Expected evolution of bank and market intermediated financing and of the competitiveness of the EU financial system following on-going reforms

This document was drafted by Eurofi with input from its members. It does not engage in any case the Greek EU Presidency nor the Greek Financial Authorities.

I. The targeted form of market based financial mechanisms, and the speed at which an economy can shift toward them strongly impact the evolution of the banking sector

1. Financial industry representatives as well as EU policy makers frequently allude to the differences between US and European financial mechanisms. In particular they usually stress that in Europe[1] banks provide more than 70% of the financing of the economy while it represents an inverse proportion in the U.S. Many of them underline in that respect the role of market finance in the economy.

The need to compare the two ways for financing the economy is triggered by the fact that the share of market finance strongly influences the scale of the regulatory capital, liquid assets etc. required to finance the economy and eventually the cost of financial resources.

Given that banking regulators have considerably tightened capital and liquidity requirements in response to the financial crisis, the definition of the most appropriate arrangements to access to market finance is critical for policy makers and the industry to define the appropriate evolutions in the context of increased regulatory constraints. It is also necessary to induce the required evolutions of the role of the banking sector.

II. The share of market finance and the role of the public sector in the securitisation market are key differences between US and EU financial mechanisms

2. Actually the United-States economy has a long history of directly accessing to investors. Indeed in a context where Eurozone and US economies have comparable sizes (e.g. the Eurozone corresponds to 70% of the US economy as the Eurozone represents 13.5% of the world GDP and the US 19.5%[2]), the outstanding U.S. bond market debt amounts[3] to $40 trillion, twice the amount of the euro-denominated debt[2] and in the Eurozone non-financial-corporation debt-securities only represent[2] 1/8 of American non-financial-corporation debt-securities.

3. More precisely beside Treasuries - 33% of the market - the share of Corporations' debt is roughly 20% of the American debt market. Mortgage securities represent around 26,9%[4] of the American outstanding debt and Municipalities 10%. In this context the ABS segment, which includes the CDOs backed by corporate bank debt, only represents 4% of the bond market. In Europe all type Assets Back Securities (ABS) weigh $1.1 trillion only.

4. American housing financial arrangements, and in particular the Federal involvement, which more than ever supports mortgage securities issuance - have a huge influence on the respective role of market finance and banks in American financial mechanisms. These arrangements had primarily been created to alleviate banks and ease their economic contribution mainly on the basis of a deep secondary mortgage market, supported by dedicated federal entities and a guarantee scheme[5]. Consequently, currently commercial banks and saving institutions only hold $4,351 billion (31%) of the current outstanding US mortgage-loans, which reach $13,119 billion. Federal and related Agencies hold $4,956 billion (38%) and mortgage pools or trusts, 90% of which are currently guaranteed by Federal related agencies - e.g. Government Sponsored Enterprises (GSEs) - hold $2,931billion (22%).

III. The impacts of the shape of financial mechanisms are manifold: cost of regulation, liquidity of assets, efficiency of monetary policy, risk profile of banks, etc.

5. Federal-housing financial-mechanisms dramatically reduce the involvement of the balance sheets of banks in the financing of the American economy. All in all[6] US banks hold 40% of household debt while EU ones hold 86%, and in addition US banks hold 35% of nonfinancial corporate debt while European banks shoulder 87%. These arrangements lead to very different regulatory costs and burdens from those triggered in European financing mechanisms. In this context assuming that risks are similar in both geographies - the new international banking regulation - higher loss absorbency capacities from capital buffers, heavier capital charges posted, reduced maturity transformation and leverage - are expected to cost the EU banking system twice what it should in the US.

6. Some observers however wonder whether non-bank financing mechanisms are safer and raise the question of their real cost in terms of capital and liquidity. They underline in that respect that non-bank financing mechanisms can pose systemic problems.

7. Regulatory costs to the American economy are also alleviated. Indeed Fannie Mae and Freddie Mac are exempt from bank regulations and may in particular maintain capital/asset ratios less than 3%. In addition, in the wake of the subprime crisis, these entities have been supporting the whole American mortgage market since 2008, holding reduced levels of regulatory capital if any: in 2008 the total equity deficit of Freddie Mac was $30,634

[1] Michel Barnier, 4èmes entretiens du Trésor, Paris, le 13 décembre 2013.

[2] 2012 - ECB data.

[3] The outstanding U.S. bond market debt amounts $39 343 billion while outstanding amounts of euro-denominated debt are about €19 950 billions i.e. #1/2 the American bond market. In the Eurozone non-financial corporations represent only 6% of the half sized euro-denominated debt-security market, while American corporations have a share of 24% in the American bond market - 3rd Quarter 2013 data.

[4] MBS amount to $10. 6 trillion among which Federal agencies represent $2.4 trillion (6% of the American debt-market).

[5] In 1938 - far before the development of securitisation - the Congress chartered Fannie Mae, not to lend money directly to consumers (the primary mortgage market) but to "support liquidity, stability, and affordability in a secondary mortgage market, where existing mortgage-related assets are purchased and sold"5. In 1970 the Congress chartered Freddie Mac to complement existing Federal arrangements. Shortly before Ginnie Mae was created to "allow mortgage lenders to obtain a better price for their mortgage loans in the secondary mortgage market, whenever they benefit from the Federal Housing Agency (FHA) guaranty" (i.e. loans to low- and moderate-income American households, currently more than 50% of American mortgages) but also "to help bringing funds from worldwide investors into the U.S. housing market", so as "the lenders can then use the proceeds to make new mortgage loans available". Eventually Ginnie Mae issued in 1970 the first mortgage-backed security (MBS) in the United States.

[6] Credit Intermediation in the United States - BNPParibas research – Céline Choulet May 2012

million and the one of Fannie Mae $105,150 million. In the same vein, 2012 leverage ratios of Freddie Mac and Fannie Mae are respectively 0,4% and 0,2%[7]. Yet currently most of securitisation programmes and consequently securitisation markets, are supported by the GSEs guarantee. Similarly the Federal Housing Agency, which currently guarantees up to 33%[8] of American purchase mortgage originations (4% in 2006), is required to hold 2% capital ahead of its liabilities. The same risks in the balance sheet of a community bank require 8%.

8. Eventually American banks have a very different risk profile from the one of EU banks. On the one hand bank deposits in the US are far less exposed to the housing risks, which are transferred to Federal entities or to a less extent to investors. On the other hand U.S. banks offload large amounts of the lower-risk assets they originate (mortgages attract in the EU RWA of say 15%) while they maintain in their balance sheets assets most of the riskiest assets they originate. Consequently their risk profiles are actually difficult to compare with those of their European alter ego.

9. In addition, partly as a consequence of the systematic offloading of banks' balance sheets in the US, loans to deposit ratios of American banks are about 85% while European ones nearly reach 130%. Consequently American banks have reduced needs to access the wholesale liquidity and face reduced efforts to comply with the new liquidity regulations.

10. Lastly in the U.S. the fact that a large part of mortgage loans, which are securitised benefit from Federal guaranties, significantly enlarges the much-needed pool of high quality collateral. This helps to answer the increasing need of such assets to perform market transactions, imposed by the various new market and banking legislations (tightening of margining policies and collateral haircuts, de-netting of repo agreements within banks' balance sheets for assessing the leverage ratio, regulatory limitation of the asset encumbrance, high quality liquid assets to comply with the liquidity ratio, etc.). Furthermore, the large size of those securities benefiting from Federal guaranties increases the impact of the monetary policy of the FED, in particular on mortgages. It is worth noting in that respect that the FED was holding in November 2013 about 13% of the outstanding U.S. mortgage debt. These assets represented 36% of Federal Reserve Balance Sheet at that moment.

11. Due to the differences in the shape of their financial sector, the combined consequences of the tightening of banking regulations are leaving differentiated marks in both sides of the Atlantic.

IV. The architecture of the financial sector influences its profitability

12. In addition it is worth noting that European banks apparently operate in a more competitive context. Indeed, before the financial crisis their net income amounted in average[9] to approximately 0.58% of total assets. After the crisis it is 0.22%. In the United States these ratios are respectively 1.07% and 0.69%. On average the operating expenses in the EU – about 1.35% of the assets - are lower than those of U.S. banks (2.81% and 3.15 before and after the financial crisis). Lastly European banks apparently did not widened lending spreads in similar proportions to American ones (respectively +22bp and + 34 bp).

In such a context the capability of the EU banking sector to increase its capital, when growth will require it, by accumulating retained earnings is reduced. Also reduced is its capability to attract investors: in the EU after the financial crisis the Return on Equity (ROE) is about 3.9% in average while it is above 7% in the U.S.

13. Though it is not easy to sort out what are their specific contributions, there is no doubt that the peculiarities of the architecture of financial sectors play a key role[10] in that respect. In particular they are necessarily instrumental to allow the U.S. 96% of the banks, which are classified as small business and the median size of which employs 39 people – to continue financing the economy. In the U.S. 38% of the banks have been in business for more than 100 years. These observations suggest reflecting on the possible role of certain constituents of the American system. Beside the secondary market for mortgages, the role in this market of the GSEs, the servicers, and securitisation, the role of the 12 Federal Home Loan Banks (FHLBs) - cooperatives created the Great Depression - is certainly critical to provide low-cost funding (so-called advances) to these small banks (the members of the FHLBs are the community or saving banks, loan associations (thrifts), credit unions etc. (7600)), and preserve their access to finance during financial downturns. Indeed these arrangements may be considered as a form of industrial integration of specific parts of the financial value-chain, namely the holding of certain assets in particular mortgages and the refinancing of such assets. One may raise the question of the influence on the competition landscape in the U.S. that such industrial integrations have.

V. The challenges ahead for the E.U.: anticipating the evolutions of the financial sector and mobilising the public sector to launch an effective EU securitisation market

14. Despite the differences between American and EU financial mechanisms, in the wake of the financial crisis the representatives of national regulators from both areas agreed on a single and common set of regulations for banks.

15. Such regulatory impacts are naturally expected to trigger a significant reduction of the role of the banking sector in Europe. However the reduction of the role of banks is proving challenging in the EU as evidenced by the intense debates linked to the financing of SMEs and infrastructures in Europe. Indeed these debates are making it clear that banks will remain instrumental at least for

[7] Freddie Mac total assets amounted to $1,989,856 millions and those of Fannie Mae amounted to $3,222,400 millions in 2012. Freddie Mac has $8,827 millions of total equity while Fannie Mae has $7,224millions.

[8] http://economistsoutlook.blogs.realtor.org/2013/02/22/just-how-big-is-the-fha-2/

[9] How have banks adjusted to higher capital requirements - Benjamin H. Cohen - BIS quarterly Sept 2013

[10] The business of banking: what every policymaker needs to know – American Banker Association, 2012

originating the financings and liaising with customers, and more importantly to deal with the fact that accessing financial markets is probably out of reach for the smaller infrastructure projects and businesses. Beside this, EU investors and financial markets are far from being ready to replace banks.

16. Indeed the E.U. is still characterised by the fragmentation of financial markets (bankruptcy law, securities law, in particular), the central role of bank financing and apparently strong competition within the banking sector. One issue is therefore to anticipate the likely evolutions that the new banking regulations are expected to provoke in the banking landscape: an accelerated reduction of the number of banks? Cross border mergers? An evolution of the pricing of financial products? Etc. It is also important to understand the likely timetable of such an evolution as the challenge for the E.U. is to be able in due time, to accompany the financial needs of recovering economies. Lastly one should also identify the success factors still missing in the E.U. to use further any market finance provided e.g. loan pricing by banks, introduction of single regimes for issuing debt, securities, critical size of financial markets, etc.

17. As soon as they have re launched their housing activity, the Americans will start reforming the role of the so-called GSEs. They are already thinking about the reduction of the implicit Federal guarantee benefiting GSEs and tax payers involvement and trying to define a specific back stop to face up to a possible dry up of mortgages primary or secondary markets. However the involvement of the public sector in the mortgage market raises many concerns. In the U.S. many argue for the elimination of GSEs, though no consensus has already emerged and the role of GSEs in the long run is still an open issue. However, one can bet that the U.S. will not give its "distribute to originate" up, nor the role the public sector plays to foster or support its efficiency in particular during economic downturns.

18. Learning from the American experience, securitisation – and mortgage securitisation due to the size of this asset class - should play a key role in developing market finance in the EU, it should free up scarce bank capital and liquidity, which are needed to finance other types of economic players, and reduce the regulatory cost of financing the economy in the EU. An appropriate definition of the public sector involvement is key to achieve a rapid transformation of EU financial mechanisms, bring together critical mass (common EU legal frameworks are required) and attract EU and global investors. It is key also to avoid moral hazard and create new forms of possible finance-sovereign negative feedback loops.
More generally the role of the single market and the setting up of optimal conditions for competition are also key elements, which should trigger policy action.