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Abstract

From mid-2007 to mid-2013 the European Economic and Monetary Union (EMU) was characterized by financial and 'real' crises that had a significant impact on the evolution of European banks. In the post-crisis phase, these banks will be unable to keep their previous dominant position in lending to the 'real' economy and in managing the households' financial portfolios. The present paper maintains that, as a consequence, the EMU's financial markets will be characterized by two main problems: (i) the definition of a new division of labor among banks and non-banking financial intermediaries; (ii) the creation of alternative sources of financing that companies can turn to. To solve these two problems, it is necessary to fill the qualitative and quantitative gap between the desired allocation of wealth owners and the provision of finance to the 'real' economy. In the new financial model the construction of this bridge cannot be fully entrusted to banks; it requires co-operation between different financial intermediaries. This paper shows that the EMU's banks have a short-term and a long-term interest in offering services to other financial intermediaries in order to facilitate the implementation of the new division of labor between them.

JEL Codes: G 21 ; G 23 ; G 28.

Key words: European banks, non-banking financial intermediaries, lending, financial services, financial allocation.

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1. Introduction

From mid-2007 to mid-2013 the European Economic and Monetary Union (EMU) was characterized by financial and 'real' crises. These crises had a significant impact on the working of the EMU's financial markets and on the evolution of European financial intermediaries. In fact, they started a process which is leading to the end of the peculiarly dominant role that the banking sector has played in the financial activities of most EMU countries for several decades.

The international crisis (2007-2009) affected the banking and financial sectors of various member states of the European Union (EU) and the euro area, in particular the largest financial institutions but also a number of regional banks in the 'core' countries. These European financial intermediaries were directly involved in the failures of the international financial markets due to their large exposure towards the troubled and illiquid assets that had originated in the United States (US) subprime mortgages and fed the chains of derivatives (ABS, CDO, CDO^2, etc.) (see Brunnermeier 2009; Adrian and Shin 2010). Moreover, they were involved in the macroeconomic disequilibria of the EMU's most fragile countries due to their large exposure towards the government bonds and the speculative 'bubbles' of these peripheral member states. From the beginning of 2008 to mid-2009, the international financial crisis led to a 'real' crisis in several economic systems. The large majority of the EMU countries reacted to these two crises by increasing public spending to support their banks on the brink of bankruptcy and to socially protect the growing number of their unemployed workers. Thus, these countries increased their government deficit to GDP and government debt to GDP ratios. Within the EMU, the international crisis also caused a 'sudden stop' of the financial and capital flows from the core member states to the peripheral member states, while increasing the bankruptcy risks of countries such as Greece, Portugal, Ireland, and Spain. These latter countries reacted by implementing dramatic short-term macroeconomic adjustments (see Chen *et al*. 2013; Borio and Disyatat 2015; Esposito and Messori 2018). Hence, in 2010 they fell into a new recession which strengthened the insolvency risks of their non-financial firms and weakened their national banking sectors.

These events explain why the following EMU crisis (from the last quarter of 2011 to mid-2013), which was also fed by Italy's involvement in the peripheral problems (May 2011), was characterized by the 'doom-loop' between the sovereign debt crisis and the crisis of the European banking sectors. The main banking groups and the various regional banks of the EMU's core countries, which had been supported by large national government aid in 2009 to overcome the impact of the international financial crisis, still had to manage three problems: (i) the liquidation of their remaining stock of troubled assets inherited from 2007-2009 and of the peripheral government bonds affected by growing risks of insolvency and by related value-losses; (ii) further recapitalizations which were required to absorb the losses in their balance sheets, to meet the new regulatory international requirements and to develop new assets after the deleveraging of traditional loans and financial derivatives; (iii) the implementation of new and profitable business models. On the other hand, the main banking groups and the various medium and small banks in the EMU's peripheral countries had to manage three analogous problems: (a) the reduction in the holding of their domestic government bonds affected by value-losses and the liquidation (securitization) of a part of their growing amounts of non-performing loans (NPLs) due to the widespread insolvency of their borrowers; (b) the implementation of significant recapitalization processes; (c) the start of new activities (see IMF 2011; EBA 2011a).

The content of points (i)-(iii) and (a)-(c) could fully explain why the last few years have been characterized by deep instability and a promising evolution of the EMU's financial markets. In Sections 2 and 3 I offer an overview of the market and regulatory factors which are hindering the revival of the dominant position that banking activities held in the financial sectors of the large majority of EMU countries before the international and European crises. These factors suggest that, in the post-crisis phase, EMU banks will have to look for complementarities and competition with new non-banking intermediaries in various segments of the European financial markets (see Section 4). My conclusion is that these new relations would allow banking activities to acquire an important innovative role, but only if EMU banks are able to select new, efficient and effective business models (see Section 5).

2. The exit from the crises: the impact of new regulation and supervision

In the US and the EU, the 2007-2009 financial crisis and the related massive government aid programs carried out to avoid the collapse of the banking sectors and the financial markets led to the immediate implementation of important innovations in financial regulation. In the EMU, at the beginning of 2010, there were significant changes in the regulation of financial assets trading, in the control of rating agencies, and in the European system of financial supervision (with the creation, for instance, of the European Banking Authority: EBA). However, the main innovations in these fields were introduced only in mid-2012 with the launch of the Banking Union process and with the progressive adoption of international capital requirements and the Basle 3 rules.

The Banking Union process implied a general assessment of the quality and riskiness of the European banks' balance sheets at the end of 2013 and mid-2014, the transfer of the banking supervision's responsibility to the European Central Bank (ECB) starting in the beginning of November 2014, the approval of new centralized rules for the resolution of European 'significant banks' on the brink of bankruptcy at the end of 2014, the involvement not only of the shareholders but also of the holders of subordinated bonds in the restructuring of banks under resolution starting in the beginning of 2015 (the so-called 'burden sharing'), and the related involvement of all the holders of bank bonds and deposits without guarantees starting in the beginning of 2016 (the so-called 'bail-in') (see EBA 2011b; Schoenmaker and Véron 2016). These new rules on bank resolution processes strengthened the content of the European Commission's Communication (August 2013), which limited new government aid for national banks to cases of systemic risks threatening the stability of European financial markets. Moreover, the progressive adoption of new international capital requirements and rules implied that the European banks that were already hit by the EBA's first stress tests and by its related

decision to impose recapitalizations in the fall of 2011 had to improve the amount and the quality of their capital ratio on the amount of their risk-weighted assets and to limit their leverage ratios.
The EMU's banking sector mostly affected by these innovations in regulation and supervision was the Italian one, which was the banking sector of the only peripheral country not involved in the EMU's full or light aid programs.[2] A number of Italian banks were constrained to recapitalize in 2015 in order to overcome the capital deficiencies stated in the EBA and ECB quality review and stress tests of mid-2014, despite the fact that their profitability at the time was lower than the market cost of capital. Others followed suit in order to meet the yearly requirements of the ECB (SREP 2015) in its new role of Single Supervisory Mechanism (SSM). Moreover, in November 2015, four small- and medium-sized Italian banks went bankrupt and their shareholders and holders of subordinated bonds arranged for 'burden sharing'. The fragility of a large part of Italian banks was further emphasized by the huge incidence of NPLs on their total assets, which reached a peak between the end of 2015 and the first quarter of 2016. To deal with this situation, which was worsened by the large gap between the average market values and the book values attributed to the Italian NPLs, at the beginning of 2016 European institutions allowed the Italian government to offer a public guarantee on the senior tranches of the securitized NPLs. Then, in April and August of the same year, the Italian government convinced a large part of the Italian banking sector, as well as other financial intermediaries and institutions, to become shareholders of two new funds (the so-called Atlante Fund), which acted as purchasers of the NPLs offered by the Italian banks in trouble and/or of the new shares issued by these same banks.
These initiatives to overcome the fragilities of the Italian banking sector, without having recourse to the European clause on systemic instability, were unsuccessful. Three of the main Italian banking groups (Monte dei Paschi of Siena, commonly abbreviated as MPS, and the two most important banks of the northeastern area) were unable to recover during 2016 and avoided resolution and 'bail-in' in 2017 only thanks to the exploitation of specific clauses and the generous interpretations of European rules. MPS was (temporarily) saved thanks to a precautionary recapitalization which was largely covered by the Italian government and which included burden sharing. The two northeastern banking groups were submitted to the Italian legislation; and the Italian authorities divided them into a bad bank, to be managed by a government entity, and a set of good assets and liabilities, to be transferred to the biggest Italian banking group for a symbolic price of 1 euro.
These measures did not solve all the outstanding problems of the Italian banks. The latter continue to hold an excessive amount of national government bonds: after a peak of its incidence on total assets (2015) and a significant reduction until the end of 2017, there have been new increases in the last

[2] See for instance: Messori (2016). Greece was involved in multiple bilateral loans offered by the other EMU countries and the International Monetary Fund (IMF) in spring 2010. Since then, it has been re-financed several times by the European *ad hoc* mechanisms (the temporary EFSF and the permanent ESM). Ireland and Portugal entered a European aid program based on EFSF and IMF financing in 2010-2011. Cyprus had to make recourse to ESM intervention in 2013. On the other hand, Spain used a lighter European aid program, launched in June 2012, which was designed to finance national banking sectors in trouble. This latter program implied a direct EMU loan to the Spanish government.

months. Moreover, there are still medium-sized and local banks that are on the brink of bankruptcy. However, together with the enormous and successful market recapitalization of Unicredit (the second largest Italian banking group) and the accelerated securitization of a significant part of NPLs, the resetting of MPS and the liquidation of the two northeastern banking groups allowed the Italian banking sector to surmount the peak of its crisis.

3. The exit from the crises: the past banking model cannot be reproduced

I have analyzed some aspects of the recent evolution of the Italian banking sector in detail since these same aspects have often characterized, to a lesser extent, other EMU banks. Even if the banking sectors of the countries benefitting from European aid programs are not considered, several banks from various euro-area member states had to manage an excessive incidence of NPLs in their balance sheets and face difficult recapitalizations on the markets because their expected rates of return were lower than the cost of capital (ECB – Banking Supervision 2017). Some troubled banks in the EMU's core countries were recapitalized with public funds, since these initiatives completed old processes which begun before the implementation of the new European regulation (2013 and 2014). A few banks in the EMU's peripheral member states followed the resolution process or went bankrupt and therefore had to arrange for 'burden sharing' and 'bail-in'. Almost all the EMU's banking sectors held and still hold an excessive amount of national government bonds; and, even if they are partly justified by the constraints in the composition of the banks' relative assets and liabilities, these holdings contrast with the diversification principles (see Enria et al. 2016; Lenaričič et al. 2016).

These shared problems imply that the European banking sector will be structurally unable to reacquire its old role. Before the international and the European crises, there were important differences in the banking activities of various EMU countries. However, compared to the US financial markets, where non-banking financial intermediaries are important actors in the picture, it was apparent that the EMU's banks played a dominant role in financing the 'real' economy and in managing the households' financial portfolios, leaving little room for non-banking financial intermediaries (cf. Allen and Gale 2007). In general, the EMU's banking sector enjoyed a kind of oligopolistic leadership with respect to the borrowing non-financial firms and retail investors. Given the list of problems faced by the EMU's banking sectors after the crises, it becomes hard to believe that European banks should maintain their oligopolistic leadership.

A bank's traditional activity, focused on lending to retail and corporate firms, is constrained by the new capital requirements and the temporary low interest margins. Unlike in the period before the international and European crises, it is now too costly to offer an excessive amount of loans to risky borrowers, since these loans can generate an unmanageable amount of NPLs, thus increasing the minimum threshold of expensive capitalization. This is *a fortiori* true given that, currently, even an equilibrated lending activity is not so profitable in the EMU due to the impact of the expansionary and non-conventional monetary policy on the structure of interest rates. The low levels of the latter compress the banks' interest margins. This is a temporary situation which will be probably overcome in a few months. However, the current low interest margins do not incentivize banks to greatly invest in information technology in order to improve the quality of the selection of their borrowers. The consequence is a vicious circle: the misallocation of loans makes capital requirements more binding, thus increasing costs and further reducing the incentives to offer an adequate and efficient amount of loans by improving the selection of borrowers.

As shown in the US, the expected increases in the structure of interest rates will allow for more profitable retail and corporate lending. However, this banking activity will become more selective than in the past, so that a number of non-financial firms will have to look for alternative finance. The impact will become particularly crucial in the EMU due to the average small size of the borrowing firms and their consequent difficulties in obtaining direct access to financial markets.

The management of financial assets and other financial services is not so promising for the future business model of the EMU's banks. After the international crisis, large financial institutions with a developed branch in investment banking had to absorb significant losses in order to liquidate the trouble assets in their balances. Unlike US investment banks, the main European banking groups have still not completed this process. Moreover, regulation has introduced severe constraints to separate activities in potential conflicts of interest and to limit the set of excessively risky financial services offered by banks. The result is that a further measure in US regulation (dated 2008), which was the forced transformation of purely investment banks into commercial banks with possible investment branches, turned out to be quite convenient for the US banking sector. Given the current regulation and the current functioning of financial markets, having pure investment banking become a profitable activity appears to be an arduous task. In the EMU, this statement is corroborated by the poor performance of the only European banking group to be mainly focused on investment activities: Deutsche Bank.[3]

In the near future the EMU's banks will also have difficulties in keeping their previous dominant position in the management of households' financial portfolios. The new regulation transformed bank bonds into financial assets with a very high risk since the possibility of 'burden sharing' and – mainly – of 'bail-in' added a specific counterpart risk to liquidity and market risks. Moreover, to have the actual option of implementing a 'bail-in', this same regulation tends to impose a cap on the share of guaranteed bonds out of the total bonds and other liabilities issued by each significant bank. Finally, the current attempt of the EMU's banking sector to further strengthen its dominant position in the mutual funds and wealth management activities will be limited by the impact of a new and different regulation: the so-called MIFID2. This regulation will transform the services offered by standardized mutual funds and by wealth management in the mass market into financial commodities with low intermediation margins. Banks will particularly be affected by this 'commoditization': their

[3] This comment does not mean that Deutsche Bank's problems are only due to its investment activity. In the recent past, the management of the most important German bank was characterized by a long sequence of mistakes and malpractices. In any case, investment banking played a crucial role.

competitiveness in the field is based on economies of scale and scope in the distribution channels, hence requiring large markets.

4. New working of financial markets in the euro area

The previous picture emphasizes that the EMU's financial markets are going through an evolutionary phase characterized by two main problems: (i) the definition of a new division of labor among banks and non-banking financial intermediaries; (ii) the creation of alternative sources of financing for non-financial firms with a very high dependence ratio towards bank loans. It is evident that these two problems are strictly linked: the solution to problem (i) is the condition to addressing problem (ii), and while (ii) is being solved it puts specific constraints on the management of (i). It is also evident that not all EMU countries will start from the same conditions to solve (i) and (ii). For instance, French financial markets already have a richer set of non-banking intermediaries than the German or Italian ones. Therefore, French non-financial firms have a lower banking leverage than the German or Italian ones. Moreover, in the Netherlands and Luxembourg, as well as in some bigger countries, institutional investors are playing or could potentially play an important role in the new working of financial markets. By contrast, this type of investor is weaker in countries such as Italy and Spain (cf. Darvas and Schoenmaker 2017).

Despite these significant internal differences, it remains true that the EMU's financial markets were and still are dominated by banks, in comparison to the situation in the US or the UK. The European institutions timely acknowledged this gap and its negative impact on the growth potential of the euro area in the post-crises period (see Gorodnichenko et al. 2018). Hence, they launched the Capital Markets Union (CMU) at the end of 2014 and began implementing it at the beginning of 2015. The CMU is a regulatory attempt to strengthen the role of the existing non-banking financial intermediaries, to develop new financial intermediaries, and to allow medium-sized and innovative non-financial firms to have easier and less expensive access to corporate bond markets and stock markets in a more integrated European financial market (see ECB 2015).

It is impossible to list in this paper all the initiatives taken within the CMU's regulatory framework. It suffices to stress that the role of financial providers was enhanced by developing the so-called 'European passport', the procedures for issuing financial assets in regulated markets were simplified, the innovative financing sources (such as venture capital and the crowdfunding) were strengthened and incentivized, the transnational investments were based on simplified rules, the construction of markets for effective and accountable securitization was encouraged, and investments in infrastructure and in sustainable long-term projects were implemented. The efforts mobilized through the CMU and the related achievements are creating the possibility to build new segments of financial markets in the euro area. These new segments will not directly address problems (i) and (ii), which were specified at the beginning of this section. Nevertheless, they will provide the opportunity and the tools to find efficient solutions.

The EMU is characterized by an enormous amount of financial wealth concentrated in households. As implicitly shown by the recurrent negative gaps between aggregate investments and aggregate savings in the euro area as a whole since the outbreak of European crises, the allocation of this financial wealth does not suit the financing needs of 'real' activities.

In the previous financial model centered on national banking sectors, the latter exploited their oligopolistic leadership in the management of households' financial portfolios and in the lending to non-financial firms in order to fill the possible qualitative and quantitative gap between the desired allocation of wealth owners and the supply of loans to the 'real' economy. The construction of this bridge is still necessary in the new financial model. Yet, it will not be fully entrusted to banks, but it will involve a number of different financial intermediaries. Some of them would have to help the firms that are ready to directly enter the bond and stock markets to issue financial assets which can meet the preferences of the least risk-averse component of wealth owners. Others could play the role of purchasers of these same issues in the market and then transfer the related assets to the financial portfolios of institutional investors or households. Certain intermediaries could directly buy the financial assets issued by firms that are too small or too ill-structured to directly enter the regulated markets and transform these assets into less risky tools to be allocated in the institutional or retail markets. Other types of intermediaries could specialize in the financing of specific firms, such as start-ups and small innovative companies.

It would be possible to continue listing the various types of non-banking intermediaries and the different financial tools which could fill the gap between the desired allocation of wealth owners and the financial needs of the 'real' economy. The abovementioned examples are, however, sufficient to point out that these intermediaries and tools tend to replace banks and bank loans by implementing a more efficient segmentation of the various groups of wealth owners, as well as of the different groups of firms in various sections of financial markets.

This observation leads – at least – to two consequences. It is first evident that the new working of the EMU's financial markets will include some types of households and firms which will continue finding it more efficient to utilize bank intermediation for – respectively – allocating their financial wealth and obtaining the desired financing. This typically applies to the most risk-averse wealth owners and to a large number of small- and medium-sized firms. Hence, the new organization of more integrated financial markets in the euro area leaves the banking sector with an important role, even if it undermines the banks' oligopolistic leadership. Banks will play a complementary role with respect to other financial intermediaries. Secondly, it is just as evident that the transition of the EMU's financial markets from the old model, centered on the dominance of the banking sectors, to the new one, centered on coexistence and complementariness between different financial intermediaries, will not be a one-shot transformation but will require a complex evolution.

5. Conclusions: the new possible role of banking

The remarks made above emphasize the crucial role that the banking sector could play during this complex evolution.

Due to their previous oligopolistic dominance of the European financial markets, the EMU's banks have accumulated strong information and competence advantages in their national 'real' economies with respect to the other financial intermediaries (Stiglitz and Weiss 1984). Moreover, due to the marginal roles played until now, these other financial intermediaries do not have the specific technologies required to 'catch up' to the banking sector and to compensate for their lack of information and competence. To obtain these results without the banks' cooperation, they would have to make costly investments and spend a significant amount of time. Finally, the EMU's banks have built long-term relationships with their customers on both sides of the market. Hence, to compete with banks in the supply of specific financial services, the other financial intermediaries would have to convince the banks' customers to abandon their habits and opt for a new unknown supplier; and thanks to their consolidated position, the banks could react by adopting predatory pricing.

In the usual circumstances, these elements are not sufficient to break the transition from the old to the new market organization. In fact, they resemble the difficulties faced by a newcomer when it starts to compete with an incumbent in an oligopolistic market; and there is a set of conditions that allow the opening of this market thanks to the newcomer's competitive pressure. In principle, these conditions also apply to the models of the EMU's financial markets. However, in the latter case, there are peculiarities that increase the probability of a successful transition. These peculiarities make it convenient for the incumbent to give up its long-lasting trench warfare. As we stressed in sections 2 and 3, the new regulation and the related new functioning of financial markets imply that a re-proposal of the EMU's old banking model would not be convenient for the banks themselves. Hence, this is a case in which cooperation would lead to improvement in the conditions for all the market actors – that is, a Pareto improvement.

My conclusion can be summarized in three steps. First, the EMU's banks have a short-term and a long-term interest in offering services to other financial intermediaries in order to transfer a large part of their information and competence, thus easing the transition towards a new model of European financial markets. In the short term, banks would be paid for their services and could select their new specific business models, avoiding a transfer of the related competence; in the long term, banks could thus eliminate a subset of their old and for now unprofitable activities, and regain advantages in their new implemented specializations. Secondly, each of the other financial intermediaries has a clear-cut interest in purchasing some of the services offered by the banks: the costs of these services would be lower than those of the investments required to 'catch up' to the banks and to compete with them in the supply of a specific financial service. Moreover, these same intermediaries would spare the time required to accumulate knowledge and would minimize the risk of heading in a wrong direction.

Thirdly, non-financial firms would benefit twice: the improvement in the quantity and quality of the financial services at their disposal would be achieved in a shorter time.

The CMU would have to stress this Pareto improvement condition and avoid possible microeconomic behavior based on free-riding, which can threaten cooperation. A rapid and linear transition of the EMU's financial markets to the new model based on coexistence and fair competition between several different financial intermediaries would increase the growth potential and the development of the euro area.

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