



ECFIN *Economic Brief*

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Financing the recovery: the state of Europe's financial sector

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Finance and growth

The relationship between finance and growth is complex and not necessarily stable over time. Although there is no doubt that financial markets are crucial for the functioning of the real economy, their exact contribution to growth is somewhat uncertain and varies over the cycle.

In principle, credit cycles are strongly correlated with economic cycles. On the one hand, access to external finance enables companies to pursue investment projects. Through the well-known financial accelerator process, credit expansion translates into economic growth. On the other hand, as an economy picks up, households and companies become more confident and increase their demand for credit. A growing economy can also raise collateral values and borrowers' income prospects, which improves perceptions of creditworthiness and makes it easier for them to get loans.

While history offers examples of credit-less recoveries, in which output grew without an increase in cred-

it, these may not provide helpful insights for the euro area because most examples come from countries with less-developed financial markets, where competitiveness gains came from exchange rate depreciation. Research shows that creditless recoveries tend to be weaker and driven more by consumption than investment. Economic recoveries accompanied by credit growth, by contrast, tend to be stronger and more broadly based. This brief analyses whether Europe's financial sector is currently fit to provide a supportive role for European growth.

Financial markets have stabilised markedly

The financial crisis hit the financial markets and real economy of Europe severely. Over the last two years, however, the situation has started to revert. And conditions on financial markets in the EU and globally have markedly improved. The rebound has been substantial, widespread and broad.

Summary

After suffering severe disruption during the banking and sovereign debt crisis, European financial markets have stabilised and started to function properly again over the last few years. Although risk sentiment has broadly recovered and disparities in financing conditions across the euro area have diminished, credit to support economic growth is not being created.

The fact that banks still need to adjust their balance sheets continues to hamper their ability to lend. At the same time, demand for credit remains low because the economic outlook is still fragile and private debt levels are already high. The weaknesses in bank lending mean that more should be done to foster alternative sources of finance.

Other challenges that remain ahead include persistently high levels of public and private debt; fragile economic prospects; external risks from emerging markets; and the uncertainties surrounding the results of the European Central Bank and European Banking Authority's comprehensive health check of the banking system.

Chart 1: Economic and credit cycles in the euro area

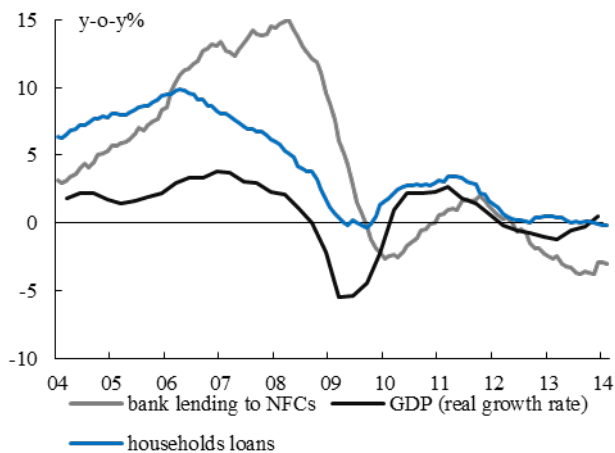


Chart 2: Variation in credit flows versus GDP growth in the euro area



European financial markets have been significantly helped by the clear communication and commitment of central banks in the euro area, the UK and the US. Policy rates are expected to stay low until the economic recovery is well entrenched. The European Central Bank’s (ECB) Governing Council has also strengthened its forward guidance and committed to the possibility of using unconventional instruments within its mandate to fend off the risk of a prolonged period of low inflation. Ongoing EU regulatory efforts and structural adjustments by Member States are strengthening and re-building trust in the stability and integrity of Europe’s financial markets. At the same time, more favourable corporate earnings results and improved economic

sentiment data have helped to raise expectations of better growth prospects for Europe.

The recovery of sovereign bond markets has been particularly noteworthy. Crisis-hit countries’ bond spreads have tightened remarkably over the last two years (see Graph 3), allowing even the most vulnerable Member States to return to market financing at affordable costs. The improvement in market conditions has also clearly been helped by the low-interest rate environment, which has made the bonds of periphery countries attractive for fixed-income investors searching for extra yield. However, the role of fiscal and structural adjustments by Member States should not be understated.

Companies and banks have also benefited from the improvement in risk appetite and fall in volatility. European stocks have picked up strongly thanks to the improving economic outlook and the ECB’s accommodative policy stance. Meanwhile, spreads on euro area corporate bond markets have narrowed, particularly in the higher-yield segment.

Money market conditions have stabilised and European banks continue to reduce their dependence on the ECB for funding. Signs of market fragmentation along national borders are also diminishing.

Lending still weak despite Banks strengthening their balance sheets

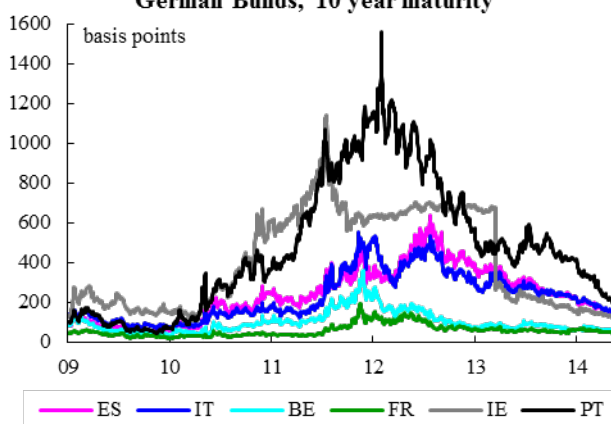
The situation in the banking sector has also improved. Amid a broad rise in market sentiment since the second half of 2013, confidence in Europe’s banks has continued to strengthen (see Graph 4). The systematic efforts of banks to reinforce their liquidity and solvency positions have started to bear fruit. Benign funding conditions have eased bond issuance terms (see Graph 5), allowing banks to reduce their reliance on short-term and central bank financing. This has enhanced banks’ resilience to potential liquidity shocks, though much of the recent market issuance has been secured funding. Banks have also been actively raising capital to shore up their balance sheets for the ECB’s Asset Quality Review (AQR) and the EU-wide stress test of the European Banking Authority (EBA).

Equally noteworthy is the improvement in European banks’ solvency ratios, which recently reached levels comparable to those of their strongest global peers. According to the EBA, the most significant EU banks increased their average

core Tier 1 ratios from 10 % to 11.7 % between December 2011 and June 2013.

Latest aggregate EU bank data signal a promising improvement in profitability across the banking system, largely thanks to lower funding and operating costs. Nevertheless, the ongoing contraction in balance sheets is putting pressure on interest income and the uncertain macroeconomic environment could have implications for asset quality, which would weigh on bank profitability in the near term.

Chart 3: Sovereign bond spreads versus German Bunds, 10 year maturity



Source: Bloomberg, own calculations

Chart 4: Itraxx default risk for financial corporations



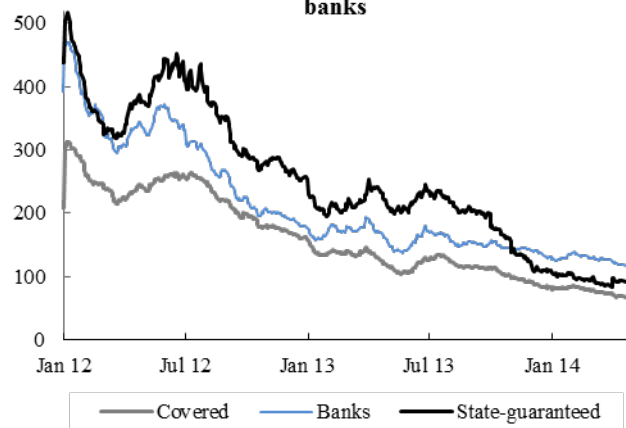
Source: Bloomberg

EU financial supervisors' comprehensive assessment of the banking sectors' health and resilience are unprecedented in their scope and offer a unique opportunity to underpin con-

fidence in Europe's banking sector and to establish a credible and robust foundation for the new Single Supervisory Mechanism (SSM). The assessments are scheduled to take place before November 2014 and under the coordination of the EBA and the ECB/SSM. The methodology and scenarios for the exercise were published by the EBA on 29 April 2014 and were well-received by markets and stakeholders.

Building on the lessons learnt from past EU-wide exercises and those of programme countries, important elements of prudence and conservatism have been included. First, the AQR, coordinated by the ECB for the countries joining the SSM, will ensure that previously unrevealed risks in bank balance sheets will be recognised appropriately. Second, the extension of the period under review from two to three years will increase its severity. Third, the use of harmonised definitions for important parameters like non-performing loans will help to identify hidden risks and enhance the consistency and comparability of results. Fourth, a common approach to the treatment of sovereign bonds in the stress test should eliminate the scope for national discrepancies. Finally, the adverse scenario is considerably more severe than in previous tests, making it clearly more robust.

Chart 5: Spreads of euro-area bonds issued by banks



Source: Thomson Reuters Eikon / Markit Iboxx

The improving situation of the EU banking system is encouraging. More stable balance sheets should allow banks to be play their role in financing the private sector thereby facilitating growth. While lending activity is still weak in many sectors and Member States, some recent data suggest that the cycle may be reaching a trough.

For the time being, however, it seems the European recovery remains largely credit-less. Lending volumes remain

low, with firms choosing to finance investments with their own funds or by issuing debt securities (see Graph 6). Credit flows to the private sector in the euro area continue to shrink mainly on account of weak lending activity to non-financial corporates. Furthermore, bank lending conditions, although improving slightly, remain highly fragmented, in contrast to other market segments, such as the sovereign or corporate debt markets where fragmentation has declined significantly (see Graph 7).

Chart 6: Loans to enterprises, index of notional stocks

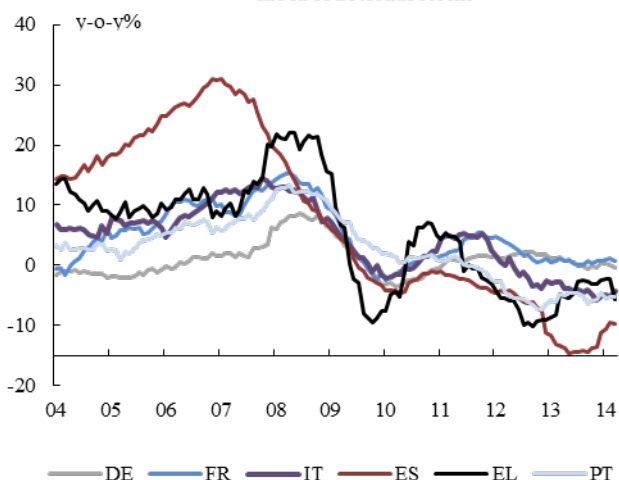
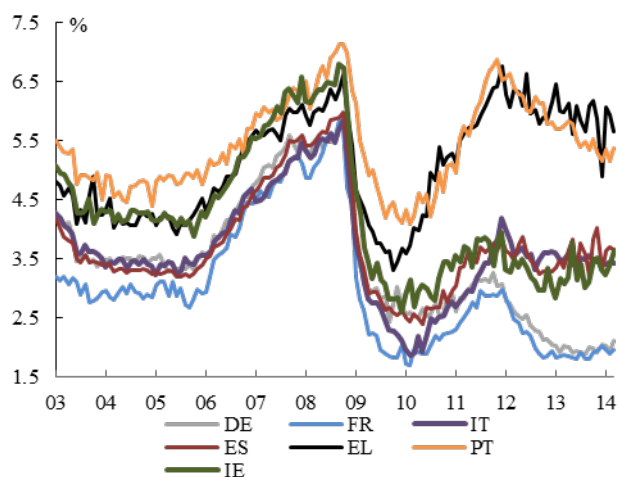


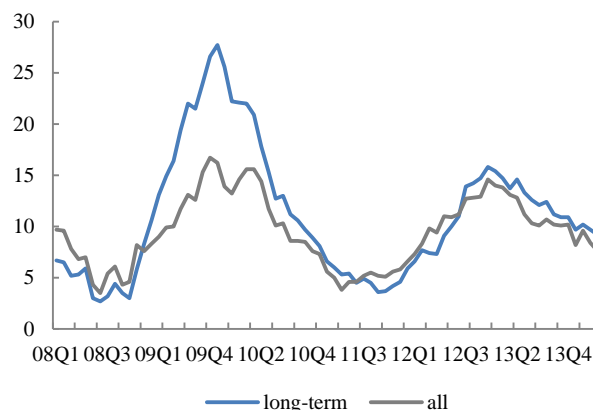
Chart 7: Interest rates on loans to enterprises (new business, maturity up to 1 year)



Weak bank lending has been partially offset by growing bond issuance. Net issuance of long-term debt securities by non-financial corporations is buoyant (up approximately 10% year-on-year, see Graph 8), as larger corporations move towards market financing. However, small and

medium-sized companies that are less able to tap financial markets and that are more dependent on banks are facing external funding constraints.

Graph 8: Net issuance of long-term debt securities by non-financial corporations (growth rates, all maturities)



The decline in bank lending is the result of supply and demand factors. On the supply side, the combination of protracted economic weakness with legacy balance sheet issues and continued property market corrections in some countries is causing credit quality to worsen and non-performing loan (NPL) ratios to rise. This in turn hampers the willingness and ability of banks to lend. Some market participants suggest that asset quality problems could be more acute than reported because banks are exercising forbearance towards borrowers with low credit quality. A high level of NPLs and forbearance on loans ties up capital and funding and reduces the capacity of banks to extend new loans. European supervisors' in-depth analysis of the banking sector's health should reveal unrecognised losses and spur banks to complete the repair of their balance sheets.

On the demand side, the high level of corporate indebtedness, deleveraging, and the fragility of the recovery weigh on borrowers' ability to repay existing debts and the demand for new credit. In some euro area countries, the slow progress on corporate sector restructuring and higher interest rates charged on loans to stressed companies further dampen demand for new loans.

Indications for the future, however, are somewhat more positive. A number of forward-looking credit indicators seem to suggest that bank lending could start to increase. For example, the latest euro area Bank Lending Survey paints a much

more positive picture than hard data on lending volumes and interest rates. Since the beginning of 2014, European banks have started to predict an end to the net tightening of credit standards on loans to NFCs, further easing for loans to households, and a pick-up in loan demand. The survey also points to a slight reduction in lending condition disparities across the euro area.

Regulatory changes have fostered stability and integrity of markets and institutions

The positive changes described above would not have occurred without the significant regulatory changes introduced by the EU and its Member States. Particularly notable has been the reform process of European banks.

Implementing common rules for banks is essential for the single market, enhancing integration and promoting a level playing field across the EU. The adoption in 2013 of the new EU rules on capital requirements, which implement the internationally-agreed Basel III framework, was an important milestone. This legislation entered into force on 1 January 2014. As a result, all credit institutions in the EU now follow the same rules on solvency. The strength of the rules are enhanced by the fact that most of them are uniformly applicable EU regulations, rather than directives, although an appropriate degree of flexibility has been preserved for financial stability.

The EU has made great progress in establishing a 'Banking Union' that should encourage integration throughout the single market via harmonised tools, standards, and powers for relevant authorities. The entry into force of the SSM in November 2013 paves the way for the ECB to assume its full powers and responsibilities as the single supervisor this year, after it completes a thorough assessment of the banking sector. The new supervisory arrangements together with the assessment and the EBA's stress tests this should go a long way towards restoring confidence in Europe's banks.

Furthermore, the agreements reached in December 2013 on a common, centralised EU approach to dealing with failing banks and common rules for deposit guarantees secure an efficient system for coping with future bank crises.

With this second pillar of Banking Union in place, authorities will have the necessary tools, powers, and financing to address critical problems should they arise. If problems are acute and institutions are placed in resolution to be orderly wound down, the new framework makes it easier for author-

ities to maintain critical banking functions and to limit the impact on the rest of the financial system. Although the framework has yet to be tested, the creation of a Single Resolution Mechanism, endowed with centralised decision-making and a Single Resolution Fund, will enable even cross-border banks to be orderly resolved.

Equally important, especially for the non-bank credit channel, have been reforms to EU rules on securities trading, clearing, and settlement. The new rules improve the transparency and oversight of less-regulated markets, address new technological developments, such as high-frequency trading, and deals with the issue of excessive price volatility in certain market segments, such as derivatives markets.

The EU has also taken action to honour commitments made by the G20 group of leading economies to reduce risks in over-the-counter derivatives markets. A new regulation, the European Market Infrastructure Regulation (EMIR) ensures that information on all European derivative transactions will be reported to trade repositories and made accessible to supervisory authorities. The Regulation also requires standard derivative contracts to be cleared through Central Counterparties (CCPs); introduces new margin requirements for uncleared trades; and establishes stringent business conduct and prudential requirements for CCPs.

There has also been significant progress on other reforms to strengthen the resilience of the supporting infrastructure behind securities trading in Europe. The recently adopted Central Securities Depositories Regulation (CSDR) harmonises and reinforces the settlement of securities trading across Europe, reducing the fallout that the collapse of a major trader could have on the wider market, and creating big efficiency gains.

In the broader perspective, it is important to recognise the evolution of the EU's support mechanisms for sovereigns which continue to service the financial assistance provided to programme Member States. The combination of financial assistance coupled with thorough policy measures and robust conditionality has proven effective. In some cases this approach has already succeeded in rehabilitating Member States' ability to finance themselves.

Spain, for example, made successful use of the European Stability Mechanism's instrument of financial assistance for the recapitalisation of financial institutions. The tool will continue to be available within the ESM framework to assist Member States whose distress is anchored in the financial sector. Meanwhile, an instrument for the direct recapitalisa-

tion of institutions is being finalised in order to better address the sovereign-banking link. With ample funds still available, Europe's stability mechanisms remain ready to provide support when needed in emergency situations, including in cases where difficulties stem from the financial sector.

Stability in sight but risks remain

The favourable trends mentioned above have a good chance of becoming more engrained and mutually reinforcing and could enjoy further help from the global economy and the impact of regulatory changes. It is equally clear, however, that a number of risks and challenges remain. Market sentiment remains inherently volatile and continued stabilisation cannot be taken for granted.

Firstly, the sustainability of the stabilisation of markets and the repair of banks' balance sheets will be seriously tested if monetary policy globally becomes significantly less accommodative and global liquidity less ample. The possibility of market corrections in the future cannot be ruled out. It remains to be seen how markets will react to a gradual withdrawal of monetary stimulus.

In addition, the current upbeat sentiment rests on the combination of economic recovery, sustained balance sheet repair in the banking sector, and continued progress in policy implementation, i.e. a smooth implementation of the banking union and continued reforms in Member States. Disappointment in any of these areas could trigger headwinds and cloud the climate in financial markets.

Furthermore, normal credit creation by the banking system still needs to be restored. Without it, a lasting recovery cannot be assured. Banks are not yet translating their improved funding conditions into better lending conditions, which remain very different across Europe. This contrasts markedly with the reduced financial fragmentation in other market segments, such as those for sovereign and corporate debt.

There is also considerable uncertainty surrounding the results of the ECB and EBA's assessments of the banking sector and the functioning of the SSM. Adequately addressing any problems revealed by the exercise will be crucial to restoring confidence in Europe's banks. If capital shortfalls are identified, all private sources of capital should be exhausted first before public money can be injected, in line with the revised state aid rules (applicable since August

2013). This includes all possible internal and market-based capital-generating measures, and burden sharing with shareholders and junior bondholders. Given sizeable outstanding subordinated debt in EU banks and continued capital-raising initiatives, there is a considerable cushion of private sources of capital available. Only in the unlikely cases where this is insufficient to cover potential identified shortfalls would national backstops be used, and then, as a last resort, EU/euro area backstops.

Finally, risks from outside the EU spilling into the euro area's financial markets have historically proven to be potentially powerful and fast. At this juncture, risks from emerging market economies remain elevated, especially for those most exposed to tighter financial conditions or facing uncertain growth prospects, such as China. Recently mounting geopolitical risks, in particular the events in Ukraine, could also impact Europe's financial markets and economy.

Policy considerations

The significant achievements in reforming market structures and stabilising market performance must be locked in and the remaining challenges tackled. Therefore, it is important that the positive reform momentum is maintained in Europe. Member States must honour their reform commitments and stay on course with the agreed growth-friendly and differentiated fiscal consolidation strategy in order to ensure the sustainability of public finances. This will aid the deleveraging process in the broader European economy. However, it is important that the public and private deleveraging does not unduly hinder normal or warranted lending activity, thereby possibly translating into an excessive speed or scope of that process.

Weaknesses in credit creation and financial fragmentation remain high in some countries, particularly for SMEs. Although some of this can be compensated by market-based funding, non-bank funding is unlikely to fully substitute the drop in bank credit. Therefore, the ambitious adjustment of the European banking sector needs to continue. While significant progress has been already achieved with banking restructuring as well as with improving bank regulation and supervision, further efforts are needed to complete the balance sheet repair where necessary and to ensure that the banking sector functions correctly and can sustain the economic recovery.

Consistent and full implementation of the banking union, including the new supervisory system will be key for im-

proving the future resilience and functioning of the banking system.

At the same time, the process of disintermediation from banks will, and needs to, continue to secure alternative, long-term funding channels. The Commission Communication of 27 March 2014 on Long-term finance sets out a number of initiatives to regulatory and market-based strategies to direct more resources towards long-term investment.

An important tool to achieve more diverse and resilient market-based finance could be safe and robust securitisation markets, which can offer securities better tailored to the needs of non-bank investors and a greater range of investment opportunities, sometimes in asset classes in which they otherwise are currently unable to invest directly. While the excesses of the past should be avoided, well-designed securitisation could help those parts of the EU financial system in need of financing, such as SMEs.