Economics
16 September 2010

Financial Markets Outlook

The forgotten financiers

The Basel Committee has agreed on stricter capital requirements for banks. It argues that the impact on the economy via bank lending should be limited. But banks account for only 22% of credit in the US and 44% in the eurozone. Since the behaviour of the remaining lenders is not well understood it is premature to conclude that the regulatory changes will result in greater stability in the financial system.

Last weekend, the Basel Committee on Banking Supervision agreed on higher capital requirements for banks. The Committee is to be commended for reaching an agreement fairly quickly. Negotiations for the preceding framework, Basel II, took a decade and singularly failed to stop the financial crisis. This time, an agreement has been reached in about a year. No small feat, given that 27 countries with diverse interests are involved—though maybe they realised the stakes were higher this time. The agreement, widely expected to be endorsed by the G20 in November, provides some much-needed clarity on regulatory capital requirements in the future.

Fig 1 Phasing in the new minimum capital ratios

(%)	2013	2014	2015	2016	2017	2018	2019
Common equity ratio	3.5	4.0	4.5	4.5	4.5	4.5	4.5
Capital conservation buffer				0.625	1.25	1.875	2.5
Common equity plus buffer	3.5	4.0	4.5	5.125	5.75	6.375	7.0
Tier 1	4.5	5.5	6.0	6.0	6.0	6.0	6.0
Total capital	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Total capital plus buffer		8.0	8.0	8.625	9.125	9.875	10.5

Source: Basel Committee on Banking Supervision

However, crucial elements are still unclear. Several issues seem to be left to national supervisory discretion. For example, the criteria for the calculation of the countercyclical capital buffer are not specified. While it is understandable that national regulators want to retain the freedom to tweak the regulatory framework to country-specific circumstances, it leaves markets uncertain about the exact capital requirements for individual banks. Systemically important banks also face higher demands, but neither the definition of systemic importance nor the additional requirements are specified at this point.

The gauging of the impact of these changes on the economy as a whole is far from clear. On the positive side, bigger safety cushions should lead to a lower incidence of financial crises, which is welfare-enhancing. Though the question remains, would the new enhanced capital requirements have been enough to significantly reduce the scale of the last crisis? Moreover, this enhanced safety has a price. As banks have to hold more capital relative to their outstanding loans, banking becomes more expensive. This translates into higher spreads charged on loans. As banks have to reduce their leverage, the volume of outstanding loans could also be curtailed.

It is therefore not surprising that policy-makers and the industry are at odds over the magnitude of the impact. The Basel Committee itself argues that the cumulative impact could be limited to half a percent of GDP. The IIF, on the other hand, thinks that the changed rules could shave off several percentage points of GDP. The number crunching is not over yet, and we will not dwell upon that here. Instead, we want to highlight another issue that is largely absent in the current debate. The Basel reforms only concern banks

Rate forecasts & market views

	3Q10	4Q10	1Q11	2Q11
ING forecasts				
US	0.0	0.0	0.0	0.0
EU13	1.0	1.0	1.0	1.0
JPN	0.1	0.1	0.1	0.1
Implied market rates (3mth strip)				
US	0.390	0.465	0.560	0.675
EU13	1.020	1.130	1.225	1.310
JPN	0.310	0.285	0.275	0.275

As at 1300 BST 16 September 2010

Source: Bloomberg, ING estimates

ING FX forecasts

	3Q10	4Q10	1Q11	2Q11
EUR/USD	1.30	1.30	1.32	1.35
USD/JPY	83	80	80	82
GBP/USD	1.57	1.57	1.55	1.53

Source: ING

Upcoming key events

20 Sep	US Oct NAHB Housing Market EU's Van Rompuy Gives Speech in Paris UK Aug Major Banks Mortgage Approvals Switzerland Sep KOF Institute Economic Forecasts
21 Sep	US FOMC Rate Decision US Aug Building Permits US Aug Housing Starts EU to propose overhaul of Budget France Aug PMI Services UK PSNCR Net Borrowing Canada Aug CPI Australia RBA Sep Minutes
22 Sep	Japan Jul All Industry Activity Eurozone Sep Consumer Conf BoE Sep MPC Minutes Canada Jul Retail Sales New Zealand 2Q10 GDP Iceland Sedlabanki Rate Norway Deposit Rate Russia Weekly CPI
23 Sep	US Sep Conference Board US Aug Existing Home Sales Eurozone PMIs Czech CNB 2Week Repo Rate Mexico Sep CPI
24 Sep	US Aug New Home Sales US Aug Durable Goods Orders Germany Sep IFO Mexico Overnight Rate

Source: Bloomberg, Reuters

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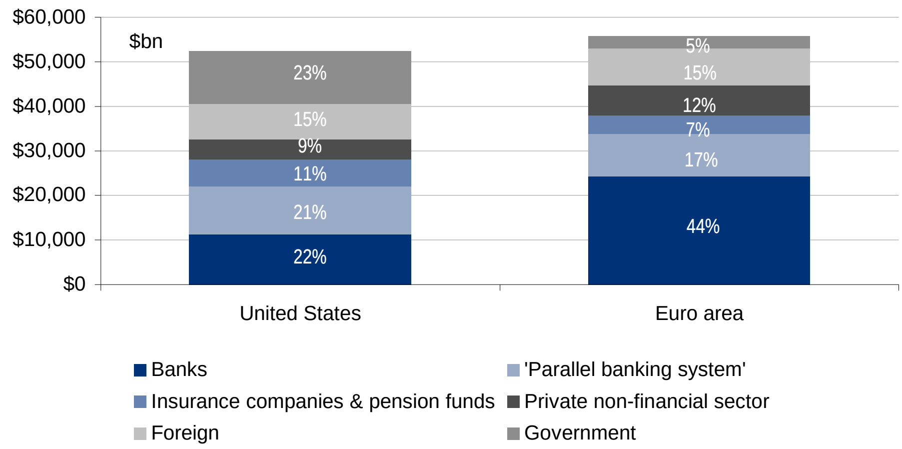
and bank lending. There are more lending institutions outside banks, however. The development of lending by non-banks may be more important for the economy in the coming years than developments in bank lending due to regulatory changes.

Fig 2 Total debt outstanding, by lender



Debt outstanding (debt securities and loans, 1Q10, US$bn), by lending sector. Percentages show sector share in total debt outstanding. Government includes the central bank and government-sponsored mortgage lenders. “Parallel banks” are other private financial institutions.

Source: EcoWin, ING calculations.

78% of US lending is not directly affected by bank regulation

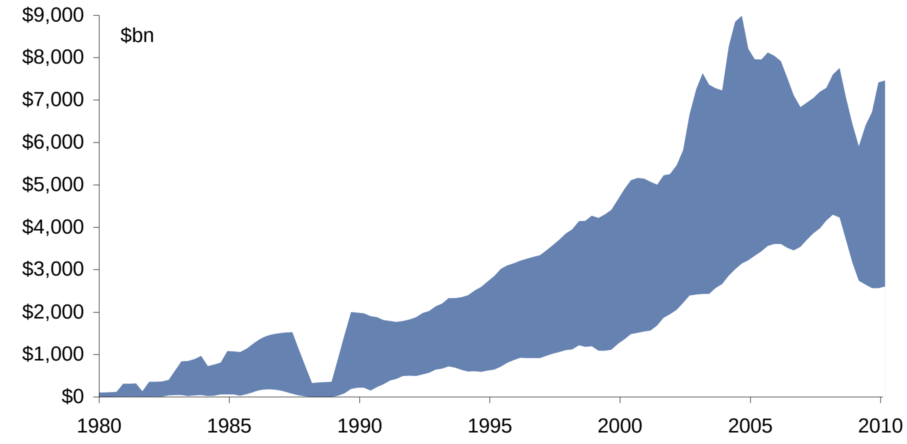
Figure 2 illustrates why. It shows that banks hold only 22% of all debt in the US: 78% of debt outstanding is not in the hands of banks, and is thus not affected by changes in bank regulation – at least, not directly. In the euro area, the banks’ share is twice as big, but banks still hold less than half of all debt. So while higher capital ratios will have an effect on bank lending, we cannot judge the effects on firms, households and the economy without taking into account other lending channels.

The first question is: Who are these – hopefully temporarily – forgotten financiers, the lenders outside the banks? The US government is an important player, holding and guaranteeing almost a quarter of all debt, mainly via its mortgage lenders Fannie Mae and Freddie Mac. The future of these two is as yet undecided. They could either be wound down, privatised, or fully nationalised. In the meantime, they keep absorbing large amounts of taxpayer money as the pipeline of losses accrues. In the euro area, the role of governments in mortgage financing is less explicit. And then there is a substantial but diverse group of other financial institutions in the lending business, which we together call the “parallel banking system”. This includes holdings of government and corporate bonds by mutual funds. It also includes securitised lending. Securitisation has been around for 40 years, being first used by the government-sponsored entities to securitise mortgages. Over the past decade, it evolved into ever more complicated products that were hardly known outside the investment banking world until the financial crisis struck in 2007.

Despite the importance of non-bank lending, data are still only scarcely available

The reality is that the rapid evolution of the parallel banking system has outpaced our ability to measure it, let alone understand or regulate it. In terms of understanding its impact on the broader economy, the numbers in Figure 2 are less useful, as they refer to total debt outstanding. A substantial part of debt is lending within the financial sector. This is especially true of the parallel banking sector, where financial flows typically pass through many intermediaries and thus lead to double counting. In fact, nobody knows for sure how much debt really is floating around in the parallel banking system. Take for example the US market for repurchase agreements (repo’s), an important source of short-term financing by financials. Based on the incomplete information that is available, the repo-market could currently be anything between US$2.5 trillion and US$8 trillion.

Fig 3 Estimated size of US repo-market



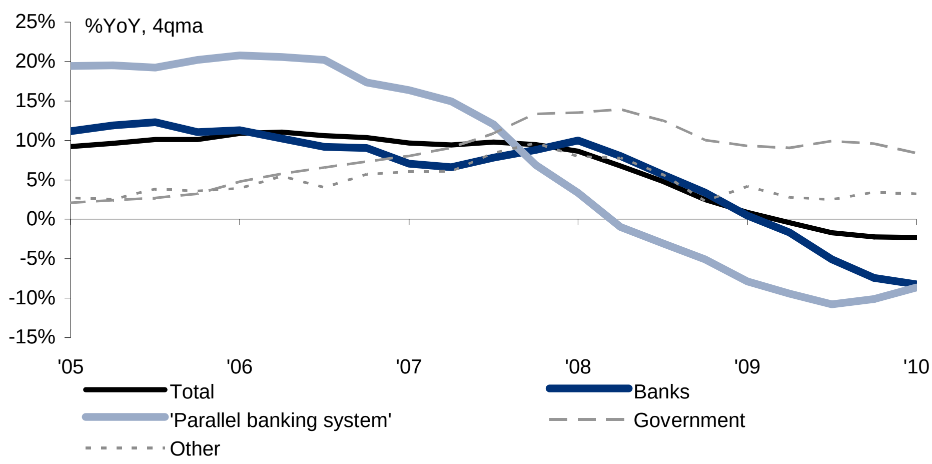
Shaded area shows range estimate. The lower bound of this range represents repo's outstanding at primary dealers only, as reported by the New York Fed. The upper bound reflects estimated repo's outstanding at all financials. To construct this estimate, we use the Fed's Flow of Funds, which contain data on net amounts outstanding. The ratio of net to gross amounts for primary dealers is known. The upper estimate is obtained by assuming the same ratio for other financials.

Source: EcoWin, ING calculations.

Parallel bank lending grew faster than bank lending in the run-up to the crisis…

The persistent lack of data is striking, given that we are already three years into the crisis. For now, we are primarily interested in final lending to households and non-financial businesses, as they are the main drivers of the economy. The government and the financial sector have a redistributing and facilitating role (at least, in theory). Based on the Federal Reserve's Flow of Funds data and a few additional assumptions, we can isolate funding flows to households and non-financial businesses in the US. The chart below shows that in the run-up to the crisis, the growth of lending by the parallel banking system was bigger than traditional bank lending growth.

Fig 4 Growth of lending to US domestic private non-financial sector, by lender



Net lending flows per sector (US$bn). 2010 covers 1Q only.

Source: EcoWin, ING calculations.

…and its subsequent collapse was more marked as well

Parallel bank lending collapsed in the early stages of the crisis in 2008 as securitisation of mortgages and other loans ground to a halt. Bank lending still increased at this time. In 2009 and 2010, bank and parallel bank lending shrunk together.

Given the substantial share of lending by the parallel banking system, this raises troubling, but unanswered, questions about the current debate on the financial system. In a post-crisis world, how much credit growth will be required to sustain growth? If bank credit growth falls short, will other sources fill the gap? In particular, will the parallel

The parallel bank system may well amplify contractions in bank lending

banking system cushion or amplify the effects of reduced bank lending? On the one hand, higher costs of bank lending will induce borrowers to look for other sources of finance. Corporates may tap capital markets directly. They did so in 2009, which saw record issuance in the US and Europe. Especially in Europe, there is scope for the share of capital market financing to increase. For corporates therefore, capital markets could cushion the impact of regulatory tightening. But the capital market is not accessible for small businesses and households. They often—but not always and necessarily—need a bank counter. One reason to suspect that the parallel banking system may amplify movements in bank lending, is the interconnectedness of the financial system. Financial flows move back and forth between banks, parallel bank institutions and other financials. A squeeze in one part of the system feeds through in the rest of the system, as the financial crisis has convincingly shown. Moreover, the parallel banking system does not consist solely of fully independent institutions. Traditional banks are major players in the parallel lending channel, either directly or via subsidiaries. This is even more true after the crisis, which has led to consolidation into even bigger financial conglomerates and to investment banks converting themselves into bank holding companies. So any rule changes affecting banks will both indirectly and directly also affect the parallel banking parts.

If left unattended, the parallel banking system could also remain a source of instability in the financial system

All in all, we think the new Basel agreement will have a small but non-negligible negative impact on the economy in the transition period. But while the debate currently focuses mostly on the possible effects on costs and quantity of bank lending, we will also pay close attention to the ease of lending via the parallel banking system. In our view, this parallel channel is at least as important for economic activity in the coming years as bank lending. Regulators are well advised to be on the alert as well. The parallel lending channel was in the epicentre of the current financial crisis. Basel III may make a repeat of the last crisis less likely, but it will intensify regulatory arbitrage. Together with financial flows, risks may shift from well-regulated banks to the least-patrolled areas of the financial system, including the scarcely visible and fragmented parallel banking system. The Dodd-Frank Bill in the US does give the Federal Reserve additional powers to supervise systemically important financials. Furthermore, there are initiatives to increase the transparency of derivatives trading. Nonetheless, this issue deserves far more attention in regulatory reform efforts worldwide. Otherwise Basel III could end up as the finger successfully plugged in the hole in the dyke, only to see the entire dyke overflown some time later.

Fig 5 Financial markets movements

	16/09/10	%WoW	%MoM
US 3-mth LIBOR	0.292	0.0	-7.7
US 2-year	0.483	-8.7	-5.0
US 10-year	2.723	-3.8	5.0
US 30-year	3.872	3.2	1.3
EU13 3-mth LIBOR	0.828	0.2	-0.4
2-year bund	0.751	5.1	9.6
10-year bund	2.404	6.8	1.1
Japan 3-mth LIBOR	0.240	0.000	-0.008
2-year JGB	0.140	0.000	-0.001
10-year JGB	1.051	10.6	6.1

As at 1300 BST, 16 September 2010

Source: Bloomberg, ING

Disclosures Appendix

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