

# The Changing Financial Landscape

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# Major Cross-Currents

- Ongoing need for bank balance sheet repair (particularly in Europe)
- Regulatory pressure on banks to
  - Strengthen buffers
  - Constrain business models
- Shift from bank credit to market based intermediation
- Increasing share EDEs in global financial system

# Cross-Current 1: Balance Sheet Repair

- Many euro area periphery banks still grapple with
  - Elevated funding costs
  - Deteriorating asset quality
  - Weak profits
- Credit transmission remains weak
- Fragmentation between the core and periphery persists

# Cross-Current 2: Impact of Regulatory Reform

- Basel III capital, leverage, and liquidity rules:
  - Weigh on traditional bank-based intermediation
  - Discourage trading activities
  - Reduce total size of banking sector
- Business model restrictions:
  - Less complex, smaller institutions
  - Less interconnected

Both (and compensation rules): Favor shift towards shadow banking

# Drawn Out Adjustment Underway

- Gradual implementation regulatory reform agenda
- Crisis measures and accommodative policies delay adjustment
- Possible forbearance by banks
- AE banks:
  - Have increased capital ratios
  - Still have high leverage and reliance on wholesale funding in Europe
  - Are matching assets/liabilities country-by-country
  - Focus on less-capital-intensive, fewer business lines

# Cross-Current 3: From Bank Credit to Market Based Intermediation

Cyclical and structural forces at work

- Monetary policy easing in advanced economies is generating rebalancing of investor portfolios towards riskier assets:
  - Corporate bonds (investment grade and high yield)
  - Emerging market assets (in particular bonds)
- Partly replacing syndicated bank loans, reflecting (European) bank retrenchment

# Cross-Current 4: Much Larger Share EDEs in Global Financial System

- Expected much higher GDP growth
- Catch up in financial integration
  - Share of global banking assets expected to double to almost 45 percent in 2023
  - Domestic EDE banks will start overtaking global banks in size
- Increasing investment flows among EDEs

# Where Will It All Lead Us?

- Global expansion of the financial system due to EDEs (increasing “South-South” activity)
- Relative decline AE banks
- Changing operating model from global to local (matching local assets/liabilities)
- Shift to non-bank financial sector (shadow banking and securities markets)
- Challenges to international regulatory coordination
- Greater political involvement?