some jurisdictions than others, this phenomenon is particularly apparent for SMEs. For example, the percentage of financially constrained but viable SMEs – defined to be those with positive turnover in the last six months seeking a bank loan – varies from a minimum of 1% in Germany and Austria to a quarter of the total population in Spain and even a third in Portugal.

There are two reasons for this.

First, bank lending to SMEs is concentrated in a handful of large banks as only they have the capacity to diversify idiosyncratic risks by lending to a broad enough range of firms. The three biggest originators in each euro area country represent on average 80% of the outstanding amount of the SME loans. This makes SMEs particularly vulnerable to any shocks to the banking sector and reduces their ability to switch between banks.

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7 At present, the legal position that an account holder "owns" as soon as securities are booked to his account differs across euro area countries: in some jurisdictions the holder enjoys full and unshared property rights, whereas in others the holder receives a position that is in comparison "inferior", i.e. a shared or indirect property interest or a mere claim against the account provider.

8 For more details see Special Feature C, "Initiatives to promote capital market integration in European bond and equity markets", in ECB report on *Financial Integration in Europe*, April 2014.

Second, as smaller firms tend to be less transparent than larger firms, it is more costly for investors to obtain adequate information. This makes it harder for SMEs to substitute capital market finance for bank finance if the latter dries up.

This is far from a trivial issue. The ability of SMEs to consistently access finance has vital macroeconomic importance for Europe. Between 2002 and 2010, 85% of total employment growth in the EU was attributable to SMEs, and SMEs have a much higher employment growth rate (1% annually) than large enterprises (0.5% a year). And within the SME class, most employment growth takes place within young firms[9], for whom external financing is particularly important as they cannot draw much on internal funds. Recent research from the US has shown that these firms also tend to be more sensitive to changes in investment opportunities.[10]

So what is the solution here? There are many schemes underway in Europe to address this problem that I will not try and cover today. But one unifying theme that I see as critical is to better match the needs of SMEs with the funds of non-bank investors, thus providing more diversification for SMEs.

One way in which non-banks provide this diversification is in terms of counter-cyclical access to credit. When banks contract credit, less risk-averse investors such as private debt funds or peer-to-peer lenders can fill the gap and thus help smooth the credit cycle.

Another way is in terms of maturities. While regulatory changes have made commercial banks less willing to make long-term loans, some large institutional investors – for example pension funds and insurance companies – need assets with maturities and returns that match their liability profiles. SME lending can provide this, especially while long-term safe assets exhibit low rates of return.

The size of this "shadow banking" system – which in my view is a misleading term[11] – has increased considerably in the euro area since the crisis, rising by almost 20% since 2008. It has also taken on a greater role in financing the real economy. At end-2013, outstanding amounts of loans from euro area non-bank financial intermediaries to euro area non-financial firms amounted to €1.2 trillion. But the key challenge from a policy perspective is to ensure that these funds make their way to the most credit-starved SMEs.

Here I see two initiatives as particularly important.

The first is to increase their capacity to lend *directly* to SMEs via loans or bond purchases. Here improving the information available for non-bank investors is key. A possible solution, proposed in the recent report of a high level expert group[12] on finance for growth in Europe, is for European institutions to work with the private sector to establish a consolidated database on SME credit risk performance. Actions are also possible at the level of Member States. In Italy, for example, "mini bonds" for SMEs are guaranteed by the Italian state up to 70% of principal, and the results are promising so far.

The second initiative is to increase the capacity for non-bank investors to lend *indirectly* to SMEs via securitisation. This requires a concerted effort to revive the flagging market for high

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9 De Kok, J. et al (2011), "Do SMEs create more and better jobs", EIM Business & Policy Research report, November 2011.

10 Adelino, M., Song, M. and Robinson, D. (2014), "Firm age, investment opportunities and job creation", NBER Working Paper 19845, January.

11 The Financial Stability Board defines shadow banking as "credit intermediation involving entities and activities outside the regular banking system", a definition which ranges from more transparent and regulated entities such as institutional investors and money market funds to highly complex and unregulated entities such as structured investment vehicles and special purpose entity conduits.

12 "Finance for Growth", Report of the High Level Expert Group on SME and Infrastructure Financing, December 2013.

quality securitisation in Europe, which the ECB and the Bank of England have been jointly pushing.[13] Securitisation has the double benefit that it not only encourages existing originators to extend more SME loans, but to the extent that it partially removes credit risk from bank balance sheets, it may also help smaller, less diversified originators to enter the SME loan market. In this way, it could also mean that SME lending is less dependent on a few large banks in each country.

It is worth reflecting, however, on what the new normal should be once the credit cycle picks up. On the one hand, there clearly benefits to having a more balanced financing mix. It is useful not only to provide a cyclical cushion in bad times, but also to increase market contestability and reduce over-banking in normal times. On the other hand, if what we are seeing is the beginning of a structural shift from bank to non-bank financial intermediation, we have to keep a close eye on the potential risks that might be building up. Indeed, there may be little long-term value in shifting risk from a highly regulated sector to a lightly regulated one, particularly if more and more lending is taken up entities that fall outside the regulatory reach.

Conclusion

Let me conclude.

My message today is simple: the euro area financial system has been hit by a major shock, which few of us foresaw, but through good policy choices it is possible to steer this development towards a positive outcome, while avoiding unintended negative consequences. And looking at the developments across the euro area today, in my view the right choices are being made.

Banks are already strengthening their capital as a result of the comprehensive assessment. The European supervisor will be fully operational in November this year. From next year we will start building up a single fund for European bank resolution. And initiatives are underway to strengthen access to finance for SMEs, especially through securitisation.

For Asia, there is every reason to be confident that the euro area is addressing the structural problems in its financial system, which should in turn support more sustainable growth in Europe and for the world economy. We still have a long way to go, to be sure, but I am confident that Europe has now moved from being a risk to the global economy to a partner in global growth.

Thank you for your attention.

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13 Bank of England and European Central Bank, "The impaired EU securitisation market: causes, roadblocks and how to deal with them", joint paper, April 2014. See also the communication from the Commission on Long Term Financing of the European Economy, COM(2014) 168 final, March 2014.