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AICGSPOLICYREPORT

FUNDING THE RECOVERY: THE FUTURE ROLE OF TRADITIONAL BANKING AND CAPITAL MARKETS

COMPARING THE UNITED STATES AND EUROPE

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AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES THE JOHNS HOPKINS UNIVERSITY

American Institute for Contemporary German Studies

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FOREWORD

Since the collapse of Lehman Brothers in 2008 and subsequent bail-out of banks deemed “too big to fail,” the United States and Europe have sought to reform the banking industry in an effort to reduce future risks to the financial system and economy. Understandably, the main interest of public opinion on both sides of the Atlantic has revolved around assessing whether the system is becoming safer.

However, the ongoing structural changes to the banking sector may also have a lasting impact on the costs of providing traditional forms of credit to households and non-financial corporations. If those resulted in credit constraints for small and medium-sized businesses regardless of the business cycle, some of the changes to the banking industry could have a lasting impact on jobs and growth. Fortunately for the U.S., its economy does not depend only on traditional forms of credit, intermediated through banks. Capital markets play a much bigger role.

Europe, too, has sought to reform its financial structure. The European Central Bank has offered generous liquidity injections to banks; however, lending remains low. The economic recovery in Europe lags behind that of the U.S., largely due to the impact of the European debt crisis on the euro zone. But there may well be deeper-seated structural differences of the financial architecture at play as well.

Europe’s economy still primarily depends on banks for its funding needs. If European regulators want to encourage the development of stronger capital markets, they will need strong public support. Some financial products associated with capital markets and the financial crisis still carry a stigma.

This is why, as part of our Annual Symposium in Germany, this Policy Report compares the role of capital markets in the U.S. and Europe in supporting the real economy. It focuses on the link between traditional banking and the weak European recovery and highlights differences between the U.S. and Europe, in particular the euro zone and Germany. By comparing the current structure of financial markets in the U.S. and Europe, the author tries to establish whether the American and European financial systems are on converging or increasingly diverging trajectories and what the potential implications are for the real economy.

AICGS is grateful to the sponsors of our Business and Economics Program for their generous support of this Policy Report, to Alexander Privitera for providing his analysis, and to Jessica Riester Hart for her assistance in editing and preparing the report.

Jackson Janes
President, AICGS

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INTRODUCTION

Over the past few decades the role of the financial sector has grown dramatically, with increases in both real sector leverage and financial sector balance sheets. Before the collapse of the investment bank Lehman Brothers in September 2008, conventional wisdom assumed that a bigger and more diversified financial sector was beneficial for the real economy because of an increased allocative efficiency of resources, as well as a wider dispersion of risk. The recent financial crisis shattered most of the pre-Lehman assumptions.

Regulators have since embarked on an ambitious overhaul of the financial sector. In the first phase they mainly focused on big banks. This was largely due to the fact that governments and central banks propped up financial institutions—large and small—that came very close to collapse. But it was primarily big banks that have since come to symbolize a culture of excessive greed and moral recklessness. Many critics interpreted the rescue of big financial institutions as a sign that banks win in good and bad times—and that taxpayers are forced to foot the bill.

In response to the crisis, the Basel Committee on Banking Supervision has strengthened bank capital requirements. Strong capital rules for banks remain the central pillar of bank regulation. But capital requirements do not directly address liquidity risk.

Hence, the Basel Committee developed new liquidity standards for global banking firms: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR should improve a bank's ability to withstand severe short-term liquidity shocks by requiring banks to hold a buffer of highly liquid assets to cover net cash outflows in a thirty-day stress scenario. The NSFR is designed to promote stronger resilience over a one-year horizon. It requires banks that hold less liquid assets to fund their activities with more stable sources of funding.

As part of the comprehensive financial reform known as the Dodd-Frank Act, restrictions on certain activities, such as the ban on proprietary trading in the United States as well as work on new domestic and cross border resolution regimes, represent further significant attempts to make the banking sector not only less vulnerable to shocks, but also less likely to trigger a financial crisis.

The European Union adopted the new internationally-mandated rules with its capital requirements directive, also known as CRD IV. In addition to that, the EU has decided to create a banking union with a powerful central supervisor and a single resolution mechanism for its credit institutions.

Public authorities in both Europe and the United States are trying to fulfill their promise to end the "too big to fail" syndrome. The stated goal is to allow banks to fail without endangering the entire financial system and the wider economy. This work is far from complete. Indeed, in its "Financial Stability Report" of spring 2014, the International Monetary Fund (IMF) warns that the "probability that SIBs (systemically important banks) will be bailed out remains high in all regions."[1] Regulators are still grappling with the need to make sure that bailing out banks with taxpayers' money will increasingly be the exception and bailing *in* shareholders and creditors of banks in distress should finally become the norm.

Regardless of which further future steps will be taken, it will be very difficult for banks to return to a pre-crisis *status quo ante*. Indeed, the profound changes in the sector could have a lasting impact on the business models of credit institutions, small as well as large, and even more importantly on the supply of credit to the real economy.

The structural changes to the banking sector may well increase the cost of providing traditional forms of credit, even if central banks keep key interest rates extremely low for a prolonged period of time. Some constraints on lending are desirable, especially if the intended goal is to build a more stable financial architecture. However, as we will argue in this Policy Report, in the absence of well-developed and sizeable capital markets, growing reluctance by banks to provide traditional loans to the real economy—in particular households and small and medium-sized enterprises (SMEs)—could have a lasting negative impact on growth and employment.

The European Central Bank (ECB) has recognized that there is a need for a bigger role for capital markets in Europe's economy. Specifically, the ECB is trying to revitalize the securitization of assets in Europe and jumpstart asset-backed securities (ABS) issuance in order to open more funding channels for the wider economy. According to the ECB's governing council member Benoit Coeure "[…] the idea is not to copy the United States. European growth is based almost exclusively on financing of households and firms by banks. For a long time that worked well, European banks did their job. But the 2007 global crisis and then the euro area crisis revealed that depending so exclusively on one sole method of financing constitutes a weakness."[2]

In its quarterly review of March 2014, the Basel Committee even writes that "evidence suggests that banks and markets differ considerably in their moderating effects on business cycle fluctuations. Banks are more likely to supply loans during a 'normal' downturn, thus smoothing the impact of the recession. But their shock-absorbing capacity is impaired when the downturn is associated with a financial crisis." The study ominously concludes that, "in this case, recessions with bank-oriented systems are three times more severe than in those with a market-oriented financial structure."[3]

In this regard it can be helpful to look at the experience in the United States, where capital markets have already overtaken traditional lending activities as the most relevant form of funding of the real economy. In the U.S., more than two-thirds of funding for the economy is intermediated by capital markets and less than one-third through traditional banking activities. In the U.S., despite a steep recession in 2009, the recovery has been underway since 2010 and now finally appears to be gaining momentum.

In the euro area the opposite is true. Indeed, despite generous liquidity injections for banks by the ECB, lending in the euro area remains extremely weak and economic growth is still disappointing.

Even in the U.S., and despite bold action by fiscal and monetary authorities, traditional bank lending remains anemic while capital markets have reached record highs. But overall constraints on credit were far milder in the U.S. than in Europe.

A variety of reasons are often used to explain the fact that Europe's economy is trailing behind the U.S. More specifically, the impact of the European debt crisis on the euro area economy ranks very high on the list of explanations given. Indeed, the fact that the economy of the euro zone is still 2.7 percent smaller than it was in early 2008 clearly had an adverse effect on credit growth. Furthermore, some European economies have become less competitive in the past decade and are now suffering the consequences of a backlog of structural reforms.

These are well-known and very valid explanations. But, as we will stress in this report, underlying structural differences in the financial architecture in the two jurisdictions could also provide an answer to the question. The divergence in credit flows in the U.S. and Europe could in fact also be the result of the much bigger reliance on capital markets in the U.S.

According to the ECB's Benoit Coeure, there are currently two driving reasons for encouraging the development of stronger capital markets, as "developing market financing via ABS, i.e., asset-backed securities (secured corporate debt) or, for example, bond issuance by medium-sized enterprises" would have multiple benefits, it would "make the financial system more balanced and more resistant to shocks.

This is essential as, by definition, we do not know where the next crisis will hit."[4]

However, European public support for a bigger role for capital markets is still weak, in part because they are often described as structurally unstable and just as threatening as big banks. Some financial products associated with the crisis, such as the very asset-backed securities that the ECB would like to see playing a bigger role in the European financial system, still carry a stigma. After all, it was when mortgage-backed securities (MBS) were mispriced and suddenly became illiquid that the crisis erupted. Capital markets allowed the disease to spread. Not surprisingly, the market for ABS has not recovered in Europe, in contrast to the U.S., where debt markets have bounced back and in some instances even appear to be once again quite "frothy."

Against this backdrop, the purpose of this analysis is to compare some aspects of credit intermediation in the U.S. and Europe, and to highlight the size and role of capital markets in Europe and the United States. We will try to explore what impact a continued preference for traditional forms of lending intermediated through banks could have on the recovery in the U.S. and in Europe, particularly in the euro area.

We will try to point out how unlocking the potential of capital markets could help the ECB transmit its monetary policy stance more uniformly across the monetary union, boost the supply of credit to households as a result and finally, provide alternative forms of investments for savers that are currently punished by the low interest rate environment.

Providing access to capital markets will continue to be primarily a task for banks that offer a variety of services. In the context of a global, interconnected European economy that slowly moves away from the over-reliance on traditional bank loans, universal banks will still have an important role to play. In the post-crisis economy, growth will increasingly depend on a well-functioning, safer, and different balance between capital markets and banks. Both the U.S. and Europe are still building a financial architecture able to address the needs of their respective economies. Getting the mix and balance right is far from assured. The work is far from complete.

01

THE COST OF PROVIDING CREDIT

Almost six years after the collapse of Lehman Brothers, the impact on the overall economy of tighter regulation, including higher capital requirements for banks, continues to the subject of an intense debate among regulators and the financial industry. Factoring in the Basel III capital requirements and the Net Stable Funding Ratio (NSFR), a Basel Committee study in 2010 suggested that tightening risk-based capital and liquidity requirements would, on net, provide economic benefits, and that benefits would continue to increase at even higher levels of risk-based capital than are part of Basel III.[5]

At the same time, it is also clear that in a tougher regulatory environment, the cost of holding securities, loans, and trading exposures will rise. The Basel Committee recognized this and suggested that "banks have various options to adjust to changes in required capital and liquidity requirements other than increasing loan rates, including by reducing ROE [Return on Equity], reducing operating expenses, and increasing non-interest sources of income. Each of them could cut the costs of meeting the requirements."[6]

These findings mainly apply to banks in a growing and relatively stable economy. Implementing the right mix of measures is much more difficult when banks operate in a weak, fragile growth environment and when their profitability is suffering.

The banking industry insists that in a tougher regulatory environment traditional lending will become more expensive, regardless of the business cycle. It maintains that tougher rules would force banks to increasingly shift away from traditional forms of credit intermediation and focus on distributing parts of their loan portfolios, resulting in a stronger emphasis on activities intermediated through the capital markets.

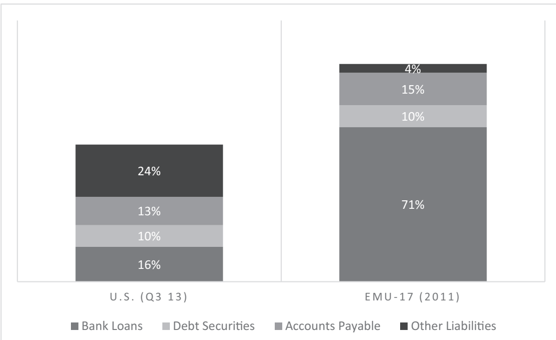
In their recent "European Banks Strategy" report Deutsche Bank analysts estimated that, in the case of loans to SMEs, "there is effectively no way for a bank to generate enough fees on a single transaction to justify a Euro 100 million loan and earn cost of capital. The bank has to recycle the credit into either the secondary loan market (syndication) or into the bond market (DCM). *The loan does not belong on the bank balance sheet*"[7] (emphasis added). If this is the case, structural differences of the financial sectors, in the U.S. and Europe, matter.

The role of banks is much bigger on the old continent than in the U.S. In the euro area alone, bank loans account for most of household borrowing and around half of all non-financial firms' external financing. In the U.S., 75 percent of firms' financing is channeled through capital markets. This explains why the banking sector in the euro area is so big—270 percent of GDP—while in the U.S. the figure is "only" 72 percent.

While traditional bank lending continues to be weak in the U.S. as well as in the euro area, it is mostly Europe that is suffering from serious constraints on bank credit. Indeed, in April 2014, six long years after the Lehman collapse, and after repeated doses of accommodative conventional and unconventional monetary policies, the U.S. Federal Reserve (Fed) finally reported an easing in lending standards to small and medium-sized non-financial corporations. "After several years of reduced lending following the recession, we are starting to see slow but steady loan growth at community banks," Fed Chairwoman Janet Yellen said in a speech before community bankers in May 2014. "While this expansion in lending must be

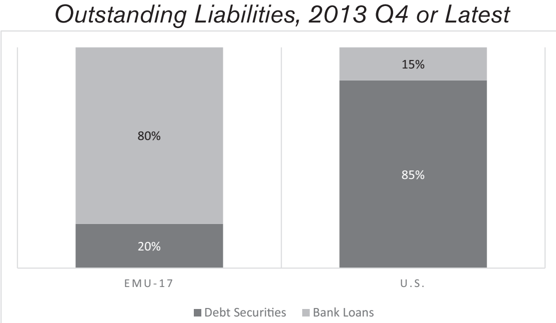
Figure 1: European versus U.S. Share of Bank Lending in Corporate Credit

(%, excluding financing from own funds)



Source: Deutsche Bank graphic using ECB and FDIC data. See Matt Spick and Nick Burns, "European Banks Strategy," Deutsche Bank *Markets Research*, 17 February 2014."

Figure 2: Non-Financial Corporations, Selected Outstanding Liabilities, 2013 Q4 or Latest



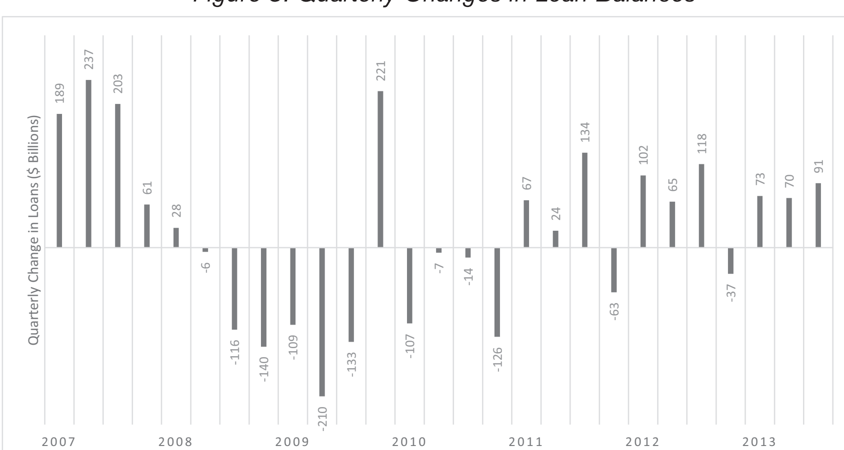
Sources: ECB, Fed, Deutsche Bank Research. See Orcun Kaya and Thomas Meyer, "Tight bank lending, lush bond markets: New trends in European corporate bond issuance," Deutsche Bank Research *Current Issues*, 15 April 2014.

prudent, on balance I consider this growth an encouraging sign of an improving economy."[8] This latest development comes after a drought in credit flows that forced public authorities in both jurisdictions to add targeted intervention in specific sectors of the economy to their policy mix in order to support lending activities to the real economy.

With the asset purchases program known as QE3 (quantitative easing), the Federal Reserve intervenes in the housing market by buying mortgage-backed securities. MBS bundle mortgages that, in the U.S., are often linked to government guarantees. When banks resumed their origination of mortgages in the aftermath of the crisis, most were backed by the government-sponsored agencies Fannie Mae and Freddie Mac. Given the pivotal role that housing plays for domestic demand and growth in the U.S., policymakers determined that a bold intervention by the official sector in one area of the economy was warranted in order to support the overall economy.

In Europe, the housing market was never targeted by the ECB, since the situation was varied among countries. But targeted interventions in sectors of the economy eventually took place in the euro area as well, albeit to a much smaller degree. Instead of supporting the housing market, authorities in Europe focused on small and medium-sized enterprises (SMEs). State-sponsored investment banks such as the German Kreditanstalt für Wiederaufbau (KfW) or

Figure 3: Quarterly Changes in Loan Balances



* FASB Statements 166 and 167 resulted in the consolidation of large amounts of securitized loan balances back onto banks' balance sheets in the first quarter of 2010. Although the total amount consolidated cannot be precisely quantified, the industry would have reported a decline in loan balances for the quarter absent this change in accounting standards.

Source: Opening Statement by FDIC Chairman Martin J. Gruenberg on the Fourth Quarter 2013 Quarterly Banking Profile, 26 February 2014.

the European Investment Bank (EIB) increasingly provided credit for small and medium-sized enterprises that were having increasing difficulties in accessing credit from banks. Over the past few years, as traditional banks have increasingly reduced the size of their balance sheets and, as a consequence, exposure to SMEs, the balance sheets of the KfW and EIB have grown dramatically. This shift is driven by the need to mitigate the negative effects of protracted weak traditional lending for SMEs, which in both the U.S. and Europe represent the backbone of job creation. It is too early to say whether those policies will achieve or are indeed achieving the desired results.

After an initial increase in mortgage origination in the U.S.—driven in part by the refinancing of older mortgage loans—the housing market is cooling down. The weaker lending activity in this particular sector of the economy may well be linked to the Fed's announcement that it will slowly exit out of its asset purchases program (quantitative easing). Despite the promise by the Fed not to raise interest rates anytime soon, interest rates on mortgages have started to rise and, as a consequence, refinancing operations have become more expensive.

However, this is only part of the story: weaker mortgage origination—especially in the subprime sector—is in part the intended effect of more stringent loan standards that are designed to avoid a repeat of the subprime crisis that led to the catastrophe of 2008. Anticipating a tougher approach by regulators, many big banks have in fact reduced their footprint in the housing market.

In the European context the reluctance by banks to increase lending boils down to the question: Is the phenomenon to be explained with a lack of demand or rather with the reluctance by banks to supply loans?

Finding the right answer is not easy. Tightened lending standards can have different reasons in different countries and they are very sensitive to different phases of the business cycle. Also, and as importantly, there is the question of whether in the case of a high public and private sector debt overhang and weak growth projections, a dramatic increase in lending really would help to put the economy on a sustainable path or rather encourage the formation of new bubbles and, by doing so, exacerbate structural weaknesses.

Let's first review some of the differences between member countries of the monetary union. In some of the stronger economies, such as Germany, credit constraints are mild or non-existent. Here, banks often

Figure 4: Volume of Mortgages Originated by Each of the U.S.' Five Biggest Banks

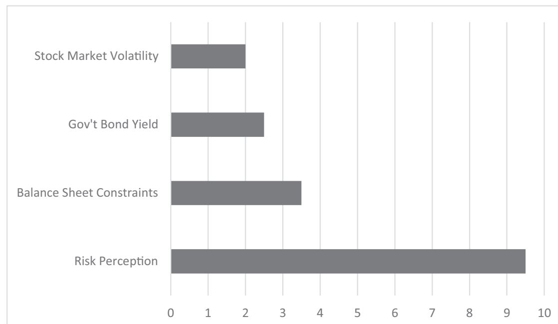
(in $ millions)	Q3 '11	Q4 '11	Q1 '12	Q2 '12	Q3 '12	Q4 '12	Q1 '13	Q2 '13	Q3 '13	Q4 '13
Wells Fargo	89,000	120,000	129,000	131,000	139,000	125,000	109,000	112,000	80,000	50,000
JPMorgan	36,800	38,600	38,400	43,900	47,300	51,200	52,700	49,000	40,500	23,300
Bank of America	33,885	22,373	15,998	18,965	21,248	22,478	25,036	26,772	24,429	13,539
U.S. Bancorp	11,509	17,415	19,168	21,667	21,529	22,111	21,698	17,796	15,192	8,563
Citigroup	17,000	21,100	14,300	12,900	14,500	16,800	18,000	17,200	14,500	8,300

Source: "Which Way is the Mortgage Market Headed in 2014?" *Forbes*, http://www.forbes.com/sites/greatspeculations/2014/03/06/which-way-is-the-mortgage-market-headed-in-2014/

compete with each other for reluctant customers. Some German SMEs have even reduced their reliance on banks and manage their funding needs through internal cash flows, for example by retaining earnings. Bigger companies can directly tap debt markets. While Germany's economy is still performing well, both the private and public sector in this key European economy are reluctant to invest. German companies explain their cautious behavior with the uncertain outlook of the euro area economy and the protracted weakness of the main European export markets.

Figure 5: Risk is the Dominant Lending Constraint

(Increase in net tightening of credit standards in pp given increase in expl. var. by one standard deviation)



R2 = 80%. Countries in the sample are France, Germany, Netherlands, Italy, and Spain.

Sources: Deutsche Bank Research, ECB. See Orcun Kaya and Thomas Meyer, "Tight bank lending, lush bond markets: New trends in European corporate bond issuance," Deutsche Bank Research Current Issues, 15 April 2014.

In Italy, one of the main German trading partners and a country where growth is anemic at best, Italian banks are publicly criticized for not extending loans to the private sector. Here, too, at least according to the Italian Banking Association (ABI), the problem is not a lack of supply but rather of demand, in this case explained with the sharp reduction in economic activity. This view is not shared by the experts at the Italian central bank (Banca d'Italia), who find that rather than weak demand, in Italy, just as in other struggling European economies, it is the perception of a dramatically increased credit risk that appears to be the most important impediment to more robust lending activities.[9] In fact, the non-performing loan (NPL) ratio in countries such as Italy or Spain has grown steadily over the course of the past few years. The deterioration of the balance sheet of many banks, coupled with a reluctance to take on more risk on their books, has clearly had an impact on lending activities. Until very recently, Italian banks preferred to lend to their own sovereign rather than to the real economy.

According to a recent study published by Deutsche Bank Research, lending constraints are in fact due to a mix of risk perception, which "is the dominant constraint on traditional lending activities, followed by balance sheet constraints. […] Government bond yields and stock market volatility also exert tightening pressure on credit standards—but for very different reasons. Volatility is a typical measure of risk aversion. During risk-off periods (i.e., high volatility) banks tend to lend only to their best clients. By contrast, government bond yields are typically a counter-cyclical indicator, i.e., they go up in good times and down when the outlook darkens. They also serve as lower bound for interest rates that banks can charge to clients. An increase in yields is thus passed on by banks to clients, lowers firm profitability, and increases the probability of default. This in turn motivates banks to be more selective."[10]

The study concludes that the contraction in bank lending "is for the most part a consequence of an adverse economic outlook and fears that a greater share of clients will be unable to service loans in the future. The collapse in lending growth is thus a symptom of a crisis rather than its cause."

Given this funding constraint, it is not surprising that the recovery in Europe continues to be "weak, uneven, and fragile."[11] According to recent findings published by the European Investment Bank, the continent is in fact experiencing an investment crisis.[12]

Understandably, the public pressure on banks to lend more is growing. But if perception of risk is the biggest impediment to traditional forms of lending, it is unclear how far public pressure can go. After all, policymakers would like to see a more resilient financial sector emerge from the crisis, one that avoids unnecessary risks.

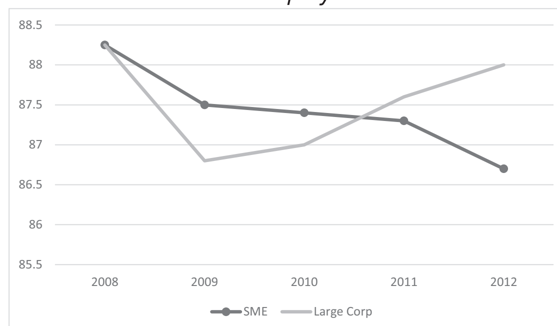
If true, this development would explain why repeated attempts by the ECB to stimulate lending activities by providing ample liquidity for banks have proven to be so frustrating. Only bigger, globally interconnected companies have truly profited from the low interest rate environment. They can tap capital markets—more specifically, debt markets—for their funding needs, even if banks are reluctant (as they are) to extend traditional loans. As a consequence, corporate debt issuance has grown strongly while traditional forms of credit for consumers and smaller companies wither. This development has created a situation in which credit-strapped consumers and SMEs—which only have limited or no access to capital markets—find themselves on the sidelines of credit flows and lushly funded big companies are awash in cash. (Figures 6 and 7 illustrate how lending constraints for SMEs have a bigger impact on the real economy in the European Union than in the U.S.)

For the ECB, the paradox is that while banks in most of the euro area remain a hurdle to a smoother transmission of monetary policy, capital markets have reacted to the central bank's action as was intended by policymakers. This could be one of the reasons for a much bigger success by the Federal Reserve in transmitting its monetary policy to the real economy. In contrast with the ECB, the Fed did not have to rely exclusively on banks as its only transmission channel.

In Europe, despite ample liquidity injections into the banking sector and the promise by the ECB "to do whatever it takes" in order to preserve the monetary union in the summer of 2012, banks still represent a bottleneck to a more uniform transmission of the central bank's monetary policy and credit channels. As long as this remains the case, the problem of financial fragmentation in the euro area will continue to be a challenge.

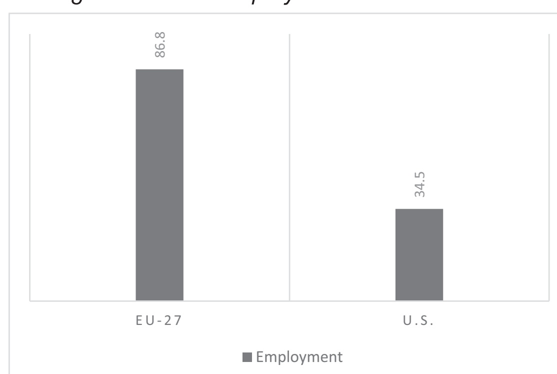
A prolonged credit crunch can have a serious negative impact on the real economy, no matter what the cause. In fact, the longer lasting the negative feedback loop between lack of credit and weak economic activity, the more irrelevant the root causes become. This was one of the central lessons that the post-Lehman Fed led by Chairman Ben Bernanke learned from the history of the Great Depression.

Figure 6: EU-27: Large Corporate vs SME Employment



Source: Deutsche Bank using European Commission data. See Matt Spick and Nick Burns, "European Banks Strategy," Deutsche Bank *Markets Research*, 17 February 2014.

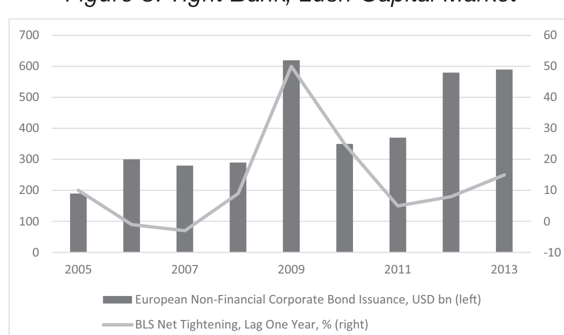
Figure 7: SME Employment: U.S. vs. EU-27



Note: U.S. data includes personnel up to 299 vs EU-27 at up to 250

Source: Deutsche Bank using European Commission data. See Matt Spick and Nick Burns, "European Banks Strategy," Deutsche Bank *Markets Research*, 17 February 2014.

Figure 8: Tight Bank, Lush Capital Market



Source: Deutsche Bank Research, Dealogic, ECB. See See Orcun Kaya and Thomas Meyer, "Tight bank lending, lush bond markets: New trends in European corporate bond issuance," Deutsche Bank Research *Current Issues*, 15 April 2014.

02

RESTORING CONFIDENCE IN BANKS: A COMPARISON

When the crisis erupted, the Fed first restored liquidity and tried to stabilize credit flows between banks and from credit institutions to the real economy. Most of the structural ills of the financial sector were only addressed when the heart of the financial system started to beat again.

But even before the comprehensive financial reform, known as the Dodd-Frank Act, became law in 2010, the Federal Reserve began to strengthen its oversight of the largest, most complex banking firms. In 2009, the Fed conducted the first stress tests of the largest nineteen U.S. bank holding companies. That test evolved into an annual exercise that now requires all bank holding companies with total assets of $50 billion or more to submit capital plans to the Federal Reserve. The Fed's stress tests greatly helped in restoring market confidence and eased the impaired interbank lending channel.

After an unsuccessful attempt by the newly-created European Banking Authority (EBA) to emulate the Fed's approach in 2011, which among other things ended with a clean bill of health for a bank that not much later had to be bailed out by the Belgian and French governments, the EBA will try to restore its credibility by conducting a new round of stress tests of some 124 banks, this time in conjunction with the ECB. The central bank will become the central supervisor in the newly-created banking union by late 2014. A single resolution mechanism and mutualized fund will follow in the course of the following years. The primary goal of the current comprehensive balance sheet assessment of banks that the ECB is undertaking with the EBA is to get credit institutions ready for the banking union.

The immediate aim is to shed light on a banking system that is still perceived as vulnerable. The exercise should openly expose and allow credit institutions to address weaknesses. The goal is to finally restore confidence in European banks, which should have a positive effect on lending activities—although it is still unclear when this would take place and how big the boost would be.

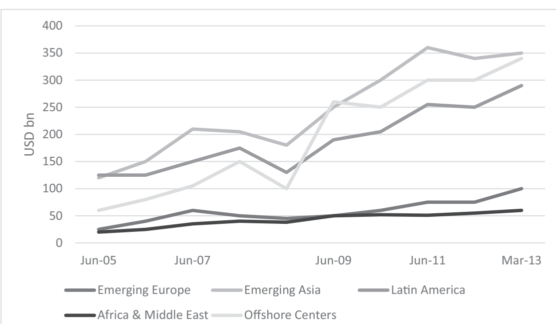
In this respect, the U.S. example provides a cautionary tale as it took almost six years after the end of the most acute phase of the financial crisis for traditional lending activities to gain momentum. In the European context, the end of the crisis would roughly coincide with the ECB's promise in the summer of 2012 to "do whatever it takes" to avoid a collapse of the monetary union. It could still take some time before banks feel confident enough to relax their lending standards. Credit constraints are not likely to disappear once the current comprehensive balance sheet assessment of banks conducted by the ECB and the EBA is completed in the second half of 2014.

The banking union that will emerge at the end of this current exercise should therefore not be seen as a silver bullet able to restore robust credit flows immediately. The overhaul of the European banking sector is primarily a medium to long-term goal that will provide some additional glue needed in order to make the monetary union more resilient, such as loosening the link between banks and their sovereigns while further integrating the European banking system. Just as it was the case in the U.S. during the crisis, some cross-border consolidation could become inevitable. As a consequence, the banking sector in Europe could shrink while some banks may well become even bigger, at least in relative terms. A smaller and healthier banking sector could eventually help to support lending activities. But even policymakers seem to have become a bit more skeptical about the positive near-term impact on lending of the start of this new chapter in the history of the euro zone.

In addition, whether the European approach will be successful highly depends on market perceptions. If there is one central lesson that the U.S. experience can teach euro zone regulators, it's that getting the timing right is at least as important as deciding on the proper policy mix.

In the wake of the Lehman collapse, some 600 (mostly small) banks failed in the U.S. This had a negative impact on lending in the local economies that suddenly saw some of their community banks disappear.[13] At the same time, big banks absorbed troubled investment banks and became even bigger. Today, the U.S. banking sector appears to be in better health and big, global U.S. banks are aggressively trying to take advantage of their return to profitability and the relative weakness of their European counterparts.

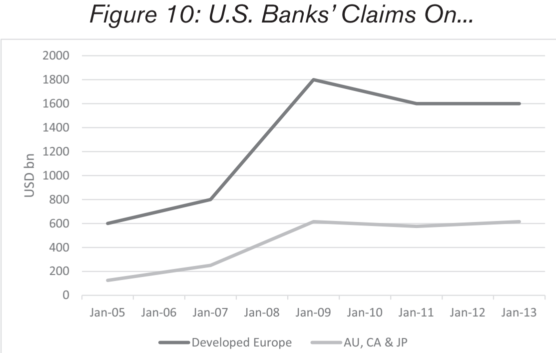
Figure 9: U.S. Banks' Claims On...



* Q1 2009 break in series due to inclusion of former investment banks in reporting population.

Source: BIS. See See Orcun Kaya and Thomas Meyer, "Tight bank lending, lush bond markets: New trends in European corporate bond issuance," Deutsche Bank Research *Current Issues*, 15 April 2014.

Figure 10: U.S. Banks' Claims On...



* Q1 2009 break in series due to inclusion of former investment banks in reporting population.

Source: BIS. See See Orcun Kaya and Thomas Meyer, "Tight bank lending, lush bond markets: New trends in European corporate bond issuance," Deutsche Bank Research *Current Issues*, 15 April 2014.

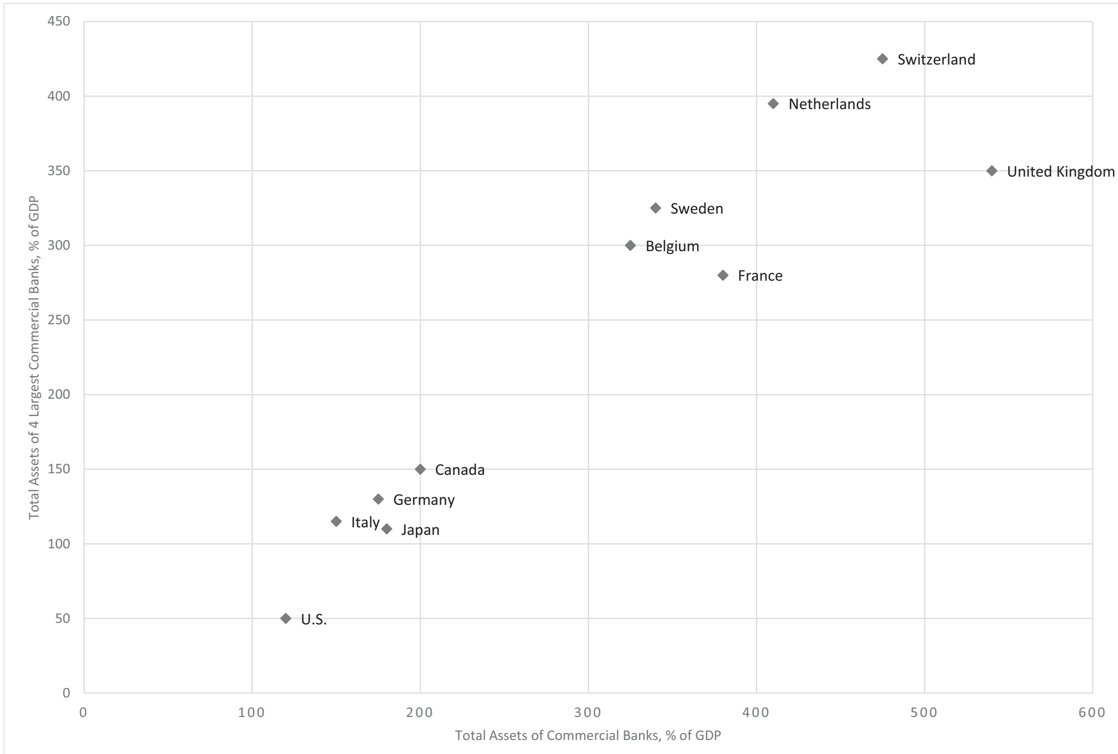
In most European countries, only a negligible number of banks were resolved (with the notable, albeit belated, exception of Spain). Before morphing into a sovereign debt crisis, and despite various assurances that Europe's banks were on balance in much better shape than their American counterparts, Europe already suffered from a deep banking crisis, amplified by the fact that the continent is "overbanked" (see Figure 11). As a consequence of various rescues of credit institutions, the public sector in many countries was put under enormous strain.

When the Greek government announced that it had repeatedly misstated its fiscal deficits in 2009, investors started to lose faith in the ability of the country to service its debt. International investors reduced their exposure to Greek sovereign bonds and eventually also retreated from other weaker euro area economies. The U.S. financial crisis finally morphed into what is commonly known as the euro crisis. This second phase of the financial crisis almost came as a knock-out punch for the monetary union and had a deep impact on the real economy of many European countries. It probably contributed to slowing down the very tepid recovery in the U.S.

Many European banks saw their non-performing loan ratio grow steadily. This balance sheet deterioration put banks under strain, impaired loan origination, and therefore reduced the shock-absorbing capacity of banks. In some cases, banks even put off necessary balance sheet adjustments and instead tried to postpone loss recognition.

This behavior can exacerbate problems in the real economy. New activity is not allowed to replace non-viable businesses because of the inability of companies with a stronger business model to access funding in order to invest and expand. Non-viable businesses are artificially kept afloat by credit institutions that are unwilling to recognize losses.

Figure 11: The U.S. Banking System is Proportionally Smaller Than That of Other Advanced Economies



Source: BankScope, IMF, Federal Reserve Flow of Funds. See U.S. Department of the Treasury, "The Financial Crisis Response in Charts," April 2012.

In such an environment, capital markets can play an important stabilizing role, particularly when the downturn is steep and linked to a severe financial crisis. They could have helped open new funding channels for non-financial corporations, large and small. As long as European capital markets primarily provide a funding platform for big, globally interconnected corporations, non-financial corporations will continue to rely on traditional forms of lending.

03

THE ROLE OF CAPITAL MARKETS

When looking across the Atlantic, the most striking feature is that notable differences in the size and role of capital markets remain between the U.S. and Europe. In the U.S., the shift from bank-based to market-based lending had already taken place well before the crisis erupted, while in the European Union, albeit with some differences among member countries, capital markets play a subordinate role to traditional forms of lending.[14]

More developed capital markets played an important role in spreading the financial crisis in 2007-2008, which was triggered by asset-backed securities that were fundamentally mispriced and suddenly became illiquid. However, strong capital markets also helped the financial system and economy in the U.S. to recover much more quickly than Europe once credit market liquidity was restored.

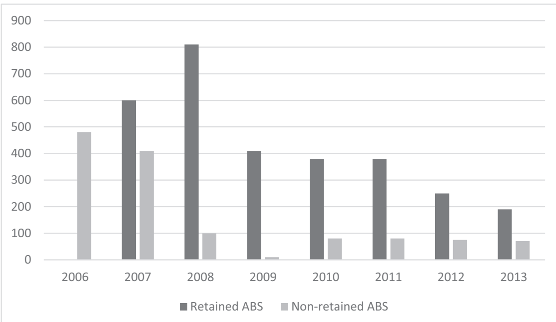
In the U.S., capital markets play a prominent role not only for the funding needs of bigger corporations, but also for consumers. For example, once home and car loans are originated, most get bundled into asset-backed securities that are sold on debt markets. Capital markets therefore have a deep impact on lending activities to households and non-financial corporations of all sizes. Capital markets allow for the transformation of relatively illiquid assets into more liquid securities. These are then sold to investors who can more easily diversify their portfolios in terms of risks and return. Of course, some excesses in "slicing and dicing" those securities need to be contained, as they were a cause of the recent financial crisis. Regulators tried to address those needs by forcing loan originators to retain some "skin in the game," in other words by requiring loan originators to keep a percentage of these loans on their books. In addition, they tried to increase transparency in the securitization structure, in order to distinguish between overly structured products and simpler, more transparent securities. It would in fact make little sense to impose stricter rules on one part of the financial sector while allowing unregulated shadow-banks to grow dramatically, as a shift in risks from one area to another would not make the financial sector safer.

Indeed, and particularly in a prolonged low interest rate environment, very liquid capital markets can help to inflate asset bubbles, as Fed Chairwoman Janet Yellen recognized recently: "An extended period of low interest rates has the potential to induce investors to 'reach for yield' by taking on increased leverage, duration risk, or credit risk. Some reach-for-yield behavior may be evident, for example, in the lower-rated corporate debt markets, where issuance of syndicated leveraged loans and high-yield bonds has continued to expand briskly, spreads have continued to narrow, and underwriting standards have loosened further."[15]

Such developments need to be closely monitored by regulators. What matters in the context of this report, however, is the fact that while big global companies on both sides of the Atlantic have successfully tapped capital markets in past years, the funding for SMEs, particularly in parts of Europe where it continues to depend on traditional forms of lending, remains very unsatisfactory. Investors have concentrated on a more limited pool of assets, a development that creates financial stability risks of its own.

In contrast, in one of the asset classes mentioned above, ABS, which is particularly important for the financing of SMEs, the outstanding amount is about €1500 billion, or one quarter the size of the ABS market in the U.S. Even in those European markets

Figure 12: European ABS Issuance (EUR billion)



Source: Association for Financial Markets in Europe (AFME). End observation: 2013 Q4. See ECB and BoE, "The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal with Them."

where tight credit conditions have not materialized, such as Germany, markets for securities issued by the so-called *Mittelstand* continue to play the role of an ugly duckling, as all too often SMEs that tap or are trying to tap capital markets are perceived by the public as incapable of accessing traditional bank loans and are therefore probably "unworthy" of credit.

The ECB is actively trying to offer a different narrative. It is encouraging a more robust securitization of assets by stressing that "in the current fragile macroeconomic environment, for example, high-quality ABS can support the transmission of accommodative monetary policy in conditions where the bank lending channel may otherwise be impaired. In particular, securitization may allow banks to lend without committing too much capital and other sources of funding, and thereby provide indirect market access to groups of borrowers that are otherwise not able to tap markets directly, such as SMEs."[16]

Of course, it is important to recognize that not all ABS are created equal and some should not get any preferential treatment. The ECB and Bank of England (BoE) encourage regulators to distinguish between "good" and "bad" ABS, i.e., those that are structured simply and prudently versus those that are much more complex and opaque.

One important aspect that needs to be stressed in this context is the fact that capital markets and banks are not two parallel universes, but rather closely intertwined. A stronger role for capital markets can help banks to better manage their balance sheet and strengthen their profitability. Only certain types of banks—universal banks, in particular—also provide the necessary services needed in order to make the link between debt markets and clients work efficiently.

Despite ongoing widespread criticism against big universal banks, in part driven by worries about their size and the perceived systemic danger that those banks could continue to pose, and despite various attempts to end the too big to fail syndrome, universal banks can still offer some notable advantages, particularly the broad range of services that are relevant for those small and big companies who operate in a global economy. In addition, universal banks tend to offer lower costs for consumers thanks to the cost synergies associated with economies of scale.

Finally, if well capitalized and funded, and if operating in the new regulatory regime that allows for an orderly resolution, universal banks can be more stable than some of their peers that are more narrowly specialized or merely rooted in a regional economic reality. Those credit institutions are far more dependent on the ups and downs of a particular sector or their local clientele and economy.

In this context it is helpful to remember that, in the U.S., it was the failure of investment banks that forced regulators to encourage bigger banks to merge with those institutions. In Germany, one notable case of a small but systemic financial institution was the credit institution Hypo Real Estate. It had a narrow business model and did not fund itself through deposits. The risk of a classic bank run was therefore non-existent. And yet, Hypo Real Estate was deeply intertwined with a variety of financial institutions and investors. It was this fact, not its size, that forced fiscal authorities to intervene in support of a spectacularly failing institution.

In Spain, it was the implosion of smaller, regional "cajas" and their narrow focus on the housing market that caused the Spanish banking crisis. Bigger banks that were exposed to a booming Latin American economy were spared. Their business model allowed for a wider and more prudent dispersion of risk.

04

CONCLUSIONS

A strong link between banks and capital markets will be very important in the future. Much work has already been done in order to make the banking system safer, and the new regulatory environment is forcing banks to become more transparent. The rather obsessive approach by regulators toward bigger credit institutions in the aftermath of the crisis should and probably will subside, only to be replaced by a stronger focus on the risks on financial stability posed by the shadow-banking sector.

Despite the public narrative, the too big, or too interconnected to fail problem will probably remain a challenge for regulators even in the future, as too radical changes to the many banking business models could have serious adverse unintended consequences on the real economy. This is an ongoing cost benefit analysis that should be made by regulators carefully and not under the pressure of vocal advocates from one or the other side trying to impose their partial interests.

More specifically, in Europe some credit institutions, such as universal banks, which already have the proper tools to support a stronger role for capital markets on the old continent, will need to be preserved, not as national but rather as European champions that connect European businesses to the global economy by helping their clients in various forms to take their products worldwide. Even smaller companies that increasingly rely on the opportunities offered by the global economy for growth will need banks that can provide them with more than just locally-based, traditional forms of credit.

It will once again be up to banks to provide the funding for the real economy, with one important caveat: rather than relying primarily on traditional forms of lending, it should be the interaction between banks and capital markets that provides the bulk of the necessary funding opportunities for the real economy in the future.

Whether the European recovery will follow a pattern similar to that of the U.S. or the two continents will instead diverge could well depend on the development of a more diversified financial system centered on more than one pillar, a system that after many corrective measures, finally allowed for a greater allocative efficiency of resources as well as a wider dispersion of risk.

NOTES

I'd like to thank all my colleagues at AICGS, particularly Jackson Janes and Jessica Riester Hart for the patience and support they showed when deadlines came and went without being met.

This Policy Report is merely what Germans would call a "Denkanstoß," a tool intended to spur a conversation and further reflection. It is the result of many conversations I had over the past five months with academics, regulators, and representatives of the financial industry in various parts of Europe and in Washington. In particular, thanks go to Celso Brunetti, a true academic and very close friend, and a real expert on all questions related to systemic risks in the financial sector, and to Nicolas Veron, who is responsible for putting the banking union on my radar screen, well before political leaders in Europe even started talking about the topic. With Andrea Montanino and Federico Arcelli I talked about the Italian aspects of the current challenges, an attempt to broaden the horizon beyond some of the more specific German-American aspects of this work. Jan Schildbach provided some of the necessary insider's knowledge about the banking industry. If I made mistakes, the responsibility is only mine. I should have listened more.

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