



# Banking On A Capital Markets Union

## The Role Of Banks Today & In A CMU

Hamilton Place Strategies | [www.hamiltonplacestrategies.com](http://www.hamiltonplacestrategies.com) | 202-822-1205 | May 2016

### Findings:

- **A Capital Markets Union is a long-term project leaving EU businesses mostly bank-dependent in the near-term.**
- **Even after establishing a CMU, regulators should recognize the unique role banks, especially large banks, play in facilitating credit in good times and bad.**
- **Regulation that stifles market making by banks in the name of safety may ensure banks survive a crisis, but risks hampering their ability to help businesses when needed most.**

Last month, European Central Bank (ECB) data showed European banks expanded lending to businesses by 1.1 percent in the past year, the fastest rate of expansion in four years.<sup>1</sup> More good news, the ECB bank lending survey revealed improving credit conditions for business lending.<sup>2</sup>

However, performance across countries varied with strong loan growth in Germany and France and continued declines in lending in southern countries. Further, European bank stocks still remain far off last year's high, weighing on a sector facing economic headwinds, regulatory demands, and legacy issues still on balance sheets.<sup>3</sup>

It's in this context that the European Union (EU) is seeking to develop the Capital Markets Union (CMU). While the focus is often on the critically important task of

unlocking nonbank financial lending capacity, banks have a critical role to play within a CMU to ensure credit flows to businesses in good times and bad. Regulations should recognize banks' role and ensure rules do not inhibit the sectors' ability to support EU business expansion.

### Defining The Need For CMU And Its Potential

With around 80 percent of corporate debt in Europe attributed to traditional bank lending, policymakers are concerned that there is too much reliance on banks to fund growth. Moreover, fragmentation within the EU leaves certain countries and specific sectors particularly vulnerable to funding challenges.<sup>4</sup>

The European Central Bank also believes this overreliance on bank lending limits the impact of its accommodative monetary policy on the real economy.<sup>5</sup>

**For regulators, it's essential to recognize the unique role banks play to ensure rules don't inhibit the sector's ability to support deep, liquid capital markets.**

The proposed CMU, is intended to encourage more nonbank finance to fill these gaps by creating a single capital market across the 28 members of the EU. As ECB Vice President Vítor Constâncio argued in a speech in March, the CMU could aid the transmission of the central bank's monetary policy, create capital markets that complement bank lending, and improve "private risk-sharing across countries" by virtue of the integrated capital markets.<sup>6</sup>

### Banking Today – Before A CMU

It's well understood that the EU is years away from a CMU, so the banking sector will remain the main credit option for many businesses in the near-term. The core challenge for the European banking sector today is that in a difficult macroeconomic environment, new regulation that both re-

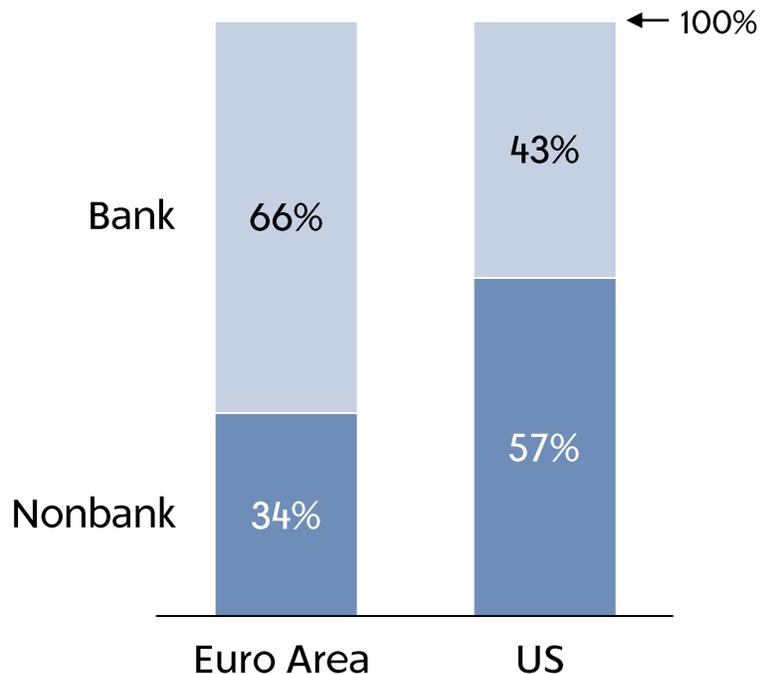
quires recapitalization and hurts profitability makes restructuring NPLs and

acquisition of troubled banks by healthy banks far more difficult (Fig. 2). Moreover, fiscal constraints and EU rules mean no help will come from governments.

Therefore, while the European Central Bank continues to expand its balance sheet,

**Fig. 1 Two-Thirds Of All Credit – Both Household And Business – Is Bank Financed In EU**

Total Credit To Private Non-Financial Sector By Source



Source: BIS, HPS Calculations

it has been offset by shrinking European bank balance sheets. The situation has sparked a number of debates on whether to loosen state aid rules, enhance the

**While the sector faces challenges, the problem should not be overstated. Bank Tier 1 capital has increased from 8.1 percent to 13.6 percent since 2008.**

borrowing capacity of the European Stability Mechanism, and more.<sup>7</sup>

While the sector faces challenges, the problem should not be overstated. Bank Tier 1 capital ratios have increased from 8.1 percent to 13.6 percent from 2008 to the first

half of 2014 in EU banks.<sup>8</sup> A Bruegel analysis from last summer examined the strength of these balance sheets in a stressed environment and found the largest banks were well-positioned to manage a crisis.<sup>9</sup> Lastly, World Bank data shows the average bank capital to assets ratio increased 32 percent in the last five years (Fig. 3). A stronger sector means banks will be in a better position to support EU economies in a downturn, but the timing and extent of regulatory demands in this macroeconomic environment have led to geographic and sector-specific economic headwinds today.

## Supporting A CMU – Banking Going Forward

Less discussed than the above is the central role banks will continue to play even after a robust CMU is in place. Recent experience in the US – where banks provide only 43 percent of all credit – shows that post-crisis regulations must continue to take into account the essential role banks play in two main regards: credit to fuel growth and support during times of economic distress.

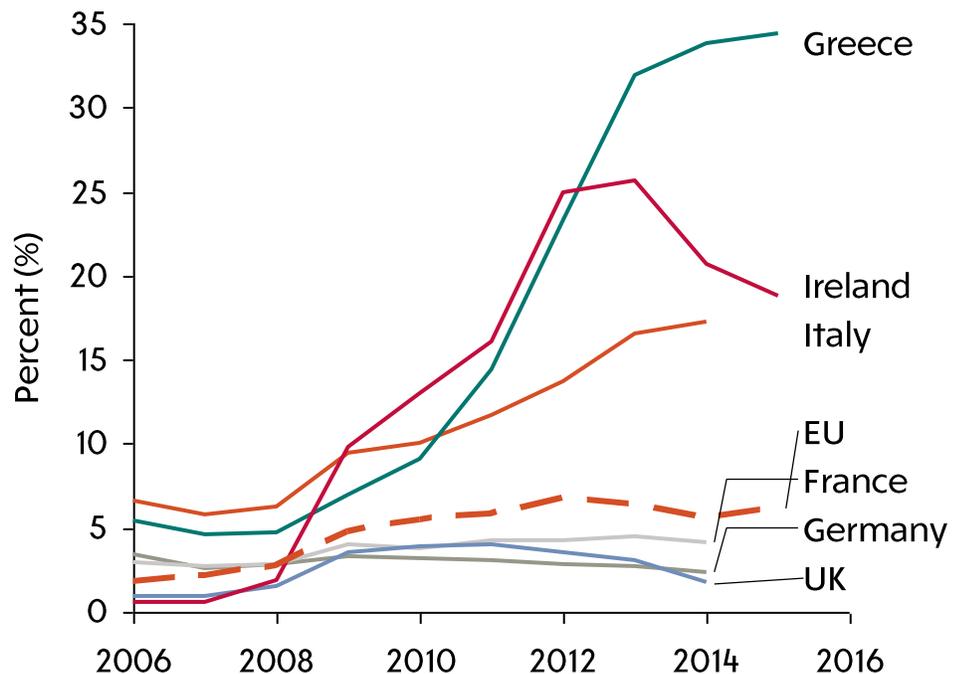
For multinational companies, large banks remain essential partners with 98 percent of multinational firms relying on them for domestic operations. Seventy-seven percent of companies found large banks to be essential or useful for large loans, while 88 percent reported the same for cash management.<sup>10</sup> Moreover, large banks top the Small Business Administration's (SBA) list for its 7(a) loans.

Similarly, in the leveraged loan market, banks have stepped away due to regulators exercising

macroprudential tools to de-risk this market. Research by the New York Federal Reserve shows that nonbanks stepped in, but loan volumes stagnated.<sup>11</sup> Moreover, to the

**Fig. 2 Nonperforming Loans Are Low On Average Across The EU, But There Are Significant Outliers**

Nonperforming Loans As Percent Of Total Loans, By Country



Source: World Bank

extent nonbanks were able to step in, they found it was the result of increased bank funding.

This situation is exacerbated during crises when banks are more likely to sustain funding for businesses, while alternative lenders have more

quickly fled to safety.<sup>12</sup> There have been exciting devel-

opments to address this challenge, such as electronic trading platforms and new business models among nonbank financials, but it's unclear whether they will

be able to replicate the role banks play in crises.

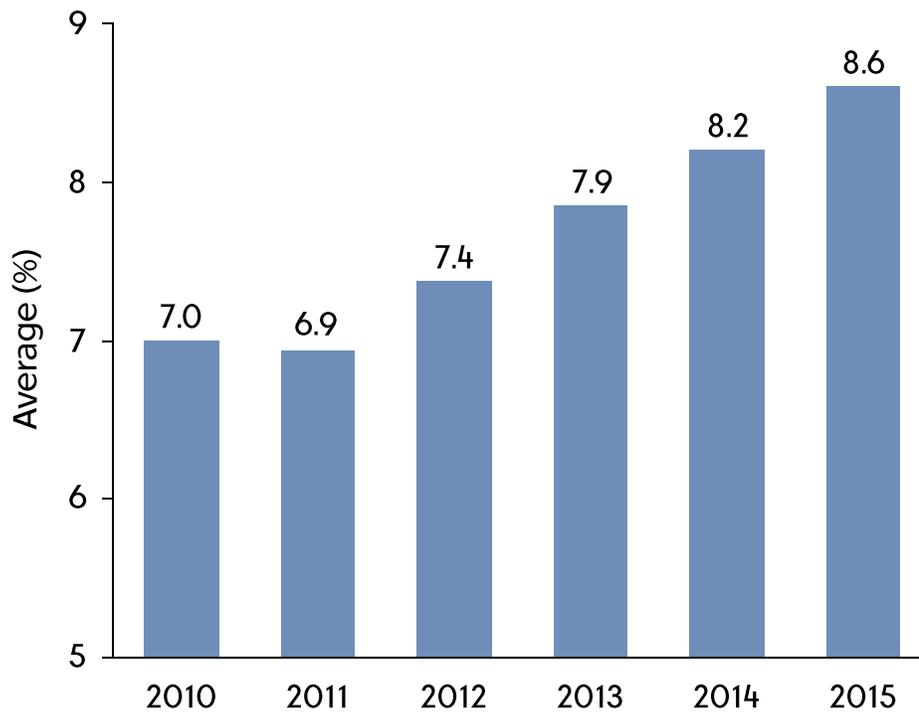
### Regulating Banks In A CMU – Capital And Structural Reform Considerations

Looking ahead, new rules in both the US and EU risk that while banks will survive the next crisis, they may be of little help to the market in the moment. In particular, these include the simple leverage ratio (SLR) and structural banking reforms that seek to separate commercial from investment banking activities.

On the former, last fall Goldman Sach's Steve Strongin pointed out that to the extent nonbank lenders want

### Fig. 3 Bank Capital-To-Assets Ratio In EU Countries Has Increased Since 2011

Average Capital-To-Assets Ratio In EU Countries



Source: World Bank

to provide liquidity during a downturn, they will often go through a bank intermediary.<sup>13</sup> However, the same rules that constrain banks' ability to quickly expand their balance sheet – such as the SLR – impact their clients. Therefore, the cost of renting a bank's balance sheet to conduct a transaction will be more expensive, reducing market liquidity. The SLR is an important back-stop to risk-adjusted capital standards, but to the extent that it's a binding constraint on market making activities it can be counter-productive in a crisis.

On structural banking reform, these efforts fail to capture the scale and diver-

sification benefits from the universal bank model that increase both efficiency and resilience. The European Banking Federation found that universal banks saw the least amount of losses as a percentage of total assets during the crisis.<sup>14</sup> Breaking up banks along activity lines or through size caps goes against market forces dictating a need for globally active banks for both large multinational companies and emerging middle market companies looking to expand across borders.

As policymakers move forward, recognizing the unique role banks – especially large banks – will play in the CMU must be at the forefront of

regulatory actions to ensure it fully serves EU business expansion.

### About Us

Hamilton Place Strategies is a consulting firm founded on the philosophy that a better understanding of business and economics leads to more effective communications and ultimately better outcomes for the global economy and its participants.

### Endnotes

- 1 Tom Fairless And Todd Buell, "Eurozone Bank Lending Expanded In March, Says ECB," [WSJ](#), 4/27/16.
- 2 "The Euro Area Bank Lending Survey," [ECB](#), 4/16.
- 3 [STOXX European 600 Banks](#), As Of May 20.
- 4 Kira Brecht, "How U.S. And EU Capital Markets Are Different," [Open Markets](#), 10/29/15.
- 5 European Central Bank, "Monetary Developments In The Euro Area: March 2016," [ECB](#), 4/27/16.
- 6 Vítor Constâncio, [Speech](#), 3/21/16.
- 7 Stefano Micosi, "Banking Crisis Yet Again And How To Fix It," [CEPS](#), 2/16; Nicola Borri And Pietro Reichlin, "Completing The Eurozone Banking Union: What Must Be Done," [VoxEu](#), 5/4/16.
- 8 "2015 Banking Sector Facts And Figures," [European Banking Federation](#), 12/15.
- 9 Ashoka Mody And Guntram B. Wolff, "The Vulnerability Of Europe's Small And Mid-Sized Banks," [Bruegel](#), 7/15/15.
- 10 "The Big Bank Theory," [Bipartisan Policy Center](#), 2014.
- 11 Sooji Kim, Matthew Plosser, and João Santos, "Did the Supervisory Guidance on Leveraged Lending Work?," [NY Federal Reserve](#), 5/16.
- 12 Jaewon Choi And Or Shachar, "Did Liquidity Providers Become Liquidity Seekers," [NY Federal Reserve](#), 10/13.
- 13 Allison Nathan, "Interview With Steve Strongin," [Goldman Sachs Top Of Mind](#), 8/15.
- 14 "What Is Universal Banking?," [European Banking Federation](#).