

Financial Disintermediation and the Future of the Banking Sector

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Conference Report



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Banks have traditionally played a more significant role in Europe for the provision of funding to firms than capital markets. However, in the recent period the role of European capital markets has increased due to both transitory and permanent factors. Understanding these factors is key to assess the implications of this process. Another relevant development in the European and worldwide financial markets is the impact of new technologies which is introducing more competition in the provision of financial services due to the emergence of new players such as FinTech companies. All these changes in the structure of financial markets may have implications for both the functioning of financial markets and the economy. In particular, the development of capital markets in Europe would contribute to a higher level of diversification of firm liabilities that could help them to face shocks affecting the bank lending channel. Additionally, it would enable households and firms to hedge against country-specific sources of risk to smooth income, consumption or investment growth. The introduction of new technologies in the financial markets may entail some social benefits in terms of efficiency gains and market inclusion. Both developments may also

have implications for the future of the banking sector. The development of capital markets and the emergence of new players pose some challenges for banks, but there are also possible synergies between banks and the other financial intermediaries that they can exploit. In any case, banks will need to adapt to these changes

This conference, which was jointly organized by SUERF and Banco de España (BE) and hosted by the BE, aimed to discuss these issues related to the financial disintermediation and the future of the banking sector among academics, policy members and financial practitioners. The conference consisted of three sessions and two keynote speeches and its content is summarized below these lines.

In his opening remarks, Banco de España Governor **Pablo Hernández de Cos** pointed out that capital markets in Europe are less developed than in the United States (US). In particular, in 2017, the ratio of financing through fixed-income securities to total debt financing was 12% in the euro area versus 43% in the United States.

He acknowledged that there is not a consensus in the literature on what source of financing has a higher contribution to financial stability and economic growth. Nonetheless, beyond the traditional perspective considering bank- and market-oriented structures as alternative and competing, he noted that recent literature suggests that they should be considered as complementary since any of the financial structures in isolation are probably suboptimal.

Governor Hernández de Cos highlighted that European financial markets are also less integrated than their US counterparts. To overcome these problems, a Capital Market Union (CMU) Action Plan was launched in 2015 by the European Commission. On his view, the CMU project is an important step forward to reach the goal of correcting some structural deficiencies of the EU capital markets in terms of their relative underdevelopment and fragmentation.

Additionally, he stressed that in recent years, the role of European capital markets as a source of funding for firms has increased. It is relevant to understand whether this increase is the result of transitory forces (e.g., unconventional monetary policies) or permanent forces (e.g., regulatory changes or new markets).

Finally, Governor Hernández de Cos emphasized that the arrival of new technologies has reduced the barriers to entry in certain traditional banking activities, creating the possibility for new competitors to banks, such as the FinTech companies. However, new technologies also offer opportunities for banks in terms of potential efficiency gains.

Philip Lane, Governor of the Central Bank of Ireland, offered the first keynote speech of the conference on “trends and cycles in financial intermediation”. Governor Lane highlighted that both, cyclical and structural forces, are contributing to the decline in the importance of banks in financial intermediation. This trend has many positive features since a more diversified financial system, in which banks play a relatively smaller role, could favour the efficiency and the risk sharing.

He mentioned a number of cyclical forces such as: i) the limited lending capacity of banking systems; ii) the accommodative monetary strategies of the major central

banks facilitating large-scale bond issuance; iii) large-scale increase in official funding, and iv) the bank’s need to establish bail-inable buffers. Among the structural forces Governor Lane stressed the following: i) the combination of ageing population, rising income level and increasing reliance of private provisions for retirements; increasing the appetite towards higher-yield financial assets; and ii) the impact of technological innovation to enable new types of financial intermediation.

Governor Lane speech also focused on the cross-border financial flows in the context of financial disintermediation. He emphasized that traditionally, banks have intermediated a large proportion of cross-border debt flows. As a consequence, a great effort has been devoted to sharing information of the exposures embedded in global-significant banks. However, financial disintermediation process has shifted the composition of the external balance sheets. Since regulators and statistical agencies know less about non-bank intermediaries, analysis of the financial stability and risk distributions properties are more complicated.

Finally, Governor Lane put particular attention on the recent developments of the investment fund sector. He emphasized that the expansion of the investment fund sector since the financial crisis is striking. The fundamental risk facing investment funds is the investors run risk. This risk is comparable to the classic run risk faced by the bank system. For this reason, IOSCO and the FSB have rightly emphasized the importance of the quality of both liquidity risk management and contingency planning. High standards in these regards will lessen the potential impact of instability in the investment fund sector on the wider financial sector.

Session 1, chaired by **Thomas Vlassopoulos**, Head of the Monetary Analysis Division, DG Monetary Policy, ECB, dealt with **financial disintermediation and the role of monetary policy and financial regulation**.

Óscar Arce, Director General Economics, Statistics and Research, Banco de España, presented his recent research of the impact of the Corporate Sector Purchase Programme (CSPP) on the funding of non-financial corporations. The ECB introduced in mid-2016 the CSPP

as part of the ECB Asset Purchase Programme. Through this programme, the ECB purchases in both the primary and the secondary market fixed-income securities issued by non-financial corporations in Europe with an investment grade rating. Arce documented that this programme contributed to lower the cost of firms' financing through the issuance of fixed-income securities. This led to an increase in non-financial corporations' willingness to issue bonds and to a bond-loan substitution strategy by large firms with access to financial markets.

The positive side of this disintermediation effect is that this credit was re-intermediated towards other segments of firms that do not have access to bond markets, according to the results of Arce's research. Thus, the increase in the space in the balance-sheet of banks made them to reallocate credit to smaller firms. This re-intermediation effect took place in waterfall process. That is, banks first reallocated credit to larger firms that do not issue bonds, to medium-sized firms to a lower extent, and finally to small and micro firms. This reallocation of credit was very beneficial for firms without access to bond markets since it contributed to a significant increase in their investments. On the contrary, large firms that issued bonds just used these funds to repay loans with no effect on their investments.

Leonardo Gambacorta, Bank of International Settlements, began showing the shift of financing structure towards market-funding, especially in emerging markets. In spite of that, he showed that there is a high degree of heterogeneity across countries. For instance, he noted that capital markets in Europe are less developed than in the United States.

Then, Gambacorta presented his recent research based on a sample of both advanced and emerging markets economies for the period 2001-2011. He documented that both the size of bank-based intermediation (measured by bank credit over GDP) and of market-financing (measured by means of turnover ratio: trades of shares over their market capitalization) affect GDP growth. However, the financial structure affects output in a non-linear way and beyond a given threshold leads to a decrease in GDP growth. In view of the average bank credit and the turnover ratio in both developed and

advanced economies, one concludes that the size of both sources of financing is closed to the optimal in emerging economies but the size of credit over GDP is oversized in developed countries.

Gambacorta also stated that the financial structure has implications on income inequality. In particular, a development of both market- and bank-oriented markets tends to reduce income inequality but beyond a given threshold the size of bank credit and market capitalization over GDP leads to higher inequality.

Importantly, Gambacorta highlighted that countries' financial structure influence the economic resilience after the realization of shocks of different nature. He showed that although bank-oriented systems are less vulnerable to "normal" downturns (i.e., those not related with financial crisis), a financial crisis can impair the shock absorbing capacity of relationship banks given that when they are under strain, they are less able to help their clients through difficult times. In fact, this situation could lead to zombie lending since banks may opt to roll over credit in an effort to postpone loss recognition. On the contrary, this mechanism is not in place for capital market investors. In a financial crisis, more market-oriented systems may speed up the necessary deleveraging, thereby fostering a sustainable recovery.

Steven Ongena, Professor at University of Zurich, presented his research on the impact of the bank's capital requirements on bank lending. Based on a sample of Belgian banks between 2011 and 2014, Ongena documented how time-varying bank-specific Pillar 2 capital requirements affect banks' lending to the non-financial corporate sector. He finds that these requirements affect negatively both the intensive and extensive margins of credit supply, especially with longer maturities. The negative effect is smaller for large, safe, profitable and well capitalized banks and stronger for large, old, risky and more indebted firms. This negative effect on credit supply is extended to mortgages and foreign corporates.

Session 2, chaired by **Patricia Jackson**, Non-executive Director, Atom Bank and SUERF Council Member, dealt with **FinTech and the future of the banking sector**.

David T. Llewellyn, Professor at Loughborough University and SUERF Council Member, stressed that the regulation (particularly Open Banking in the UK and PSD2 in the rest of the EU) and the developments in technology have come together in a way that has the potential to transform the banking industry, since their combination undermines some of the traditional comparative advantages of banks. Llewellyn admitted that this is too apocalyptic a view because the emphasis has been given to the potential threats to incumbent banks. On the contrary, he highlighted that there are also opportunities for existing banks to be derived from the same pressures. In this context, conflicting forces are operating. While some aspects of technology enhance finance and increase its potential (and thereby create opportunities for all players in the market – the expansion effect), at the same time, they potentially threaten the entrenched position of incumbent banks (substitution effect).

Loriana Pelizzon, Professor at Goethe University Frankfurt, presented her recent research on how peer-to-peer (P2P) platforms compete with banks. She first sketched a theoretical model of competition between banks and P2P platforms. That model predicts a negative correlation between P2P lending and bank lending. In addition, this effect is more pronounced in periods in which banks are capital-constrained and borrowers are aware of alternative funding sources. Interestingly, Pelizzon showed that the loans that migrate from the banking sector to the P2P platforms are the riskiest and the least profitable customers from banks. However, in spite of getting the riskiest borrowers, P2P lenders charge lower risk-adjusted interest rates than banks. She also provided empirical support to all the previous theoretical predictions using region/bank-level data on new consumer lending by German regional banks and the German P2P platform Auxmoney.

Javier Sebastián, Principal Economist, Digital Regulation and Trends, BBVA Research, addressed on his talk future scenarios for financial services. According to Sebastián the effect of the new competitors has to be interpreted taking into account the time in which it occurs. More specifically, Sebastián sustained that it is taking place in a complex economic environment with weak economic growth, negative interest rates, and

increasing regulatory pressure for banking institutions in the form of higher capital requirements. Of course, this context could contribute to a higher extent to the appearance of Fintech and BigTech players. In view of Sebastián, three areas will shape the future of the financial sector: regulation, technology, and market. In the case of regulation, there should be a shift from seeing innovation as a threat, to a more friendly approach (without reducing the relevance of intense financial regulation). In the second case, technology is approaching a level of maturity high enough to increase the adoptiveness by participants. Finally, those market participants (i.e., banks but also third parties) should look more for a collaborative environment rather than a competitive one. The role that banks will play, is unclear yet, according to Sebastián, and it will depend on whether they create this new environment (leading role), enter into strategic partnership with third parties (partner role), or act as mere provider of financial services in a digital ecosystem dominated by other (Bigtech) institutions.

Luc Laeven, Director General of the Research Department, European Central Bank, offered the second keynote speech of the conference on “credit booms and crisis: the role of information”.

Laeven firstly stressed that credit regulation has to be carefully designed. In order to do so, a key element is distinguishing between good and bad credit booms. Based on his previous research Laeven showed that only about 1-in-3 credit booms (defined either on the basis of real credit growth or deviations from trend) ended up in a financial crisis or below-trend economic performance. On the other hand, financial crises result in high output losses and are associated with high fiscal costs including those that arise from financial sector containment and resolution policies that contribute to large increases in public debt. This implies that the cost of intervening too early and running the risk of stopping a good boom have to be carefully weighted against the desire to prevent financial crises.

Laeven next presented a new theory of credit booms based on information. According to his model there are two potential drivers of booms: i) collateral; and ii) productivity. In a collateral-driven boom there are lower

incentives to produce information for the credit scoring, contributing to funds' misallocation and exacerbating the following crisis. By contrast, productivity-driven booms do not deplete information on the potential debtors and don't end in a financial crisis. Thus, an optimal regulation requires understanding the source of booms, because productivity driven booms need to be preserved.

Finally Laeven presented the empirical findings of his research. He documented that firms' investment increases with real estate value, being this effect stronger for unscreened investment firms (firm-level information is proxied as those firms whose shares have high bid-ask spreads). In addition he showed that regions with larger real estate booms allocate more investment to unscreened firms and that during housing bust (2007-2012), the fall in investment was stronger in regions that allocated more investment to unscreened firms during the boom. All those empirical findings are in line with the theoretical predictions of his model.

The policy panel, chaired by **Michala Marcussen**, Group Chief Economist at Société Générale and SUERF Council Member, dealt with **Capital Markets Union (CMU)**.

Rodrigo Buena Ventura, Director General for Markets at CNMV, focused on the financing of small and medium enterprises (SME). He enumerated several reasons why SMEs do not have access to capital markets including the cost of being listed and the higher supervision to which they will be exposed, the crowding out of the government and large companies, their riskiness, the lack of liquidity in their equity and bonds, low research coverage or the existence of home bias. According to Buena Ventura, the CMU could help to promote SME financing in capital markets whenever it can contribute

to overcome the previously enumerated restrictions faced by SMEs. In any case, Buena Ventura concluded that regulations cannot create markets, just facilitate them.

Andrea Enria, Chairperson, European Banking Authority, stressed that private risk-sharing in the Euro Area is impaired, as can be inferred from the development of the quantity-based indicators of financial integration or the evolution of the mergers and acquisitions process. In addition, Enria highlighted that distrust is persistent 10 years after the financial crisis struck, despite the ongoing macroeconomic recovery, the substantial progress in banks' balance sheet repair and the Banking Union (BU) reform.

On his view, the resilience and the productivity of the banking system can be enhanced through the implementation of the CMU and the BU. In the context of the CMU, banks will be able to improve their funding, risk sharing and the transfer of legacy risk on a cross-border basis. Complementary, the BU will improve the direct cross-border lending through the establishment of branches and subsidiaries.

Nicolas Véron, Senior Fellow at Bruegel and Visting Fellow at Peterson Institute for International Economics, argued that CMU is just another name of single market for financial services but banks will remain central to the European financial system and the CMU. That is why according to him, completing the BU is the real centerpiece of the CMU. Véron explained that the three main steps to complete the BU are: (i) the break of the bank-sovereign nexus, (ii) a level playing field for banking business, (iii) cross-border integration. Véron explained that to achieve these steps, at least the following elements are required: (i) sovereign concentrations charges; (ii) a European Deposit Insurance Scheme (EDIS); and (iii) phase out the penalties of cross-border expansion.

Conference presentations are available at:

www.suerf.org/madrid2018