AN HISTORICAL PERSPECTIVE TO CURRENT TRENDS IN THE BANKING INDUSTRY IN EUROPE

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Historical reasons behind the limits to current Eurozone architecture

With the end of the Bretton Woods regime on August 13th 1971, when the US decided to leave behind the era of Gold Exchange Standard, Western European countries were forced to give up the convertibility of their currencies, and exchange rates started to float. In the wake of such change, financial and monetary stability seemed to be suddenly at stake. Europe reacted with the Werner plan, put in place in 1973. Europe entered a new era, and looked for a new equilibrium. The birth of the EMS scheme (centered on the D-Mark) appeared to create this sought after stability. It developed a new figurative currency, the ECU.

The system, despite several realignments between currencies, appeared to be stable. With the signing of treaty of Maastricht in 1992, political leaders decided to move further, to create a monetary union. In order to allow the new currency to emerge, they focused on creating a framework that would put limits to public spending, deficits and debt. Those constraints seemed to be the necessary preconditions for a strong currency backed by an independent

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central bank. Essentially, the founding fathers of the EMU recognized that if fiscal policies are not pooled or at least constrained by a rule which ensures the sustainability of debt, the central bank is ultimately forced into inflationary policies and its independence is put at risk. The result of this thinking was a central bank modeled on the Bundesbank, strong, independent, and with a simple, single mandate, price stability.

The crisis of the European Monetary System in 1992 was a major hit for this ambitious project, but it was only a temporary setback. In April 1998, all major EU member states took a giant leap towards closer monetary integration. They agreed on the introduction of a new single currency, the Euro, to be circulated as paper bills from January 1st, 2002. At the same time, they also enshrined into the treaty constraints on public spending and debt. Initially the new Euro seemed strong, with markets pricing it above the USD, with initial trading at around 0.85 to the dollar. When the euro finally materialized, it was politics that had prevailed over economics. The voices of those who suggested that the new monetary union was not an optimal currency area were silenced by its initial success. But significant steps towards closer fiscal integration were postponed. Economically weaker members that were not yet able to live within the constraints of a common currency became part of the project from the start. In short, critics were drowned by a general consensus that saw Europe inevitably moving closer together. The agreement on the common currency seemed to be sufficient to sustain the drive towards an ever closer union.

But the 1998 agreements were the result of a deal between Chancellor Helmut Kohl and French President Francois Mitterrand, a political view born in early '90s (and then supported by his successor Jacques Chirac after 1995), when Germany was reunified, regained its full national sovereignty and triggered some deep seated anxieties among its neighbors, most notably France. France pushed for a larger Euro area in order not to be "alone" in a potentially unequal partnership with Germany. In order to achieve this objective, Italy and others were allowed to participate from the very beginning to the project, despite their shaky public finances. The political decision of both German and French leaderships to refuse a "two speed" Europe and to push for a single Europe, single market, single currency approach, coupled with a belief that the EU would inevitably continue to move towards closer political integration, allowed for the Euro to materialize. Despite some initial difficulties (the narrow French referendum in 1994), the consensus amongst EU members on the perspective of a European Union, as a political body in the long run, remained strong.

Against this background, the pledge, under the European Stability

Pact, to keep public budget deficits within a narrow range of GDP (3%), and the commitment for a long term target of sovereign debt to GDP ratios at or below 60%, seemed sufficient to provide the necessary underpinnings for a progressive convergence of European economies. Unfortunately, the attempt in 2003, to reshape European Union governing rules failed. A year later, when 10 new member states (then followed by other two in 2007) joined the EU, the burdensome decisional architecture showed all its limits. With too many persons sitting at the same table and trying to make decisions under the constant threat of multiple cross-vetoes, the political project stalled, as did the convergence of different economies. Among them, only some had a single currency.

The Euro was born with a flawed architecture. It was and is the common currency for very different economies, with substantive differences in fiscal as well as in macroeconomic performance. Furthermore, the Euro was borne with no single Treasury behind it. Instead, it relied on a Central Bank that had a very narrow target of price stability. The treaty seemed to confine the ECB to the role of ensuring the stability of the system rather than an instrument of economic support through monetary policy (like the Fed). However, as recent decisions taken but the ECB in January 2015 have confirmed, even a narrow mandate centered on price stability, allows for discretion. The decision to launch the European version of quantitative easing, a broad program of asset purchases, including sovereign bonds, demonstrates that contrary to what many critics believe, the ECB can and is willing to act. However, even a modern central bank and its monetary policies cannot offset economic weaknesses and institutional shortcomings in other areas of the EMU. This is particularly true for fiscal policies and growth enhancing structural reforms.

Indeed, the decisions of 1998 left fiscal policies in Europe in the hands of national governments. European institutions in Brussels were not given the effective tools to enforce common rules.

Despite these structural flaws, for a decade markets implicitly accepted the convergence theory. Sovereign bond spreads between Eurozone countries converged between 1998-2008. Financial markets simply assumed that European economic growth would facilitate the convergence. Even in higher debt countries, the debt burden would prove to be manageable. In short, the Euro was a currency launched without an adequate institutional foundation, or, as events a decade later proved, insufficient political commitment to avoid an existential crisis.

From Lehman to Greece: the debt crisis

The Lehman crisis (September 2008) was the spark for a debt crisis that rapidly enveloped banks, non financial corporations, households and last but not least, national governments. Initially it was primarily the banking sector's stability that was at stake, worldwide and in Europe. Governments reacted by supporting the banking system (with guarantees, capital and debt). In order to avoid a deep recession, most countries supported collapsing demand by expanding public spending. Those actions stretched public finances and increased sovereign deficits and debts. Indeed, rather than to act in concert, each Eurozone member decided to support its 'own' banks. This choice was perceived by markets as the end of the European convergence: the risk was shifting from commercial banks to sovereigns states, but in an uneven manner: each one was on its own.

Economic fundamentals in each member country came under much more scrutiny. Markets began to reprice national risk. As a result borrowing costs for the highly indebted Eurozone (the so-called 'PIIGS' – Portugal, Ireland, Italy Greece and Spain) countries spiked. While the default of a sovereign Eurozone borrower was no longer unthinkable, it was still a reasonably remote case. But for investors, the danger of incurring in real losses started to be factored in.

The so-called sovereign debt crisis in Europe was triggered by the Greek case. In 2009, the government in Athens admitted that for years it had cooked the books in order to meet the stringent Maastricht criteria and gain full membership in the monetary union. The Greek government finally conceded that its real deficit was much higher (over 13% versus a previous estimate of around 4% of GDP). The awareness of the high level of interconnectedness between European economies and the fact that main German and French banks were overexposed, forced EU governments to rescue weaker countries as the situation deteriorated. In Greece, as well as in Portugal and Ireland, this was the start of the age of bail outs.

But Ireland, a Eurozone member, was broadly supported. Furthermore, it also benefitted from the intervention of the government of the United Kingdom (which is not a Eurozone member), which believed that its own national interests were at stake. Portugal was supported by EU members and institutions and started a bold program of reforms and tax increases. However, this did not prove to be sufficient to shield the country from contagion. Indeed, after Greece, Portugal was the first victim of a different perception of sovereign risk by financial markets.

But the case of Greece was different from the very beginning. There, Greek banks were largely foreign owned or at the very least heavily re-

liant on foreign financing (in particular by French and German groups). Also, Greece was already overleveraged in terms of public debt, since the decision to join the Eurozone. Finally, the Greek economy suffered from a chronic lack of competitiveness. In order to limit potential losses to its creditors, the 'price' for the bail-outs (eventually funded by public money – coming from the Trojka composed by the EU Commission, the ECB and the IMF – and commercial banks through 'voluntary' debt forgiveness) was the introduction of austerity: deep public spending cuts, savings and higher taxes.

In other words, the initial concern for stronger European economies was to contain the situation, not to tackle its root causes. This implied that creditors would only commit to just enough solidarity able to keep countries afloat, and only in exchange of serious commitments to significant debt/deficit reduction measures and spending controls. Such measures would have been far more effective in a different macroeconomic environment before the crisis and they remain essential if the long term goal is convergence. However, in the short term such policies deepened the economic crisis. They were imposed in the midst of an economic recession in a synchronized manner across the euro zone, thus making it very difficult for Greece and Europe to recover and grow. When those measures fell short of restoring confidence, creditor countries added the need to implement structural reforms to the mix of policies needed to repair weaker member countries.

Indeed, front loaded fiscal adjustments failed to bring down yields for sovereign bonds substantially. Spreads remained significant and the associated drop in economic activity caused a vicious circle. Austerity deepened the recession. The recession worsened the fiscal situation of many countries with deficits coming down too slowly and the debt to GDP ratio increasing.

As the issue became more and more a debate about conditionality for keeping weaker economies afloat, and recognizing that the Growth and Stability Pact had failed, 25 of 27 EU countries, including all Eurozone countries, agreed, in March 2012, a new "fiscal compact" that would force those countries with a debt to GDP ratio above 60% to arrive to a structural deficit of maximum 0.5% and to bring back the debt to GDP ratio to 60% within 20 years. This target remains very ambitious and can only be met if the euro zone economies start go grow again and inflation in the euro zone can be brought back to levels closer to the target of the ECB of a rate below, but close to 2%.

What happened in the markets

Paradoxically, until the ECB's promise to "do whatever it takes" to

save the euro zone, in the summer of 2012, while many European countries struggled, the debt crisis helped the US and Germany to overcome the consequences of the post-2008 recession. Both countries, perceived as safe havens, experienced significant capital inflows. As a consequence, yields for their sovereign bonds fell. While credit conditions in the stressed countries of Europe tightened, borrowing costs in the United States and Germany decreased. Both nations have since restored confidence in their respective financial systems. Various unconventional steps undertaken by the Federal Reserve (multiple rounds of quantitative easing and the so-called Operation Twist) have helped the U.S. stock markets weather the European storm.

Nonetheless the era of the so-called "great moderation" that started in the early 1980s, is likely over. Risk—and the fear of it—is back. The West has accumulated unsustainable amounts of debt and financial markets are expressing doubts about the advanced economies' capacity to pay it back. This uncertainty is compounded by a major global shift in the economic balance of power.

Over the past few decades the role of the financial sector had grown dramatically, with increases in both real sector leverage and financial sector balance sheets. Before the collapse of the investment bank Lehman Brothers in September 2008, conventional wisdom assumed that a bigger and more diversified financial sector was beneficial for the real economy because of an increased allocative efficiency of resources, as well as a wider dispersion of risk. The recent financial crisis shattered most of the pre-Lehman assumptions.

In response to the crisis, the Basel Committee on Banking Supervision has strengthened bank capital requirements. Strong capital rules for banks remain the central pillar of bank regulation. But capital requirements do not directly address liquidity risk.

Hence, the Basel Committee developed new liquidity standards for global banking firms: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR should improve a bank's ability to withstand severe short-term liquidity shocks by requiring banks to hold a buffer of highly liquid assets to cover net cash outflows in a thirty-day stress scenario. The NSFR is designed to promote stronger resilience over a one-year horizon. It requires banks that hold less liquid assets to fund their activities with more stable sources of funding.

As part of the comprehensive financial reform known as the Dodd-Frank Act, restrictions on certain activities, such as the ban on proprietary trading in the United States as well as work on new domestic and cross border resolution regimes, represent further significant attempts to make the banking sector not only less

vulnerable to shocks, but also less likely to trigger a financial crisis.

The European Union adopted the new internationally-mandated rules with its capital requirements directive, also known as CRD IV. In addition to that, the EU has decided to create a banking union with a powerful central supervisor and a single resolution mechanism for its credit institutions.

Public authorities in both Europe and the United States are trying to fulfill their promise to end the "too big to fail" syndrome. The stated goal is to allow banks to fail without endangering the entire financial system and the wider economy.

Regardless of which further future steps will be taken, it will be very difficult for banks to return to a pre-crisis status quo ante. Indeed, the profound changes in the sector could have a lasting impact on the business models of credit institutions, small as well as big, they profitability, and even more importantly, on the supply of credit to the real economy.

Indeed, the structural changes to the banking sector may well increase the cost of providing traditional forms of credit, even if central banks keep key interest rates extremely low for a prolonged period of time. Some constraints on lending are in part desired, especially if the intended goal is to build a more stable financial architecture. However, in the absence of well-developed and sizeable capital markets, growing reluctance by banks to provide traditional loans to the real economy—in particular households and small and medium sized enterprises (SMEs)—could have a lasting negative impact on growth and employment.

A possible new role for capital markets

The European Central Bank (ECB) and the European Commission have recognized that there is a need for a bigger role for capital markets in Europe's economy. Specifically, the ECB is trying to revitalize the securitization of assets in Europe and jumpstart asset-backed securities (ABS) issuance in order to open more funding channels for the wider economy. According to the ECB's governing council member Benoit Coeure "(…) the idea is not to copy the United States. European growth is based almost exclusively on financing of households and firms by banks. For a long time that worked fell, European banks did their job. But the 2007 global crisis and then the euro area crisis revealed that depending so exclusively on one sole method of financing constitutes a weakness."[1]

In this regard it is helpful to look at the experience in the United States, where capital markets have already overtaken traditional lending

1 Interview with Benoit Coeure and Le Monde, 17 April 2014, <http://www.ecb.europa.eu/press/inter/date/2014/html/sp140422.en.html> (15 May 2014).

activities as the most relevant form of funding of the real economy. In the U.S., more than two-thirds of funding for the economy is intermediated by capital markets and less than one-third through traditional banking activities. Despite a steep recession in 2009, the recovery has been underway since 2010 and now finally appears to be gaining momentum.

In the euro area the opposite is true. Indeed, despite generous liquidity injections for banks by the ECB, lending in the euro area remains extremely weak and economic growth is still disappointing. Even in the U.S., and despite bold action by fiscal and monetary authorities, traditional bank lending remained anemic for years while capital markets' indices reached record highs. The role of capital markets allowed overall constraints on credit to be far milder in the U.S. than in Europe.

In the U.S., capital markets play a prominent role not only for the funding needs of bigger corporations, but also for consumers. For example, once home and car loans are originated, most get bundled into asset-backed securities that are sold on debt markets.

Capital markets therefore have a deep impact on lending activities to households and non-financial corporations of all sizes. Capital markets allow for the transformation of relatively illiquid assets into more liquid securities. These are then sold to investors who can more easily diversify their portfolios in terms of risks and return. Of course, some excesses in "slicing and dicing" those securities need to be contained, as they were a cause of the recent financial crisis. Regulators tried to address those needs by forcing loan originators to retain some "skin in the game," in other words by requiring loan originators to keep a percentage of these loans on their books. In addition, they tried to increase transparency in the securitization structure, in order to distinguish between overly structured products and simpler, more transparent securities. It would in fact make little sense to impose stricter rules on one part of the financial sector while allowing unregulated shadow-banks to grow dramatically, as a shift in risks from one area to another would not make the financial sector safer.

According to the ECB's Benoit Coeure, there are therefore valid reasons for encouraging the development of stronger capital markets in the euro area as well, as "developing market financing via ABS, i.e., asset-backed securities (secured corporate debt) or, for example, bond issuance by medium-sized enterprises" would have multiple benefits, it would "make the financial system more balanced and more resistant to shocks. This is essential as, by definition, we do not know where the next crisis will hit."[2]

2 Interview with Benoit Coeure and Le Monde, 17 April 2014, <http://www.ecb.europa.eu/press/in-

However, European public support for a bigger role for capital markets is still weak, in part because they are often described as structurally unstable and just as threatening as big banks. Some financial products associated with the crisis, such as the very asset-backed securities that the ECB would like to see playing a bigger role in the European financial system, still carry a stigma. After all, it was when mortgage-backed securities (MBS) were mispriced and suddenly became illiquid that the crisis erupted and capital markets allowed the disease to spread. Not surprisingly, the market for ABS has not recovered in Europe, in contrast to the US.

Unlocking the potential of capital markets would also help the ECB to transmit its monetary policy stance more uniformly across the monetary union, boost the supply of credit to households as a result and finally, provide alternative forms of investments for savers that are currently punished by the low interest rate environment. In this context, providing access to capital markets will continue to be primarily a task for banks that offer a variety of services. Recognizing this, and following the launch of the banking union in November 2014, the EU Commission intends to take a further step towards a dramatic overhaul of the EU financial sector by proposing concrete plans for a truly integrated capital markets union. First suggestions on how to achieve this ambitious goal will be made in the course of the year 2015.

Both the U.S. and Europe are still building a financial architecture able to address the needs of their respective economies. Getting the mix and balance right is far from assured and regulators are still struggling to find the best way to end the too big to fail syndrome. Understandably the focus on banks has been at the forefront of all initial efforts to overhaul the financial system in advanced economies. This explains why regulators have focused on banks' capital levels that were found to be simply too low and flimsy before the crisis.

A Basel Committee study in 2010 suggested that tightening risk-based capital and liquidity requirements would, on balance, provide economic benefits, and that benefits would continue to increase at even higher levels of risk-based capital than are part of Basel III.[3]

At the same time, it is also clear that in a tougher regulatory environment, the cost of holding securities, loans, and trading exposures will rise. The Basel Committee recognized this and suggested that "banks have

ter/date/2014/html/sp140422.en.html> (15 May 2014).

3 Basel Committee on Banking Supervision, "An Assessment of the long-term impact of stronger capital and liquidity requirements," Bank for International Settlements, August 2010, page 2, http://www.bis.org/publ/bcbs173.pdf (15 May 2014); see also: Basel Committee on Banking Supervision, "Basel III: A global framework for more resilient banks and the banking system," Bank for International Settlements December 2010, <http://www.bis.org/publ/bcbs189.pdf> (15 May 2014).

various options to adjust to changes in required capital and liquidity requirements other than increasing loan rates, including by reducing ROE [Return on Equity], reducing operating expenses, and increasing non-interest sources of income. Each of them could cut the costs of meeting the requirements."[4]

These findings mainly apply to banks in a growing and relatively stable economy. Implementing the right mix of measures is much more difficult when banks operate in a weak, fragile growth environment and when their profitability is suffering.

On the old continent, bank loans account for most of household borrowing and around half of all non-financial firms' external financing. This explains why the banking sector in the euro area is so big—270 percent of GDP—while in the U.S. the figure is "only" 72 percent.

Understandably, in EU the public pressure on banks to lend more has grown in the past years. But if the perception of risk is the biggest impediment to traditional forms of lending, it is unclear how far public pressure - and accommodative monetary policies for that matter - can go. After all, policymakers would like to see a more resilient financial sector emerge from the crisis, one that avoids unnecessary risks.

As a consequence, the ECB has been less successful than its US counterpart in transmitting its generous conventional and non-conventional monetary policies across member countries. In fact, the paradox is that while banks in most of the euro area remain a hurdle to a smoother transmission of monetary policy, capital markets reacted to the central banks' actions as was intended by policymakers. Bond yields have dropped substantially across a number of asset classes and stock prices have risen substantially. This seems to be one of the reasons why the Federal Reserve has had much more success in transmitting its monetary policy to the real economy. In contrast with the ECB, the Fed did not have to rely exclusively on banks as its main transmission channel.

In Europe, despite the recent comprehensive assessment of banks' balance sheet, undertaken in 2014, banks still represent a bottleneck to a more uniform transmission of the central bank's monetary policy and credit channels. More recent ECB data indicate that conditions are improving somewhat. But confidence in the banking sector as well as the European economy is far from restored. As long as this remains the case, the problem of financial fragmentation in the euro area could continue to be a challenge, in spite of the de-

4 Basel Committee on Banking Supervision, "An Assessment of the long-term impact of stronger capital and liquidity requirements," Bank for International Settlements, August 2010, page 2, http://www.bis.org/publ/bcbs173.pdf (15 May 2014).

termined actions undertaken by the ECB intended to create more benign financial conditions.

Indeed, in the past years we have witnessed how a prolonged credit crunch can have a serious negative impact on the real economy, no matter whether its cause is a lack of demand or supply. In fact, the longer lasting the negative feedback loop between lack of credit and weak economic activity, the more irrelevant the root causes become. This was one of the central lessons that the post-Lehman Fed, led by Chairman Ben Bernanke, learned from the history of the Great Depression.

How to restore confidence

When the crisis erupted, the Fed first restored liquidity and tried to stabilize credit flows between banks and from credit institutions to the real economy. Most of the structural ills of the financial sector were only addressed when the heart of the financial system started to beat again.

But even before the comprehensive financial reform, known as the Dodd-Frank Act, became law in 2010, the Federal Reserve began to strengthen its oversight of the largest, most complex banking firms. In 2009, the Fed conducted the first stress tests of the largest nineteen U.S. bank holding companies. That test evolved into an annual exercise that now requires all bank holding companies with total assets of $50 billion or more to submit capital plans to the Federal Reserve. The Fed's stress tests greatly helped in restoring market confidence and eased the impaired interbank lending channel. But despite these efforts it took six years for traditional forms of lending to households and non-financial corporations to increase in the US. Thus, the real economy had to rely on alternative forms of funding.

In the EU a more robust banking sector should eventually emerge after the end of the comprehensive assessment of banks undertaken by the ECB and the European Banking Authority (EBA). But the end of the exercise and the work of the new single banking supervisor (SSM) should not be seen as a silver bullet able to restore robust credit flows immediately. The banking union and the ongoing overhaul of the European banking sector is primarily a medium to long-term goal. It will provide some additional glue needed to make the monetary union more resilient and result in a healthier banking sector, but only if it manages to address legacy issues that still weigh on the balance sheet of many credit institutions, loosens the link between banks and their sovereigns and is able to spur further integration of the European banking system. Just as was the case in the U.S. during the crisis, some consolidation will be inevita-

ble. As a consequence, the banking sector in Europe should shrink while some banks may well become even bigger, at least in relative terms. A smaller and more profitable banking sector could eventually help to support lending activities.

In the wake of the Lehman collapse, some 600 (mostly small) banks failed in the U.S. This had a negative impact on lending in local economies that suddenly saw some of their community banks disappear. In most European countries, only a negligible number of banks were resolved (with the notable, albeit belated, exception of Spain). Before morphing into a sovereign debt crisis, and despite various assurances that Europe's banks were on balance in much better shape than their American counterparts, Europe suffered from a deep banking crisis, amplified by the fact that the continent is "overbanked." Many European banks saw their NPL (non-performing loan) ratio grow steadily. This balance sheet deterioration put banks under strain, impaired loan origination, and therefore reduced the shock-absorbing capacity of banks. In some cases, banks even put off necessary balance sheet adjustments and instead tried to postpone loss recognition.

This behavior clearly exacerbated problems in the real economy. New activity did not replace non-viable businesses because of the inability of companies with a stronger business model to access funding to invest and expand. Non-viable businesses were artificially kept afloat by credit institutions that were reluctant to recognize losses.

In such an environment, capital markets can play an important stabilizing role, particularly when the downturn is steep. Unfortunately, as long as European capital markets primarily provide a funding platform for big, globally interconnected corporations, smaller non-financial corporations will continue to rely on traditional forms of lending.

Conclusion: Capital Markets may provide a way out, if this is allowed…

It is certainly true that developed capital markets played an important role in spreading the financial crisis in 2007-2008, which was triggered by asset-backed securities that were fundamentally mispriced and suddenly became illiquid. However, strong capital markets also helped the financial system and the economy in the U.S. recover much more quickly than in Europe once credit market liquidity was restored.

Of course in a prolonged low interest rate environment, very liquid capital markets can help to inflate asset bubbles, as Fed Chairwoman Janet Yellen recognized recently: "An extended period of low interest rates has the potential to induce in-

vestors to 'reach for yield' by taking on increased leverage, duration risk, or credit risk. Some reach-for-yield behavior may be evident, for example, in the lower-rated corporate debt markets, where issuance of syndicated leveraged loans and high-yield bonds has continued to expand briskly, spreads have continued to narrow, and underwriting standards have loosened further."[5]

Such developments need to be closely monitored by regulators and should, if necessary, be addressed with macroprudentioal tools. What matters in the context of this report, however, is the fact that while big global companies on both sides of the Atlantic have successfully tapped capital markets in past years, the funding for SMEs, particularly in parts of Europe which continue to depend on traditional forms of lending, remains very unsatisfactory. Investors have concentrated on a more limited pool of assets, a development that creates financial stability risks of its own.

In contrast, in one of the asset classes mentioned above, ABS, which is particularly important for the financing of SMEs, the outstanding amount is approximately €1500 billion, about one quarter the size of the ABS market in the U.S. Even in those European markets where tight credit conditions have not materialized, such as Germany, markets for securities issued by the so-called Mittelstand continue to play the role of an ugly duckling, as all too often SMEs that seek to tap into capital markets are perceived by the public as incapable of accessing traditional bank loans and therefore probably "unworthy" of credit.

The ECB is trying to offer a different narrative. It is encouraging a more robust securitization of assets by stressing that "in the current fragile macroeconomic environment, for example, high- quality ABS can support the transmission of accommodative monetary policy in conditions where the bank lending channel may otherwise be impaired. In particular, securitization may allow banks to lend without committing too much capital and other sources of funding, and thereby provide indirect market access to groups of borrowers that are otherwise not able to tap markets directly, such as SMEs."[6]

Of course, it is important to recognize that not all ABS are created equal and some should not get any preferential treatment. The ECB and Bank of England (BoE) encourage regulators to distinguish between "good" and "bad" ABS, i.e., those that are structured simply and pru-

5 Chair Janet L. Yellen, *"The Economic Outlook,"* Testimony Before the Joint Economic Committee, U.S. Congress, Washington, DC, 7 May 2014, http://www.federalreserve.gov/newsevents/testimony/yellen20140507a.htm (15 May 2014).

6 ECB, Bank of England, "The impaired EU securitization market: causes, roadblocks and how to deal with them," Paper prepared jointly by the Bank of England and ECB for the G20/IMF Spring meetings, 11 April 2014, page 2, <http://www.bankofengland.co.uk/publications/Pages/news/2014/070.aspx> (15 May 2014).

dently versus those that are much more complex and opaque.

One important aspect that needs to be stressed in this context is the fact that capital markets and banks are not two parallel universes, but rather closely intertwined. A stronger role for capital markets can help banks better manage their balance sheet and strengthen their profitability. Only certain types of banks—universal banks, in particular—also provide the necessary services needed to make the link between debt markets and clients work efficiently.

Despite ongoing and widespread criticism of big universal banks, and attempts to end the too big to fail syndrome, well capitalized universal banks can still offer some notable advantages, particularly the broad range of services that are particularly relevant for companies that operate in a global economy. In addition, universal banks tend to offer lower costs for consumers thanks to the cost synergies associated with economies of scale.

Finally, if well-capitalized, universal banks can be more stable than some of their smaller peers that are typically more narrowly specialized and rooted in a regional economic reality. Smaller banks are far more dependent on the ups and downs of a particular sector or their local clientele and economy, and can easily become systemic, as the recent crisis has shown, for example in Spain.

A strong link between banks and capital markets will be very important in the future. Much work has already been done to make the banking system safer, and the new regulatory environment is forcing banks to become more transparent. The approach by regulators that has primarily targeted bigger credit institutions in the aftermath of the crisis should probably be extended to some of the smaller banks, such as the German savings banks, whose weaknesses – extremely low profitability being one of them - are increasingly exposed by the low interest rate environment. Regulators are also starting to focus on the risks to financial stability posed by the so-called shadow-banking sector.

But the overhaul of the financial sector may not be sufficient to create a more benign environment for closer economic integration and stronger growth if political leaders remain trapped in largely national, or even nationalist, narratives. In fact, the debt crisis has placed an excessive burden on the European Council and exposed its institutional shortcomings as an effective crisis-fighting institution acting on behalf of the whole euro area. Because of its composition (made up of heads of government and state), the Council has had a hard time striking the right balance between national and European interests. It is therefore up to political leaders to create the conditions for a stronger euro zone. True financial integration is a necessary precondi-

tion, but it will prove to be insufficient and unsustainable if national political leaders remain reluctant to undertake bolder steps towards closer fiscal and political integration. If political leaders are tempted simply to ring-fence individual countries from the fallout of developments in other euro zone member nations, the euro zone will likely remain stuck in a no man's land, economically and politically vulnerable.