Markus Demary

# The Case for Reviving Securitization

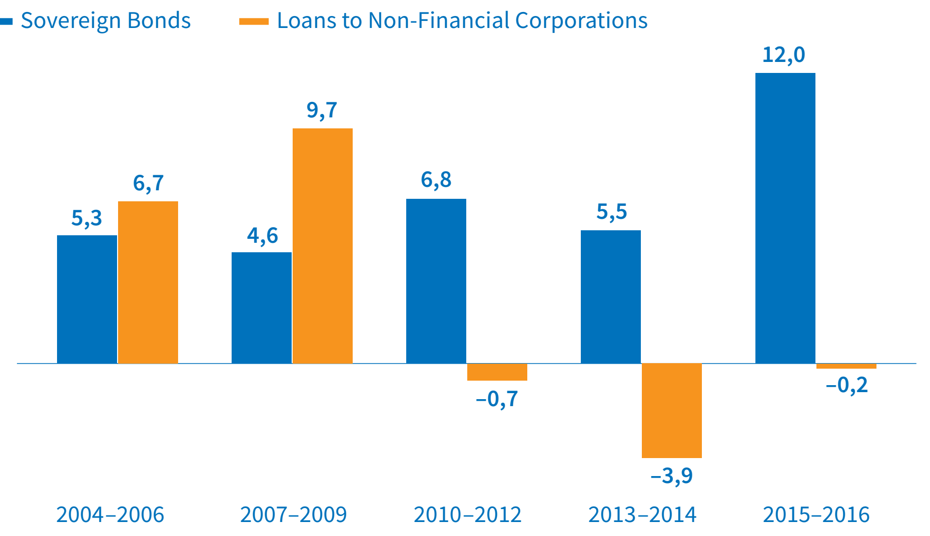
**European financial markets are still fragmented. A lack of cross-border lending and cross-border asset holdings hinders the financing of the economy, the conduct of monetary policy as well as cross-border risk-sharing against asymmetric shocks. Reviving the market for securitizations is vital for achieving these goals. A true European Capital Markets Union is needed, but there are still a lot of obstacles to overcome.**

Bank lending to the real economy has still not recovered from the financial crisis. This problem is pervasive since banks play a dominant role in the transmission of monetary policy in Europe. The relevance of the bank lending channel is based on the fact that about 80 percent of companies' debt financing is based on bank loans in Europe, while only 20 percent is based on the issuance of corporate bonds. Different from this is the US, where bond issuance sums up to nearly 90 percent of the US companies' debt financing. In short, the financial structure has important consequence for the transmission of monetary policy. While the US Federal Reserve Bank can target companies' funding conditions by influencing market-based reference rates via asset purchases, the European Central Bank (ECB) aims at influencing lending conditions via targeting banks' funding conditions. Despite the ECB's efforts, lending conditions are still fragmented in the Eurozone and cross-border lending and investment are still weak.

European banks recovered at a different pace from the last crisis, depending on the economic recovery of their home country and the efforts of their governments to recapitalize them. Bank supervision is highly relevant to the smooth functioning of monetary policy transmission in the Eurozone, where bank lending can become restrictive when banks need to achieve higher regulatory capital ratios. The reason why a credit rationing can happen in times of scarce equity capital is based on the fact that it is optional for banks, whether they achieve their capital ratios by an increase in the nominator or by a reduction in the denominator. For the increase in the nominator banks can either issue stocks or retain earnings. Since stock prices have plummeted for half of the systemically important banks in the Eurozone by more than 56 percent compared to their pre-crisis level, stock issuance is off the table for most of them, and the retention of profits, mainly interest rate income, is hampered by the persistent low interest rate environment. As a result, the reduction of risk-weigh-

**Banks' Exposures to Sovereign Bonds Are Way too High**

Average year-on-year growth rate, in percent




Source: European Central Bank, own calculations

Institut der deutschen Wirtschaft Köln

ted assets is the dominant way of increasing capital ratios, and that's why lending to businesses is currently tight in several Eurozone countries.

Under those circumstances the ECB is pushing a string. In addition to lowering the borrowing conditions for banks through the purchases of sovereign bonds and covered bonds, the ECB intends to incentivize banks to lend by means of a negative interest rate of currently -0.4 percent on banks' reserve holdings and by targeted longer-term refinancing operations (TLTROs), which allow banks to borrow at a negative, but not lower rate than -0.4 percent, if they have lent sufficiently to the economy. But the allotted amounts of the TLTROs were below expectations. Instead of lending to business and households, banks preferred to increase their exposures to sovereign debt (figure). In times of scarce equity capital, holding reserves at the ECB and holding sovereign debt become perfect substitutes, because both do not count as risk assets in banks' capital requirement regulation.

In November 2014 the ECB started its Asset-Backed Securities Purchase Program (ABSPP) in order to foster bank lending directly. Thereby banks could free equity capital for new lending by repackaging existing loans into asset-backed securities (ABS) which they could sell to the ECB. However, the outstanding amounts of ABS on the ECB's balance sheet summed up to only 20.1 bill. Euro in September 2016, which is tiny compared to the 223.5 bill. Euro of covered bonds and 1001.9 bill. Euro of sovereign bonds the ECB has purchased up to now. The ineffectiveness of the ABSPP lies in the fact that the ECB has only accepted ABS based on high quality loans. But it is the banks with high amounts of non-performing loans whose loan supply is weak. In short, incentives to sell high-quality loans were very small for those banks.

The European Commission is aware of companies funding problems and therefore launched the Capital Markets Union action plan last year. The aim of this action plan is to strengthen capital markets in Europe and to develop the EU's financing system further towards a more market-based system like the US has. One crisis lesson has been that companies with access to capital markets face less severe financing restrictions when banks got into distress compared to companies which rely predominantly on banks for financing.

Although the EU capital markets need to be developed further, bank financing remains extremely important since it is doubtful that European companies will loosen their reliance on banks and turn instantly to capital markets. Reasons are the following:

- The US has practically a two-tiered banking system since the Glass-Steagall Act in 1932. Due to a lack of universal banks, the financing of large investments needed the issuance of stocks or bonds. Other than in Europe, deep capital market have developed in the US long time ago.
- Deep capital markets need large investors. This is the case in the US, but in Europe only in Finland, the Netherlands or the United Kingdom, and outside the EU in Switzerland.
- Bond issuance might be unattractive for small and medium-sized enterprises due to fixed costs and minimum issue volumes.

For these reasons, a European Capital Markets Union has to connect the dots between bank financing and capital market financing.

The greatest potential in deepening capital markets is expected by a revival of securitization. In a securitization transaction the issuing bank sells a loan portfolio to a special purpose vehicle (SPV), which refinances itself through the issuance of bonds, i.e. ABS. Illiquid loans can thereby be transformed into liquid securities which can be purchased to capital market investors. Moreover, securitization can free bank capital which can be used for further lending to households and companies. Thereby, securitization can foster the loan availability especially for the bank-dependent small and medium-sized companies. In addition to that, credit risk can be distributed across different market participants and different regions by means of securitization, thereby fostering geographical risk-sharing and financial integration in Europe. Would the Italian banks have had securitized their loans in advance and sold the credit risk to a large investor base, this credit risk would have been more efficiently shared geographically. Thus, the Italian recession, which worsened the credit quality of Italian loans, would not have mainly hit the Italian banking sector.

The success of the Capital Market Union depends a lot on the revival of European securitizations. Although European ABS had lower default rates compared to their US-counterparts and did not experience the faulty practices which were applied in the US, investors lost confidence in European securitizations. The Commission's proposal for simple, transparent and standardized (STS) securitizations was intended to revive confidence in European securitizations, but the markets have still not revived yet. Practitioners refer to the high legal uncertainty about which securitizations qualify as STS. Moreover, STS are currently unattractive to investors, because the capital requirements for STS are too tight in relation to their default rates. Investors' demand for sovereign bonds with the same default rate as an STS-securitization is higher because of the lower capital requirement for sovereign bonds. In order to revive the market for securitizations, those distortions to investment decisions must be balanced out.

In short, a Capital Markets Union is needed to enhance financing the economy, improving monetary policy transmission and geographical risk sharing. Reviving the market for securitizations is vital for achieving these goals, because it connects the dots between the traditional European bank-based financial system with market-based financing. A prerequisite for European capital markets to evolve is a level-playing-field between sovereign bonds and other asset classes.