“Evolving landscapes of bank and non-bank finance”
Banca d’Italia-LTI@UniTo Conference

Panel on “Institutional investors’ asset allocation and the real economy”

Opening remarks by the Deputy Governor of the Bank of Italy

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I am very happy to be here today at this joint Banca d'Italia-Long-term Investors conference on the evolving structure of bank and non-bank finance. As the first session already highlighted, the conference provides useful indications on how to stimulate firms' access to market finance, alongside the traditional banking sector.

My role today is to chair the roundtable on "Institutional investors' asset allocation and the real economy", which focuses on how institutional investors can contribute to expanding the range of services and the volume of financial resources available to businesses. The panel will benefit from the contributions of distinguished participants, who will share their experience in the field with us. But before we start the discussion, let me briefly explain why, in my view, it is crucial that institutional investors play a larger role in funding the real economy.

The global financial crisis of 2008 was triggered and amplified by developments in the banking industry.[1] In the preceding years, banks had increasingly adopted the "Originate-to-Distribute" model, so that instead of holding the loans they had originated on their balance sheets, they transferred them to third parties. This weakened incentives to carefully screen and monitor debtors. Loans were repackaged and passed on to other entities, but in many cases the risks ended up being borne by banks' off-balance sheet vehicles and conduits. The rapid expansion of the banking system made the real economy highly vulnerable to financial shocks.

The risks connected with an overstretched banking sector emerged fully during the financial and sovereign debt crises. Since then, regulatory action has been taken to rein in the banking sector. Wider and tighter prudential requirements at the global level[2] and, in Europe, the Single Supervisory

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1 Brunnermeier, M. K., "Deciphering the Liquidity and Credit Crunch 2007–2008," *Journal of Economic Perspectives* 23 (2009), 77–100.

2 The main regulatory changes adopted after the crises include higher capital requirements, the introduction of liquidity requirements and a minimum leverage ratio.

Mechanism, the Single Resolution Mechanism and the Bank Recovery and Resolution Directive are acting to discourage excessive risk taking by banks. The burden of bank failures has been progressively shifted from taxpayers to banks' stakeholders.

As an intended consequence of these regulatory changes, banks have been steadily deleveraging, in particular by reducing the riskiest positions on their balance sheets. The contraction of bank intermediation has been accelerated by two factors. First, the macroeconomic environment, with its low level of interest rates and flat term structure, has put further downward pressure on banks' profitability. Second, banks are facing increasing competition from fintech companies, which use technological innovation to offer services such as payments and asset management. Even though core banking activities have not as yet been significantly affected by these new players, there are reasons to believe that fintech will in time become a more serious challenger in lending and also retail funding.[3]

Regulatory changes, combined with competition and the low level of interest rates, are paving the way for a contraction of the banking sector. As a result, non-bank forms of financing for the real economy need to be found. This need is particularly acute in the case of small and medium enterprises (SMEs), which are more bank-dependent than larger companies. Accordingly, as the deleveraging of the banking sector began, policymakers started voicing concerns about SME financing. Unfortunately, those concerns proved to be well-founded: during the crisis the deterioration in the economic outlook – together with the tightening of credit supply conditions – led to severe financial strains for SMEs.[4]

Larger firms, on the contrary, managed to weather the crisis better, partly because they enjoyed relatively easier access to capital markets, which allowed them to offset, at least in part, the decline in bank credit.

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3 Cortina, J. J. and S. L. Schmukler, "The Fintech Revolution: A Threat to Global Banking?," Research & Policy Briefs 14, World Bank, April 2018 and Lumpkin S., J. Mosher, "Framework for digitalization in finance," in OECD, *Financial Markets, Insurance and Private Pensions: Digitalisation and Finance*, 2018 and Panetta, F. "Fintech and banking: today and tomorrow," Speech, 12 May 2018.

4 ECB, "Survey on the access to finance of small and medium-sized enterprises in the euro area," November 2012, and Rodano, G., N. Serrano-Velarde and G. Tarantino, "Lending standards over the credit cycle," *The Review of Financial Studies*, 31 (2018), 2943–2982.

These observations regarding the ability of firms to finance themselves in the post-crisis landscape emphasize the importance of facilitating the growth of market finance. Apart from filling the void created by the contraction of the banking system, more developed market-based finance and the accompanying financial diversification will enhance the stability and the efficiency of both the financial system and the real economy. Indeed, the complementarity of bank and non-bank finance and the need to further develop the latter have long been emphasized by Banca d'Italia and other European institutions, which have long encouraged efforts in that direction. A large body of literature supports this endeavour, arguing that firms' optimal funding structure is diversified, in the sense that it includes both bank and non-bank debt, and that diversification has positive effects on firms' growth.[5]

A balanced mix of funding sources is also desirable from an aggregate point of view. Cross-country studies suggest that economies that overly rely on bank funding may be characterized by lower and more volatile long-run growth than more market-based economies.[6] There is no question that healthy banks act as shock-absorbers in normal recessions; but when recessions coincide with financial crises, as in recent years, bank-dependent economies are more severely hit than economies with a diversified financial system.

In order to ensure a stable and adequate supply of financial resources to the real economy, it is therefore necessary that the deleveraging of the banking sector be accompanied by a greater role for the financial markets and non-bank intermediaries. Institutional investors play a key role in this structural transformation. Indeed, one of the most important drivers of the development of financial markets is the growth of the institutional investor base. It has also been recently argued, for example, that an increase in pension

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5 Claessens, S. and L. Laeven, "Financial dependence, banking sector competition and economic growth," *Journal of the European Economic Association*, 3 (2005), 179–207.

6 Reinhart, C. M. and K. S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009, Cournède, B. and O. Denk, "Finance and Economic Growth in OECD and G20 Countries," OECD Economics Department Working Papers 1223, OECD, June 2015 and Langfield S. and M. Pagano, "Bank Bias in Europe: Effects on Systemic Risk and Growth," *Economic Policy* 31 (2016), 51-106.

savings favours participation in capital markets[7] and there is evidence that institutional investors have positive effects on corporate governance.[8]

A look at the development of institutional investors in advanced economies highlights the challenges ahead. Countries in continental Europe continue to lag behind the UK and the US. The gap is all the more serious in the pension funds sector, reflecting the relative weight of funded retirement schemes in national social security systems. The gap is very noticeable in Italy. For example, in 2015 the assets managed by pension funds accounted for less than 10 per cent of GDP in Italy, compared with more than 100 per cent on average in the UK and the US. We definitely need to attain a more comprehensive understanding of the underdevelopment of institutional investors in most euro-area countries.

For all of these reasons, policymakers look favourably at the development of market-based financing and the growth of institutional investors. It must be stressed, however, that banks and market-based finance remain complementary, rather than substituting one another, and that a level playing field should be ensured for all financial intermediaries. If regulatory changes put banks at a disadvantage, firms may end up having difficulties accessing both bank and non-bank forms of external finance. Indeed, apart from remaining a vital source of corporate funding, especially for SMEs, banks are uniquely equipped to help firms to access the capital market. Moreover, banks offer contracts (such as overdrafts or credit lines) and services (such as lending assistance) that are often complementary to market-based finance. These contracts and services can be helpful to firms, especially in periods of distress.[9]

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To conclude, the corporate sector would greatly benefit from a more developed market-based segment within our financial systems. Institutional investors play a pivotal role in this structural evolution. At the European

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7 Scharfstain, D. S., "Presidential Address: Pension Policy and the Financial System," *The Journal of Finance*, 73 (2018), 1463–1512.

8 McCahery J. A., Z. Sautner and L. T. Starks, "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors," *The Journal of Finance*, 71 (2016), 2905–2932.

9 Bolton, P., X. Freixas, L. Gambacorta and P. E. Mistrulli, "Relationship and Transaction Lending in a Crisis," *The Review of Financial Studies*, 29 (2016), 2643–2676.

level, this aim is being pursued by implementing the Capital Markets Union project: enriching the types of financing available to non-financial corporations, broadening the portfolio choices of investors, enhancing the efficiency of financial intermediation, removing barriers to cross-border investment, and increasing funding options for SMEs and infrastructure. In Italy, a number of additional initiatives with similar goals have been taken in recent years, such as minibond issues, debt funds, tax incentives for venture capital and allowances for corporate equity. Yet in Italy, as well as in many other European countries, the role played by the financial markets and non-bank financial institutions is still limited. This is why I am looking forward to discussing these issues with our eminent experts.

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