

## From the Investment Plan to the Capital Markets Union: European Financial Structure and Cross Border Risk-sharing

Jesper Berg, Laurent Clerc, Olivier Garnier,  
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### Highlights

- Investment needs to be revived in Europe, and adequate financing tools should be deployed to channel savings to the “right” places.
- This paper argues that the three key policy initiatives - Capital Markets Union, the Juncker Investment Plan and the ECB's asset purchases, could be combined to that aim.
- Our proposed strategy for the European financial structure is three-pronged. First, the traditional bank-based European structure should be preserved, however allowing for some disintermediation. Second, covered bond markets should be proactively developed to allow banks to outsource risk. Third, the European economy needs more, longer-term, risk takers.



## Abstract

Following the financial crisis, Europe is suffering from a significant investment deficit. It has long been appreciated that growth will suffer in Europe over the medium term unless the shortfall in investment is addressed, but considerable disagreement on how to achieve this, and in particular on the role public investment should play. In addition, mobilising finance to increase investment in Europe requires both a good understanding of Europe's financial structure, and a fine knowledge of the composition of cross-border financial imbalances. In this paper, we take stock of the state of play regarding investment, financial structures and cross-border imbalances. We contend that any initiative meant to provide a sound basis for long-term, stable investment flows has to acknowledge the fact that Europe is engaged in a debt-deflation deleveraging phase, with accompanying disintermediation, the full extent of which is as yet unknown.

We then draw policy conclusions that would allow for a sustainable investment revival, insisting on the need to have an overall strategic vision for the main EU policy initiatives - the Investment Plan, the Capital Markets Union, and the €1,100bn new money issued by the ECB within its Large Asset Purchase Programme

## Keywords

ECB, Capital Markets Union, Policy Strategy, Securitization, Covered Bonds, Financial Structure, Quantitative Easing, Cross-border Capital Flows, Public investment.

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RESEARCH AND EXPERTISE  
ON THE WORLD ECONOMY



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Jesper Berg, Laurent Clerc, Olivier Garnier, Erik Nielsen, Natacha Valla<sup>1</sup>

### 1. Introduction and overview

**To stimulate and finance investment in Europe the three “policy stars” of Europe need to be aligned.** These stars - the Capital Markets Union initiative, launched by the European Commission (CMU) in 2015, Mr Juncker’s €315bn Investment Plan, initiated autumn 2014, and the ECB’s €1,100bn asset purchase scheme, triggered in January 2015, face a unique set of issues. First, the resilience and the cyclical performance of the European bank based system needs to be improved. Second, the “right” markets need to be developed for monetary and financial institutions to outsource risks in a way that does not jeopardise financial stability. Third, cross-border risk-sharing urgently needs to be rebalanced, because it has become, in the wake of the Great Recession, overly reliant on debt instruments as opposed to equity.

**We believe that to achieve this alignment, there needs to be an overall strategic vision for the European financial structure that would form the bedrock for EU policy.** Synergies between initiatives - the flow of money expected from the Investment Plan, the structural and infrastructural improvements the CMU may generate, and the €1,100bn new money issued by the ECB - should be explicitly exploited. Our proposed strategy would be fourfold.

**First**, we believe it is neither feasible nor desirable to force a change from the traditional bank-based European financial structure to a fully-fledged US-like structure. However, more diversified financing sources, also leading to some disintermediation, should be envisaged. We see in particular great benefits from a more developed corporate bond market, and an improved SME access to equity markets. Our vision would therefore encompass a corporate bond market that is bigger and stronger, and would serve more structurally as a “spare” financing source when banks are under pressure.

**Second**, banks should have the proper means to outsource risk when needed, regardless of where they are located and without the help of central banks. The proactive development of covered bond markets in countries where they are still embryonic seems to us a promising approach. Market harmonisation is not necessarily a prerequisite. Instead, countries with embryonic covered bond markets should study best practices and adapt those that fit their

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circumstances, including general legal structures. Securitisation-like markets could be developed as well as an additional, temporary buffer to disencumber assets. To this respect, ‘untranching’ securities seem to be superior to traditional securitisation.

**Third**, the European economy needs more, longer-term, risk takers. This is because long-term potential growth would benefit, and because intra-European cross border financial flows as they currently stand nurture macroeconomic vulnerabilities. Regulatory constraints aside, we believe that the Investment Plan, the CMU and the ECB’s asset purchase programme should strongly focus on a bigger and deeper family of “equity-like” instruments rather than debt securities.

**Fourth**, the ECB’s comparative advantage in the financial field should be fully exploited in synergy with the Investment Plan and the CMU. This comparative advantage has two dimensions. The first is based on “know-how” and informational advantage. The ECB is better placed proactively to stimulate the development of certain markets (e.g., securitisation), and to become a nodal point in a value chain of “creditworthiness information”. The other dimension is related to the quantitative easing (QE) adopted in January 2015. The new money should be used in the best possible way, and it is not clear to us that creating €1,100bn to spend it primarily on sovereign debt is the best way. A more direct allocation of QE to the Investment Plan or to the real economy would square well with the needs of the European economy – and, as a matter of fact, with the ECB’s own mandate.

## **2. European investment: the diagnosis**

### **2.1. Deep investment deficit...**

Following the financial crisis, Europe is suffering from a significant investment deficit. While there may be some disagreement on the exact magnitude of this investment shortfall, the numbers are broadly as follows.

Since 2011, when significant fiscal cuts kicked in, public sector investment has dropped to less than 2.5% of euro area GDP, down from an average of about 4.5% during the previous 30 years. As a result, pent-up demand for public investment (that is, the difference between current levels as a proportion of GDP and pre-crisis average levels) is likely to be at least €190bn. The number is probably even higher because Germany’s net investment ratio was already comparatively low in the pre-crisis years (Fratzscher (2014)).

The private sector tapered down their investment activities earlier in the crisis than the public sector. Since 2008, private investment has fallen to below 19% of GDP, more than 3% points below its average over the previous 15 years. At face value, this difference suggests significant pent-up demand for private investment once there is an economic upturn. However, some pre-crisis private investments, e.g., house-building in Spain and Ireland, turned out to be unneeded, so the numbers probably overstate the shortfall. But even if we assume half of all private investment during the previous 15 years was unproductive (a highly

unlikely assumption), the private sector would still be facing pent-up demand of some €1.0-1.5 trillion.

It has long been appreciated that growth will suffer in Europe over the medium term unless the shortfall in investment is addressed, but considerable disagreement on how to achieve this, and in particular on the role public investment should play, has so far clouded much of the debate (IMF (2014)).

The two key arguments commonly put forward against an increase in public investment are: the public sector tends to waste the money; and, there is no fiscal room to do so. To put these arguments into perspective:

- Concerns as to whether the public sector is able to invest in an efficient way are fundamentally an argument for putting safeguards in place, not an argument about the level of public investment (Goulard and Monti (2014)).
- It is certainly true that most countries have excessive debt levels, but the very definition of an investment is an outlay with an expected positive financial return. The IMF has devoted considerable research to the issue of public investment and its effects, concluding that “public investment shocks have statistically significant and long-lasting effects on output (IMF (2014)). An unanticipated 1 percentage point of GDP increase in investment spending increases the level of output by about 0.4 percent in the same year and by 1.5 percent four years after the shock.” Meanwhile, Valla et al. (2014) find that fiscal multipliers on public investment spending are significantly above 1. After five years of severe under-investment, and at a time of record low funding costs and near-record unemployment levels, the claim that there is no room for additional public investment is a bold one.

But alongside public investment expenditure, Europe also needs a significant boost to private investment, and achieving this requires:

- The credible prospect of an increase in domestic demand
- The strengthening of pan-European market structures and infrastructure, together with an easing of regulations and other impediments to investment (wherever this does not jeopardise financial stability), to make the EU a destination of choice for EU and non EU private sector investment.
- Financing at affordable real rates. This relies on continued low funding rates for the financial system, a limit to the cost of intermediation and, perhaps even more importantly, policies that lift inflation expectations.

## **2.2. ... not helped by increased banking regulation ...**

Banks are increasingly feeling the impact of by tighter regulatory constraints. The regulatory response to the 2007 crisis has been to strengthen banks' capital and liquidity positions. In Europe, this has been enforced by the gradual implementation, starting in January 2014, of CRDIV and CRR (respectively the Fourth Capital Requirements Directive and the Capital Requirements Regulation), which also aim to limit the scope for maturity transformation and leverage. As a consequence, European banks have already made noticeable efforts to significantly improve their capital and financial positions, a process further fostered by the recent Asset Quality Review conducted by the ECB and the stress-test exercise carried out by the European Banking Agency (EBA).

Under this environment, European banks' deleveraging has accelerated over the past two years and has taken three main forms: recapitalisation; disposal of assets; and de-risking. So far, the bulk of the adjustment has relied on recapitalisation, mostly through retained earnings and less so by reduced lending. The regulatory framework, however, incentivises de-risking, that is the reduction of risk-weighted assets as a proportion of total assets, and entails a bias against long-term or SME financing, while favouring central bank's liquidity, cash and government debt. The liquidity ratios also encourage mortgages and securities trading portfolios. In addition, it should be noted that the global regulatory framework (Basel III, FSB proposals on OTC derivatives market and their European equivalents in CRDIV/CRR or EMIR) does not fully recognise, and even sometimes penalises, hedging, therefore adding an additional constraint on risky lending. This may explain why banks have been less willing to issue long-dated loans required for the build phases of larger projects.

Additional capital requirements and tighter supervisory and regulatory regimes may also contribute to tighter monetary conditions. In a world where the Modigliani-Miller theorem does not hold, variations in a bank's capital structure do affect its funding costs because of frictions that arise in the real world. On the one hand, higher capital requirements, by adding to the funding costs of banks, also add to the cost of banks transmitting money – possibly by a few percentage points. In a financial structure relying predominantly on banks (as we illustrate in section 3), this implies a cost on the non-financial sector as well. On the other hand, the steady-state costs of higher capital requirements might end up being low relative to more substantial longer terms benefits (Schanz et al. (2011), Admati et al (2013)). Taking those two arguments into account, while we remain agnostic on the longer-term trade off (short-term pain for long-term gain), we still consider that the higher capital requirements already applied (compounded by the ongoing uncertainty with respect to possible surcharges such as TLAC) have very likely caused a significant increase in the transmission cost.

## **2.3. ...and regulatory barriers to cross border flows**

Another impediment to the long-term financing of the European economy is the weakness of investment flows from long-term institutional investors owing to regulatory barriers. Despite considerable efforts by the EC, regulations differ considerably amongst European countries: in some countries, these effectively prevent institutional investors from investing in long-term

assets or restrict investment flows to long-term projects or infrastructure. Other barriers relate to the cost of setting up financial intermediaries, such as funds, or selling them cross-border. Diverging national conflict-of-law rules, insolvency regimes and tax regimes across Member States and on cross-border investments, as well as the different pieces of EU regulation for the providers of pensions add to the complexity and thereby the cost of the transmission of money to the real economy.

#### **2.4. Investment Plan on the table...**

On the back of the pressing investment needs, the long awaited Investment Plan for Europe was finally announced at the end of 2014. The three pronged strategy encompasses: (i) the creation of a Strategic Fund (the European Fund for Strategic Investment, or EFSI); (ii) a project pipeline; and (iii) the promise to take “measures” to create an investment friendly environment on the continent.

Mr Juncker deserves considerable credit for making a significant expansion in public and private investment (and the partnership between them) a cornerstone of his European Commission presidency. The Investment Plan, includes many of the components needed to address the severe investment shortfall in Europe, although, as we discuss below, a lot of the (vital) detail still needs to be hammered out.

#### **Not enough fresh public money, too much leverage?**

Out of the headline number of €315bn, only €8bn will actually be set aside by the Commission from the margins of the budget, to back up a €16bn guarantee, with an additional modest €5bn from the EIB. “Is that it?”, complain those who would have loved to see a massive financial involvement by the public sector. As a corollary, the foreseen leverage of the EFSI is often perceived to be excessive.

But it is not so much the lack of fresh public money that we find questionable as the failure to re-direct existing EU funds. The ‘Structural and Cohesion Funds’ are a good case in point: these have become sadly infamous for lacking strategic vision and their allocation is perceived as opaque and sub-optimal. Redirecting the money to the EFSI would have therefore made much good sense. Unfortunately, that option has been foregone (for now).

#### **Attracting investors will be challenging**

The plan’s stated objective is to mobilise (at least) €315bn by the end of 2017 to invest in the real economy. With an initial stake of €21bn, this corresponds to a leverage of 1:15. There is some doubt as to whether the mechanism will be able to seduce external investors to such an extent.

There are three ways in which the EFSI targets external investors: via levered funds co-invested in projects; as buyers of bonds issued by the EIB; and (this is key) as equity holders in the EFSI itself. Member states, National Promotional Banks, regional authorities and

private investors have all been invited to signal their interest, although the period for negotiation is not likely to last much beyond summer 2015, which given the number of details that still need to be clarified may be too short a timeframe.

But most EU Member States have little - if any - fiscal room to increase spending on public investment. And even though the Commission announced at the end of 2014 that it would treat government contributions to EFSI's capital favourably (the impact of contributions on a country's deficit will be ignored by the European Semester and the SGP procedure) (European Commission (2015)), there is still little hope that financially constrained states will be forthcoming with large sums. Of particular significance, therefore, are the three largest National Promotional Banks (NPBs): Germany's KfW; France's Caisse des Dépôts and Italy's Cassa dei Depositi. With balance sheets as big as 15-20% of their country's GDP, if they choose to invest, they have the fire-power to ensure the EFSI has enough cash to work effectively. Given this, it is regrettable that their role has not been more formalised.

**Table 1 - National Promotional Banks have huge financing capacity**

EUR bn (2012)	KfW	CDC	Cassa Depositi e Prestiti	ICO	European Investment Bank	Total
Country	Germany	France	Italy	Spain	EU*	
Balance sheet total (total assets)	511.6	393.7	328.5	115.2	567.8	1946.7
Total loans	118.5	155.9	240.8	46.2	293.4	870.4
Balance sheet/GDP	19%	21%	21%	11%	4%	15%
Total loans/GDP	4%	8%	15%	4%	2%	7%
Total loans/MFI	13%	20%	28%	6%	6%	19%
Loans to NFC						

Except MFI Loans to NFC for which the aggregate field is the euro area.

Source: Bloomberg, Annual Reports, Valla et al. (2014).

As for private investors – mostly pension funds, insurance companies, banks, asset managers – they will need to scrutinise carefully what has been put on the table. There are three key issues that still need to be clarified. First, the conditions under which public guarantees will be exerted. Second, whether or not the EIB would lose seniority. Third, the nature and conditions of the 'first loss' capacity within the fund.

### **The project pipe-line is too opaque**

The decision to ask member states to propose potential projects in advance has been controversial, and there is concern that the selection of projects will be too arbitrary and vulnerable to vested national political interests. To attract private investors, a transparent selection process, involving non-government agencies and experts, will be needed to ensure the process is politically independent and the projects chosen are financially viable and economically relevant. The CMU can play a role here by helping suitable projects to emerge.

### **Lack of detail on the removal of cross-border obstacles is of concern**

A key challenge for the Investment Plan will be its ability to boost long-term relevant, and pan-European, investments. Yet, the third pillar, the removal of the (deep) obstacles to cross-border investment, is the least defined part of the plan, and this is of considerable concern. More than twenty years of the single market have failed to create integrated and level playing fields in energy, transport, digital and telecommunications. And these areas are the most obvious candidates for investment under the Investment Plan. This is where synergy with the Capital Markets Union, together with other initiatives – such as the EC framework on long-term investment introduced in December 2014 (see European Commission (2015b)) could be instrumental in making the plan a success. One way this can be achieved is by emphasising the pivotal – but ambivalent - role of *public guarantees* in long-term financing and project funding.

We notice that the East European countries seem to have already understood what's at stake: the 'Visegrád Four' (Poland, Hungary, the Czech Republic and Slovakia) are already planning to interconnect their energy networks so as to speak with one voice to target EFSI funds. A lesson for their western neighbours!

### **A step in the right direction**

All of the above being said, however, the Investment Plan is a step in the right direction: the challenges now are to ensure it genuinely is able to bear risk and diversify away from loans (rather than becoming yet another risk-averse EU lending programme) and to address the broader issues facing cross-border investments.

### **2.5....Capital Markets Union in the making**

In the absence of detail in the Investment plan on how it intends to remove barriers to investment, we look at the role the Capital Markets Union (CMU) can play. The Capital Markets Union (CMU) is still in its infancy. However, in its 2015 Green Paper (EC(2015)), the Commission has suggested five key areas to prioritise.

1. Developing high quality securitisation to free up bank balance sheets to lend.
2. Reviewing the prospectus directive to make it easier for smaller firms to raise funding, including cross-border funding.
3. Improving the availability of credit information on SMEs.
4. Putting in place a pan European private placement regime.
5. Supporting the new European long-term investment funds.

As the Commission notes, many of the initiatives necessary to promote capital markets financing touch on very sensitive issues related to creditor and shareholder protection, including property, contract, corporate and insolvency law. Clearly, harmonising national law in these areas is not a realistic plan. However, Europe has for centuries thrived by allowing competition among political and business models, making it possible for countries to pick the best practices and improve on them. The Commission could instead of harmonising, choose to serve as a hub for information and discussion in order to facilitate countries being inspired by each other.

## **2.6. ...ECB asset purchase programme underway**

The third of the big three policy stars, the ECB's €1100bn Public Sector Purchase programme (PSPP) is underway. The structure of assets that can be purchased (i.e., quantities, issuer country) has been defined in quite precise terms. But the advantages of "conventional" sovereign purchases appear to be fairly limited. Sovereign yields were already low when the PSPP was launched, sovereign interest rate spreads were very compressed (in February 2015, Portuguese bond yields were lower than those on US public debt of comparable maturities), and many sovereign debt markets are expected to end up in negative net supply territory once the ECB purchases have been conducted. All these factors are expected to make these purchases difficult to conduct and likely to distort bond prices, already very high, even further. As we discuss in the Policies Priorities section below, there is a strong argument for broadening the range of assets included in the PSPP.

## **3. The European financial structure: the diagnosis**

Mobilizing finance to increase investment in Europe requires a good understanding of Europe's financial structure. In this section, we contend that any initiative meant to provide a sound basis for long-term, stable investment flows has to acknowledge the fact that (i) Europe is engaged in a debt-deflation deleveraging phase, with (ii) accompanying disintermediation, the full extent of which is as yet unknown. In this context, we argue that allowing MFIs to outsource risk (covered bonds and securitization) will be a key factor for any initiative to successfully finance investment.

### **3.1. A bank-centric system**

#### **The financing of the European economy is mostly through debt**

The European financial system is bank-centric as opposed to the US's capital markets-centric structure. In the EU, banks' balance sheets total more than 300% of GDP, whereas in the US they come to less than 100% (see Table 2). Recognition of this fact is key to ensuring the success of the Investment Plan and other initiatives to kick-start investments in the EU through an easing of financing conditions. Longer-term initiatives, such as the CMU, should also take full note of this.

**Table 2 - Financial balances of the euro area and US banking sector as of March 2014**  
(Percent of GDP)

	EU18		US	
	Assets	Liabilities	Assets	Liabilities
Deposits	97%	232%	17%	73%
Bonds	69%	49%	21%	4%
Loans	132%	0%	50%	0%
Shares and other equity	21%	29%	2%	1%
Other	11%	11%	5%	15%
Total	330%	321%	95%	98%

Source: European Central Bank and Federal Reserve

The debt financing of non-financial corporates in Europe is dominated by bank loans, whereas in the US corporate bonds are of almost as much importance as loans (see Figure 1). It is interesting to observe that corporate bond issuance in the US increased in the most critical phase of the financial crisis, making up for the fall in corporate loans (see Figure 2).

*(Chart 1a+1b about here – the two charts next to each other)*

*(Chart 2a+2b about here – the two charts next to each other)*

*(Source: ECB and FED)*

However, the composition of corporate debt between bank and other sources of finance has been shown to be time-varying (Adrian et al. (2012), Becker and Ivashina (2014)). In hard times, the issuance of market debt helps firms to mitigate the contraction in the supply of bank debt by troubled banks (Allard and Blavy (2011)). In addition, economies with high bond share and significant bond-loan substitution recover from recessions faster (Grjebine et al. (2014), see chart XO). This seems to us a desirable property.

*Chart XO: Economies with a high substitutability of bank and bond financing recover faster*

*Source: CEPII – Grjebine et al. (2014)*

*[Insert Chart XO here]*

### **Securitisation and equity still relatively small scale**

Securitisation has also never reached the scale in the EU as in the US. In ECB statistics, securitisation is included in what is called ‘issuance by financial institutions other than MFIs’. Even if we use all of this as a proxy for securitisation, the numbers – although they have grown – are small compared to the US as well as to euro area bank financing (see Figure 3).

*(Chart 3 about here)*

*(Source: ECB)*

Equity financing in the EU at first sight looks considerable, but in terms of new external financing it is tiny. Equity financing is by far the largest liability on the aggregated balance sheet of EU non-financial corporations, but net new equity issuance is very limited, cf. table 3 and chart 4. The apparent paradox is explained by the fact that equity financing primarily comes from retained earnings and valuation adjustments. The pegging order of capital holds,

i.e., corporates finance themselves first from their own earnings, second from bank loans, third from corporate bonds, and last through public equity offerings.

**Table 3 - Financial balances of Euro area non-financial corporates as of March 2014**

(Percent of GDP)

	EU18	
	Assets	Liabilities
Deposits	22%	0%
Bonds	3%	12%
Loans	32%	89%
Shares and other equity	95%	161%
Other	41%	39%

Source: European Central Bank and Federal Reserve

*(Chart 4 about here)*

*(Source: ECB and FED)*

Given all of the above, Europe is likely to suffer much more than the US from the process of bank disintermediation, a process which is likely to continue over a good number of years. New players have emerged and will continue to do so, and this should be encouraged, but it is unlikely that they can make up for the loss of bank financing, at least in the medium term.

### **Europe's financial model reflects its corporate structure**

The financial structure of Europe reflects the underlying economic structure as well as the institutional framework, such as the legal system. We cannot, therefore, impose a US financial structure on Europe and expect the European economy suddenly to behave like the US economy. Even if we could, some would argue that the US financial structure is not the ultimate state of financial development. Allen and Gale(2001) gives much credit to the European relationship banking model and La Porta et al (1998) has shown the link between underlying legal traditions, in terms of creditor protection vs. shareholder protection, and whether countries have a bank based or capital markets based financial system. We should also not forget that securitisation played a less than honourable role in the start of the financial crisis.

The most important structural feature in determining the best fit of financial system is probably the corporate structure. Europe is characterised by more small and medium sized enterprises (SMEs) than the US (see Figure 5). Access to capital markets requires scale and SMEs do not have scale. There are high fixed costs to accessing capital markets. For corporates these relate to both the initial documentation and the ongoing costs of observing reporting obligations. For investors there are higher costs per invested euro in understanding an SME compared with a larger corporate.

*(Chart 5 about here) –*

*Note: An SME is defined as an enterprise with 249 employees or fewer.*

*Source: European Commission*

Furthermore, SMEs rarely have the same internal financial expertise as large corporates and therefore depend on banks to provide a degree of corporate governance. This is probably one of the most important benefits of relationship banking. Banks have both the incentive (as the most important suppliers of external financing) and the information (access to the SME's current accounts) to fulfil this role.

### 3.2. The strengths and weaknesses of covered bonds

Is there then no help that financial engineering can provide to ease financing conditions in Europe? There is one financial instrument that is truly European and has been remarkably successful in some countries in providing additional external financing. That instrument is covered bonds.

Covered bonds are to banks what securitisations are to capital markets. Covered bonds are claims on a bank, or other MFI, that are secured by a loan pool, typically mortgages, that in turn are secured both by the capacity of the ultimate borrower to pay and the value of the underlying collateral, typically a house. Covered bonds are strictly regulated, for example in relation to LTV and ALM making them very safe instruments compared to the more chequered history of securitisations. Furthermore, the fact that the issuer has full exposure to credit risks eliminates "the originate to distribute" principal agent problem, and ensures that the corporate governance features of relationship lending can be maintained.

#### Covered bond markets are heterogeneously developed in Europe

The covered bond market in Europe is large, but its importance across countries differs (see Figure 6). The legal constructions differ depending *inter alia* on national insolvency law and tax law. While these differences could give rise to EU calls for harmonisation, this would likely be very destructive as, at worst, it would endanger the possibility of issuing the instruments in certain countries and, at best, be a clumsy and indirect way of harmonising fundamental national legislation. We do note, however, that the way repossessions on mortgaged properties are treated will have a significant impact on each nation's ability to develop covered bonds: in some countries repossessions take less than six months while in others they take more than five years or are politically unacceptable. While repossessions can have problematic social consequences, without recourse to timely repossession, the collateral value of a property is limited and the robustness of the covered bond system weakened. It is thus a national political choice as to the trade-off between developing a covered bond system and accepting repossessions.

*(Chart 6 about here)*

*(Source: European Mortgage Federation)*

In some countries, covered bonds are primarily issued by specialised non-deposit taking institutions, while in other countries banks are the issuers. Issuance by non-deposit taking institutions has the advantage that difficult issues in relation to the structural subordination of depositors are avoided, cf. Berg and Bentzen (2014). However, some of the advantages of

relationship banking can be lost. The optimal structure could be a narrow banking structure with both a covered bond funded entity and a narrow bank. cf. chart 7.

*(Chart 7 about here)*

Denmark is the country in Europe where covered bonds play the largest role in relative terms, and its experience during the financial crisis is illuminating. In Denmark, covered bonds are mostly issued out of specialised institutions that in various ways are part of bank holding structures. Covered bonds finance more than 60 pct. of all credit in Denmark, and unlike credit from banks, covered bond financing increased steadily during the financial crisis, cf. chart 8.

In Germany, covered bonds also finance loans to public authorities. In Germany, there was also recently an innovative covered-bond-like structure, which financed commercial lending without real estate as collateral.<sup>2</sup>

*(Chart 8 about here)*

*(Source: Statistics Denmark)*

### **The “cost” of covered bonds has evolved with their regulatory treatment**

The regulatory treatment of covered bonds has evolved over time. Historically, covered bonds were more expensive as a source of finance in terms of capital than securitisations, but this is no longer the case. As the assets backing the covered bonds remain on the balance sheet of the banks, there is no capital relief, and covered bonds are thus purely a source of funding. However, following the financial crisis the requirements for “skin in the game” in relation to securitisations, imply that securitisations generate little capital relief.

Provided that they fulfil a number of specific criteria, covered bonds benefit from a preferential regulatory treatment implying that institutions investing in those bonds may seek preferential risk weight treatment on their portfolios (see for example EBA (2012) and EBA (2014) for details about the regulatory and supervisory perspectives on covered bonds). The rationale behind a preferential treatment of covered bonds is manifold, as suggested above, but it was overall spurred by their overall positive track record, ie the absence of default event on such instruments. The specifics of covered bonds within the Juncker Plan

There should be scope for using some of the funds from the Investment Plan to guarantee loans going into covered bond-like structures. One possibility is to raise the maximum LTV through the use of EU guarantees for more than the current LTV limit. Another possibility is to use the guarantees to make funding possible for immaterial assets either through covered bonds or covered bond-like structures. This would also allow companies without fixed assets to benefit from covered bond structures.

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[https://www.commerzbank.de/en/hauptnavigation/aktionaere/informationen\\_f\\_r\\_fremdkapitalgeber/emissionsprogramme/sme\\_structured\\_covered\\_bond\\_programme/sme\\_programm.html](https://www.commerzbank.de/en/hauptnavigation/aktionaere/informationen_f_r_fremdkapitalgeber/emissionsprogramme/sme_structured_covered_bond_programme/sme_programm.html)

The advantage of using covered bond or covered bond-like structures compared to capital market instruments is that the banks or bank-like institutions that issue them involve themselves in the day-to-day monitoring and governance of the SMEs that are the backbone of the European economy. The advantage of using covered bonds or covered bond-like structures relative to traditional bank finance is that longer-term financing can be generated without the risks traditionally involved in maturity transformation, and liquidity constraints are reduced. Moreover, covered bonds have already proved themselves to be an instrument that works in many countries in Europe.

On a longer-term perspective, we are likely to see a significant shift in the structure of financial intermediation in Europe. Many countries in Europe still have underdeveloped pension systems. The exceptions are mostly found in Northwest Europe (see Figure 8). Pension obligations in most countries are not sufficiently funded. As pension savings move out of government sphere, we will see an increase in savings going into pension funds, and probably a decrease in bank deposits. The challenge in financial intermediation will be to ensure that the pension funds can contribute to the financing of European corporates and households. Pension funds are not as close to those in need of financing as banks and also typically are less skilled in making credit decisions.

*(Chart 9 about here)*

*(Note: Data as of end 2013) (Source: OECD)*

Covered bonds could serve a useful purpose in such a scenario. Covered bonds are long-term assets that fit better into the maturity preferences of pension funds than those of banks. The high credit quality of covered bonds is also a good fit for pension funds.

It is interesting to note that, well before announcing, and then implementing the Public Sector Purchase Programme (PSPP) in March 2015, the ECB embarked on a series of Covered Bonds Purchase Programmes: the CBPP which launched in 2009 and ended in June 2010; the CBPP2, launched in 2001 and ended in October 2012; and the CBPP3, launched in September 2014. These programmes were well intended, but as of end 2014 they had failed to raise sufficient volumes to generate a sufficient quantity of liquidity. To give an order of magnitude, the outstanding amounts of covered bonds standing on the Eurosystem balance sheet were (as of February 2015): €26bn (CBPP); €11bn (CBPP2); and €51bn (CBPP3). These programmes might stimulate the development of covered bond markets by mechanically creating demand for those assets, but they could also affect, even temporarily, their liquidity.

### **3.3. Securitisation and the merits of untranch securities**

The financial crisis clearly illustrated the vulnerabilities of the complex and opaque securitisation markets, and, more generally, of the off-balance-sheet model of financing that developed and prevailed in the United States. The CMU's stance on securitisation resembles a high wire act. On the one hand, securitisations have been strictly regulated following the financial crisis. On the other hand, as the Commission is well aware, securitisations would help generate credit, either directly or by relieving banks' balance sheets.

### **The solution may lie in developing “high quality securitisation”.**

We see indisputable merits to the development of what is now generally referred to as “high quality securitisation”. The idea being that in the future, securitisation markets would support financial stability rather than pose a risk to it. A lot has been written already about how this could be achieved (see, e.g., Segoviano et al. (2015), EBA (2014)). Commonly cited criteria for a high quality securitisation market are:

- first and foremost, high quality underlying loan origination practices;
- transparent, straightforward-to-value structures;
- a securitisation chain where legal ambiguities are eliminated – for example with the use of loan registers (see Kromann Reumert (2014));
- a secure, transparent, and cost-effective transfer of claims on collateral.

But securitisations are legally defined as tranching securities, where the different tranches take different degrees of risks. Securities that finance a pool of loans, but where there are no risk tranches, are not considered securitisations. They are therefore not subject to the same draconian regulations, including prohibitive capital requirements for the issuer. Untranching securities could, therefore, even within the present regulatory regime, offer some possibilities.

### **Existing initiatives in untranching securities already meeting success**

The attractiveness of untranching securities is illustrated by a number of government or central bank sponsored initiatives that are already meeting success. One example is the French scheme sponsored by the Banque de France (see FBF (2014)). Euro Secured Notes (ESN – see Box 2), as they are called, are based on bank loans to SMEs that meet the eligibility criteria for Eurosystem refinancing operations. In turn, the financial instruments issued may be used as collateral by those who buy them. The underlying assets (private loans) remain managed by the banking groups that granted them and the securities cannot be issued in tranches. The ESN do however suffer from certain key handicaps. In particular, they do not fulfil the prudential definition of securitisation. Not being off balance sheet, they do not free up bank assets and contribute to encumbering banks’ balance sheets. But these shortcomings would be alleviated if the ECB allowed ESN to be eligible to open market operations. And, more importantly, such securities have desirable properties sought by both the CMU and the Investment Plan. They give liquidity to financing granted to SMEs and mid-caps. They are a first step towards creating a new, liquid, collateral, whose quality should be high because the quality of the loans is counterchecked against the credit information held at the central bank (the French FIBEN database).

For both tranching and untranching securities there are a number of other legal issues that need to be considered. These include making sure that assets sold actually legally represent a true sale and preventing ‘free riders’ taking advantage of collective action by creditors. Securitisation registers in Germany and Denmark offer a solution to the first problem,

whereas the Norwegian trustee arrangement is a fairly inexpensive way to deal with free rider problems.

To sum-up, while we can see the potential benefits of securitisation, there are still some open questions over its comeback. How can credit assessments on the underlying loans be successfully managed? What are the implications of capital charges and eligibility criteria on the development of securitisation markets?

#### **4. Cross-border risk sharing in Europe: the diagnosis**

Europe as a whole is suffering not only from a large investment deficit, but also from adverse cross-country funding mismatches.

##### **Reliance on debt instruments is excessive**

The first mismatch is geographical: savings surpluses and investment deficits are distributed unequally across countries. On the one hand, Northern European countries (Germany the Netherlands, Sweden, Denmark) have high gross national saving ratios (above 25% of GDP in 2014) which structurally exceed their investment needs, even at full employment. On the other hand, most euro area crisis countries suffer from structural deficits in domestic savings (with gross national saving ratios below 20% of GDP in 2014, and even below 10% of GDP in Greece and Cyprus). Consequently, the recent rebalancing of their current accounts has required a dramatic contraction in domestic investment spending.

In theory, with free capital mobility, geographical savings/investment mismatches should not matter too much. This should be even more true within a monetary union. However, intra-euro-area current account imbalances do continue to matter due to a composition mismatch: during the pre-crisis years, the external funding of the investment boom in the euro area periphery quasi-exclusively relied on debt flows from core countries (primarily through bond purchases and inter-bank lending) as opposed to direct and portfolio equity investment (see table below). This reflects the behavioural biases of both groups of countries. In periphery countries, policy-makers have been more prone to protect and promote their 'national champions' than to attract foreign equity capital. In core countries, and especially in Germany which is the largest contributor to the overall savings surplus, savers are averse to equity investments, preferring to put their savings into bank accounts or life insurance (which invest predominantly in debt instruments).

**Net Financial Flows from the Core Countries to the Peripheral Countries of the Euro Area**  
Annual Average 2004-2006 (EUR bn)

<b>Net Debt (portfolio debt + other investment)</b>	<b>138</b>
<b>Net Equity (direct investment + portfolio equity)</b>	<b>-10</b>
<b>Total</b>	<b>128</b>

*Core countries: AT, BE, DE, FR, FI, LU, NL*

*Peripheral countries: CY, EE, EL, ES, IE, IT, MT, PT, SI, SK,*

*Source: European Commission*

### **The lack of cross border equity induces vulnerabilities**

This excessive reliance on cross-country debt flows has had several adverse implications.

First, it has made euro area economies more vulnerable to liquidity strains and ‘sudden stops’ in the financing of their current account imbalances. It has also exacerbated the domestic credit boom-bust in periphery economies.

Second, while financial integration is usually expected to enhance cross-country risk-sharing, it has had the opposite effect within the euro area owing to the lack of cross-border equity investment. As a result, the euro area is now excessively dependent upon mutualisation mechanisms through fiscal backstops (EFSF/ESM) and the Eurosystem balance sheet, which have a limited capacity in the absence of fiscal union. Since a genuine fiscal union is unlikely to be established in the foreseeable future, it would thus be desirable to enhance market-based risk-sharing through equity capital markets. It is worth noting that in large federations such as the US or Germany, the federal budget is neither the sole nor even the main channel of risk-sharing among states. Indeed, according to empirical studies, the largest absorber against state-specific shocks is cross-ownership of equity capital, far ahead of the federal tax-transfer system<sup>3</sup>.

### **Savings-investment mismatches are being perpetuated**

Last but not least, inadequate and incomplete financial integration solely through debt markets has ultimately resulted in renewed fragmentation along national borders, thus perpetuating savings-investment mismatches. This is counterproductive for both periphery and core economies. On the one hand, periphery economies are still too highly leveraged,

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3 For the US, see Asdrubali, Sorensen et Yosha : « Channels of interstate risk sharing : United States 1963-1990 », Quarterly Journal of Economics, Vol 111, 1996. For Germany, see Hepp and von Hagen: “Interstate risk-sharing in Germany: 1970-2006”, Oxford Economic Papers, Oxford University Press, vol. 65(1), pages 1-24, January 2013

and their banks and companies primarily need equity financing. On the other hand, savers in 'surplus' countries have kept their strong preference for investing in debt or deposit instruments. In Germany, for example, private savings have stopped financing periphery debt and the bulk of savings stand idle in domestic bank deposit accounts (an amount which exceeds €3trn). As a result, German savers now earn zero nominal returns on their savings while as taxpayers they remain substantially exposed to peripheral credit risk through the Bundesbank's Target2 claims on the Eurosystem. Converting these excess savings into equity investment abroad would be a 'win-win' solution: it would improve the risk-reward trade-off for German savers, while enhancing investment and growth prospects in the periphery.

It is thus important to promote genuine and complete financial integration by encouraging cross-border direct and portfolio equity investment. In theory, this process should take place spontaneously through market mechanisms. In peripheral economies, the fall in equity prices combined with the ongoing downward adjustment in unit labour costs should create attractive investment opportunities for core country companies and investors. In practice however, this process is hindered by political, regulatory and economic obstacles both in the periphery and in the core. Therefore, more centralised solutions combining private and public funds are necessary, at least as catalysts in the initial stage of this process.

### **A rebalancing of cross border flows should result from the Investment Plan**

Against this backdrop, the Investment Plan is welcome. As a pan-European investment vehicle combining public and private money, it can play the role of catalyst by financing cross border investments. However, there are some caveats. First, as we have already stated, there is a risk that member states will be reluctant to invest their own public money in the capital of the EFSI despite the favourable treatment of these contributions under the Stability and Growth Pact. National authorities (directly or through their National Promotional Banks) are likely to prefer to participate in the Plan by co-financing domestic projects alongside the EFSI/EIB, in order to ensure that national taxpayers' money is targeted on the financing of national investment. Second, there is a danger the Investment Plan will concentrate solely on debt financing, but many European companies remain too leveraged, and what they primarily need is new equity.

On a longer term horizon, the Capital Market Union (CMU) project should also play a key role in enhancing cross-country risk-sharing through equity markets. However, here again there is a caveat. The preliminary discussions on CMU appear to focus more on disintermediating credit markets than on integrating capital markets and removing barriers to cross-border ownership of equity capital.

## **5. Aligning the stars: policy priorities**

The "stars" to be aligned are the three big European economic initiatives currently in place – the Investment Plan, the CMU and the ECB's €1100bn QE programme. These should foster

short and long-term growth and ultimately create jobs and improve well-being, by improving the resilience and reliability of the supply of credit to the real economy. But as we highlight below, in isolation these initiatives will not be enough: an holistic approach is needed to create and exploit synergies between them.

### **5.1. Formulate an holistic strategy for the CMU, Investment Plan and the ECB**

We see the involvement of the ECB as being indispensable to the success of the Investment Plan and CMU. This should not be an issue as the objectives of the Investment plan and CMU are in line with the Eurosystem's own mandates and objectives, creating the opportunity for synergies to be exploited. We can see this interdependency at work if we look at the need for greater diversification of funding sources for corporates: one of the CMU's main stated objectives.

As the crisis has shown, the bank-centric financial structure of the European economy, is not only an issue for corporate funding during a time of pressure on the banks, but is also problematic for monetary policy transmission. This is in part what the ECB has tried to address with its QE programme. Greater diversification of funding sources for corporates would thus not just contribute to improving the investment environment, but would also improve general financial stability and help restore the impaired monetary policy transmission mechanism; both areas that fall under the mandates of the Eurosystem. There is therefore a strong case for greater, hands-on, involvement by the ECB in promoting more diversified funding sources to the real economy. As we shall argue, ECB involvement is justified not only in the development of covered bonds and securitisation markets, but also in venture capital, private equity and private placement opportunities.

To reiterate, if the three policy initiatives are taken in isolation, valuable firepower would be foregone. Ideally, synergies would be enhanced by formulating an explicit, holistic strategy, ensuring that the instruments intended to generate the leveraging in the Investment Plan receive appropriate treatment in the regulatory context of the CMU and in the ECB's QE program and collateral framework (albeit without crossing the line into monetary financing or preferential treatment).

### **5.2. Incentivise public investment**

To restore public investment to levels that enhance long-term growth, governments should be encouraged to reverse recent trends and boost their public investment budgets. The European Commission has understood this need and has announced that member states' contributions to EFSI will not be counted when deficits are assessed for compliance with EU budget rules (under either the preventive or corrective arm of the stability and growth pact), and, moreover, that the "investment clause" will allow for temporary deviations from agreed fiscal adjustment targets to accommodate these contributions (see European Commission (2015)). This preferential treatment will not necessitate any changes to the existing rules, which is probably just as well as the outcome of taking legislative steps would not be guaranteed, whereas now the new guidance will be applied immediately.

However, we consider that *governance shortcomings* have not been addressed: nothing has been said about rules guiding new public investment decisions. There is a strong case for imposing stricter disciplinary measures when it comes to investing taxpayers money to ensure mistakes of the past are not repeated (when public money was wasted on, for example, dubious roundabouts in France). These are currently still missing from the Investment Plan.

### **5.3. Formally involve NPBs in the EFSI**

Another way to restore public investment in a way that is compatible with good governance is through a coordinated expansion of the NPBs' activities. The Investment Plan offers a unique opportunity to do this with a Europe-wide, rather than national, vision in mind. NPBs have better local knowledge than the EIB and the combined balance sheet of just the four largest development banks (i.e., KfW, Cassa dei Depositi, CDC and ICO) amounts to some €1.2 trillion, which is more than twice the size of the EIB. A natural route would be to organise, around the EFSI, a Eurosystem of NPBs (Valla et al (2014)). The system would have the capacity to channel the euro area's excess savings towards investment in the right places throughout the continent. To do so in an economically sustainable and financially profitable way, funding would be conditional on firm commitments to growth-enhancing structural reforms and economic policies. The system would be given a mandate to promote long-term growth, well-being and employment in Europe, and this mandate would, by definition, reflect a political consensus. Ownership and governance would be set up to ensure the investment process was ring fenced from national political agendas not linked to the promotion of long-term growth. Involving private shareholders as well as public ones would make sure that the system acted independently from political processes.

### **5.4. Assign realistic reform objectives to the CMU and Investment Plan**

To be successful, the CMU and the Investment Plan also need to be realistic. For example, expecting that they could, by law, solve old, deep-seated issues such as national differences in tax regimes, regulatory regimes for private investment or bankruptcy law would probably condemn the whole exercise to failure.

With this pragmatic mind-set in mind, the CMU initiative and the third pillar of the Investment Plan (improving the cross-border environment and eliminating barriers) could start with a list of "best practices" to smooth out the main obstacles to efficient financial market integration. Of the long list of proposals by the European Commission in its CMU Green Paper (EC (2015)), we would be tempted to single out the following as the most powerful levers: first, jurisdictions could be assigned to cross-border insolvencies (see Commission Recommendation of 12 March 2014 on business failure and insolvency). Second, concrete suggestions could be made to each EU country on how to improve their national investment environments. One good, "neutral" place to start would be the World Bank's "Ease of doing Business".

### **5.5. A bank- or market-based financial structure? Aim for Greenspan’s “spare wheel” model**

The Investment Plan, CMU and QE will affect the way the real economy is financed. An obvious question is therefore what *strategic* objective should Europe have for its financing structure? Should it aim at retaining a dominant role for bank intermediation? Or should it aim at permanently increasing the share of non-bank financing? Should the evolution of the financial system even be a policy goal (can it be one?) or should it be left to market forces alone to decide?

We have argued that Europe is likely to suffer substantially from a long phase of deleveraging and disintermediation. But the European banking model does have its own strengths and is deeply intertwined with the economic fabric of Europe. We have noted that policies in support of bond market development in Europe should recognise that the composition of external corporate financing between bank and other sources of finance has been shown to be largely time-varying. We have seen that economies with a high substitutability between bank and market finance tend to recover faster from recessions.

So given the above, rather than “forcing” a given financing structure onto the European economy, the policy aim of the Investment Plan and the CMU should be to ensure its cyclical flexibility, i.e., the development of “elastic” markets for corporate debt securities, capable of acting as a buffer to cyclical credit contractions. A desirable outcome would be for the EU to have what Greenspan famously called a “spare wheel”, a corporate bond market that could step in when the banks are down.

To help develop elastic corporate bond markets, the large fixed costs to enter them would need to be reduced. This could be done by reducing the initial documentation and ongoing information requirements on corporates. The corporate bond market could also be boosted by the standardisation and dissemination of information on credit quality, as argued below.

### **5.6. A new value chain for credit assessment featuring commercial and central banks**

Larger and elastic corporate bond markets would indeed improve macroeconomic cyclical dynamics. But as argued above, banks – and more generally MFIs that provide credit – are likely to retain their clear comparative advantage in collecting granular data on the credit quality of SMEs. This creditworthiness information – which is very costly to collect and keep up to date – could be made “sharable”, without jeopardising the business model of banks. This is more easily said than done, however, because it would rely on a segmented value chain in which commercial banks would gather and maintain the data and then be willing either to originate a loan or simply sell the credit information to another financial entity. The CMU initiative tentatively suggests proposals along these lines.

Alongside commercial banks, some central banks – for now mostly national central banks – also collect invaluable granular information about borrowers or potential borrowers. The Banque de France’s FIBEN database is a good case in point. If disseminated, this

information could in many cases be used as a substitute for rating agencies, and a complement to the information collected by commercial banks on smaller borrowers. And while the historical conditions that led to the constitution of such detailed registers might be difficult to replicate on a large scale (the Banque de France was able to develop FIBEN thanks to its very dense network of local branches and for refinancing purposes in the context of the implementation of monetary policy), at least sharing the underlying methodology that was used to develop the registers could be useful.

The Eurosystem is in fact contemplating collecting granular credit data at the euro area wide level so Europe might be heading in this direction (ECB (2014)). In the meantime, collateral eligibility of loans portfolios is used as a (noisy) signal about credit quality, as central banks are perceived to be well equipped and conservative risk managers.

### **5.7. Focus on covered bonds and untranching securities for MFIs to outsource risk**

Allowing MFIs to outsource risk will be key to successfully and sustainably reviving investment financing. As we have shown, risk outsourcing can be done in various ways, although historically covered bonds and securitisation have been the main avenues.

Covered bonds have proven to be successful in providing additional external financing, while eliminating the ‘originate-to-distribute’ dangers of securitisation and preserving the corporate governance features of relationship banking.

There would be benefits therefore in prioritising the development of covered bond markets in places where they have not yet taken off. Cross-border harmonisation is unlikely to be feasible, however, as long as national insolvency and tax laws differ substantially, and since this is unlikely to change in the short term, if ever, we favour other ways to encourage the development of covered bond markets. One option would be to earmark funds from the Investment Plan to guarantee loans going into covered bond like structures. LTV levels could be lifted through EU guarantees that go beyond existing LTV limits. Such guarantees could also be used to make funding possible for immaterial assets through covered bonds or covered bond-like structures. This would allow companies without fixed assets to benefit.

Our view on securitisation is more conservative. As a complement to covered bonds, we see indisputable merits to the development of untranching securities with a key role for central banks, as illustrated below.

### **5.8. Fully use comparative advantages of central banks**

Eurosystem central banks have developed rich market infrastructures, market contacts and in some cases unique sources of information on corporate credit quality. As such, they are in a strategic position to help achieve the aims of the Investment Plan and CMU and should be fully utilised to this end.

Two examples illustrate how efficient central banks can be in this respect. The first example is the “Euro PP” initiative for private placements that began in February 2015, and which

benefited from the support of the Banque de France. While still small (€12bn had been issued between end 2012 and beginning of 2015), the Euro PP project has now established model agreements, creating a robust market framework as the PP market expands (see FBF (2015)).

The second example is the securitisation scheme (or strictly speaking, scheme of untranchéd securities) sponsored by the Banque de France, as mentioned in section 3.3 (see FBF (2014)). It seems to us that ESNs would not be as attractive if they did not benefit from input from Banque de France, in particular its ability to assess creditworthiness. ESN are based on bank loans to SMEs meeting the eligibility criteria for Eurosystem refinancing operations. They are backed by loans that have been awarded a high rating by the Banque de France.

### **5.9. Promote equity instruments for more sustainable cross-border risk-sharing**

Cross-country risk-sharing has worsened inside the euro area and the predominance of debt instruments in cross-country asset holdings has resulted in autarchic risk taking. The presence of political, regulatory and economic obstacles means that market solutions to rebalance the asset profile of cross-border portfolio holdings are unlikely to emerge spontaneously. More centralised solutions combining private and public funds might be warranted to act as a catalyst. A priority for the Investment Plan (in particular, its third pillar, that aims to improve the cross-border environment and eliminate barriers to investment) and for the CMU should therefore be to proactively encourage cross-border direct investment and portfolio equity investment. As we argue below, there is even a case for the ECB playing a role in this.

### **5.10. ECB's asset purchases: less sovereign debt and more macroeconomic risk on the balance sheet**

The ECB's actions can be tied in with the aims of the Investment Plan and the CMU through the quantitative easing programme.

As we have already argued, the purchase of "conventional" sovereigns under the QE programme appears to offer limited benefits and is likely to distort bond prices and be difficult to conduct. While the initial terms of the programme did explicitly include instruments issued by European "agencies" such as the European Investment Bank or, surprisingly, CADES (France's agency to amortise the country's social debt), they stated that such purchases should amount to no more than 12% of the total. There is an obvious case for the ECB to significantly increase the share of such purchases and in some cases to purchase these instead of instruments issued by national EMU member states (as shown in Table 1, the universe of purchasable instruments issued by the EIB and other eligible agencies is large enough to allow this). The ECB did, in fact, subsequently announce (in March 2015) that agency securities could be purchased instead of national government bonds, if the latter were too hard to find in the market, but it also reiterated the 12% limit, which seems contradictory.

We would argue that another asset class the ECB should buy outright is equity. Equity purchases for monetary or financial stability purposes would not be new: they have been implemented in Hong Kong (1998) and in Japan (2002-2003) (see Szczerbowicz and Valla (2015)). Listed equity markets are liquid in all major currencies. They cover a wealth of sectors. Unlike debt instruments, equity cannot default. And equity exists in many forms: plain vanilla, listed, non-listed, private, etc.

Purchasing equity and other non-debt instruments issued by the non-financial corporate sector would achieve several key aims. It would channel central bank money to economic sectors where it is needed. It would position the central bank as a long-term risk taker to sustain long-term growth. And increase the money supply without interfering too much with the banking sector. It would also be less distortive than bond purchases, assuming debt is more mispriced than equity. And last but not least, it would keep the central bank away from sovereigns, thereby preserving some degree of prohibition on monetary financing by central banks. All of these factors, seem to match the ECB's preferences fairly well. Equity purchases would need to be conducted passively on the basis of a diversified set of indices, to avoid choices being made between financing "firm A" versus "firm B". The indices should be broad-based so as to be as market neutral as possible. This is of course harder to achieve – but not impossible – for purchases of unlisted or private equity.

Outright asset purchases by the ECB will lead to a transfer of macroeconomic risk onto its balance sheet. Assets that are purchased by the Eurosystem will constitute an ongoing transfer of risk from the private to the public sector. In fact, any loss materialising while an asset is on the central bank balance sheet would be socialised. Obviously, a loss on equity is instantaneously realised (in the day-to-day equity price fluctuation), while losses on fixed income instruments only materialise in case of default. Unlike a commercial bank, however, a central bank can never become illiquid and therefore technically insolvent. Central banks can always hold assets until maturity, which is why they are only exposed to credit risk and not to liquidity risk. Losses incurred by national central banks do not necessarily have to be offset directly via additional capital injections from their owners, i.e., governments. So while we certainly accept that Eurosystem central banks have less experience in managing risk on equity or, more generally, on non fixed income portfolios, we still see valid arguments for deviating from sovereign purchases and venturing in the direction of a more direct, long-term financing of the real economy. After all, this squares well with the objectives of the Investment Plan.

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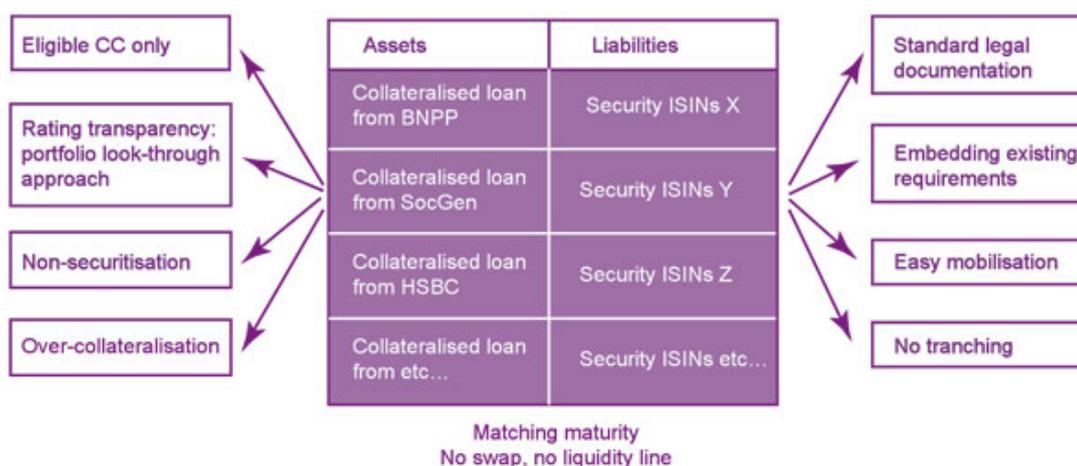
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### BOX 1: An example of untrancheted securitisation: the French Euro Secured Notes

Central banks are looking to change the collateral mix of covered bonds in order to better fund loans to SMEs. In France, this has been achieved through the euro secured notes issuer (ESNI) programme, which has the backing of the French Banking Federation (FBF) and the support of the Banque de France. This programme enables the issuance of dual-recourse notes backed by SME notes from five French banks (BNP Paribas, BPCE, Crédit Agricole, HSBC France (Groupe HSBC) and Société générale). The first issuance was in April 2014 for an outstanding amount of €2,650m with maturities of up to 3 years.

The ESNI structure



Source : Banque de France

ESNI is open to all European banks. This new form of securitisation is based on bank loans to SMEs meeting the eligibility criteria for Eurosystem refinancing operations. The instruments issued may be used as collateral between capital market participants and as a new investment asset class for investors. Private loans transferred as part of a collateral arrangement ("pleine propriété à titre de garantie") in favour of ESNI shall nonetheless remain managed by the banking groups that granted them and the securities shall not be issued in tranches. Each credit institution participating in ESNI has its own independent segment. In addition, the ESN are backed by loans that have been awarded a high rating by the Banque de France (FIBEN).

**Tables and charts (to be inserted in the main text)**

Chart 1a:

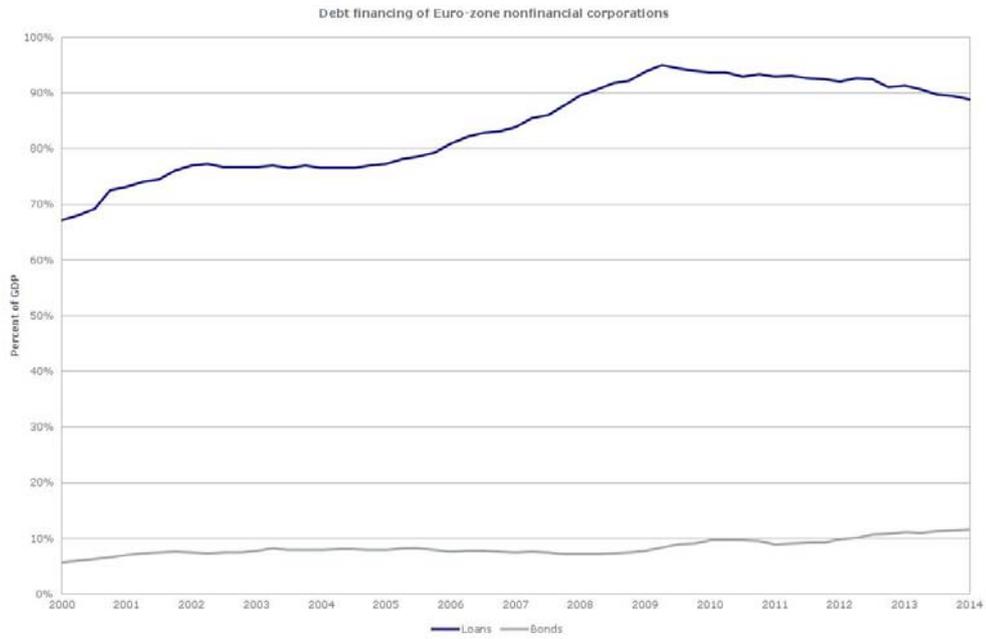


Chart 1b:

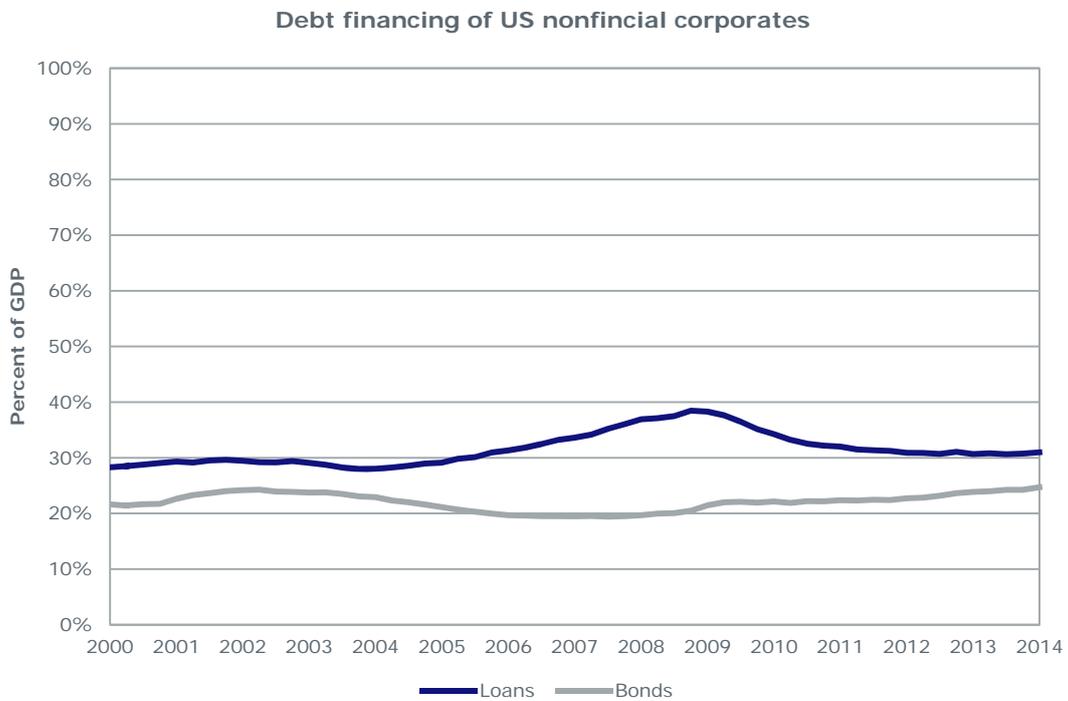


Chart 2a:

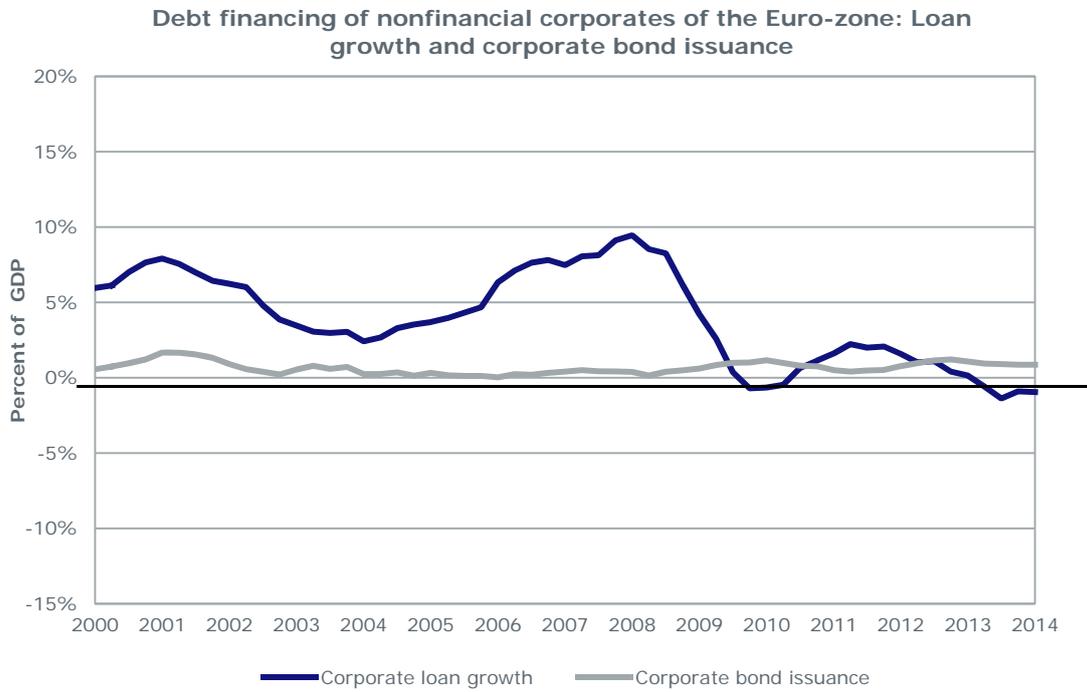
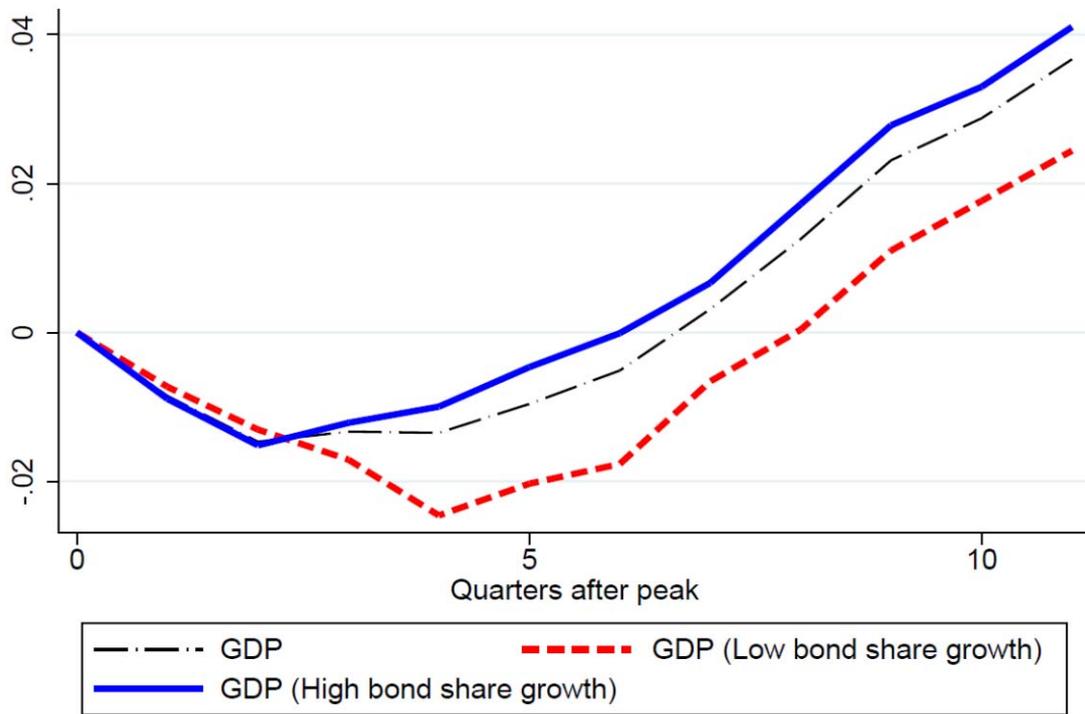


Chart 2b:



Chart XO: Economies with a high substitutability of bank and bond financing recover faster.



Average variations with respect to GDP peak. Growth with respect to the peak period.

Chart 3:

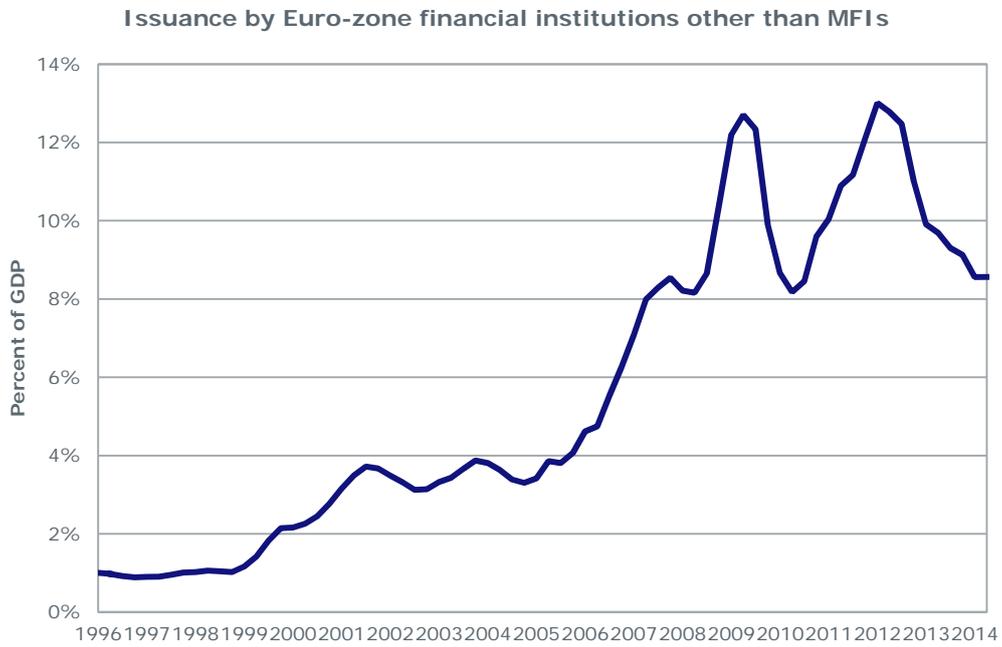


Chart 4:

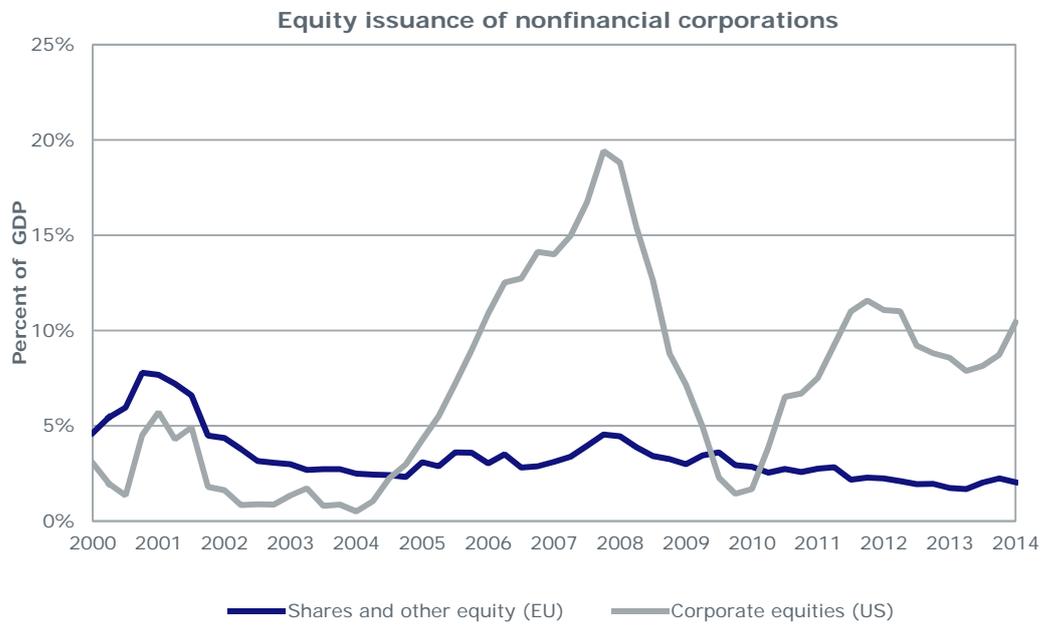


Chart 5:

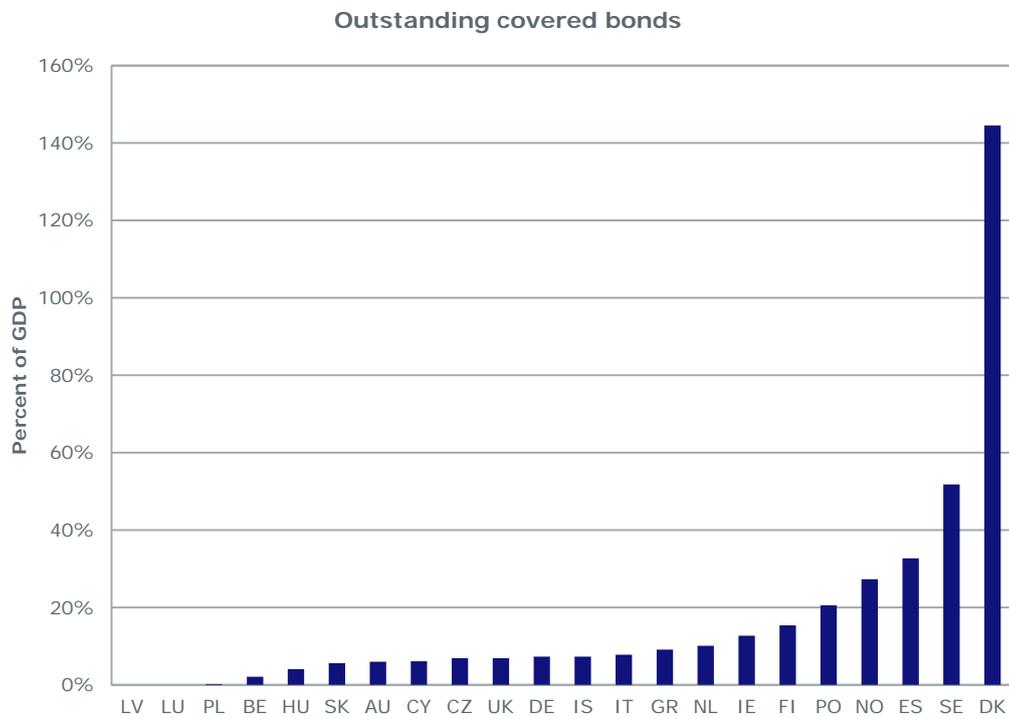
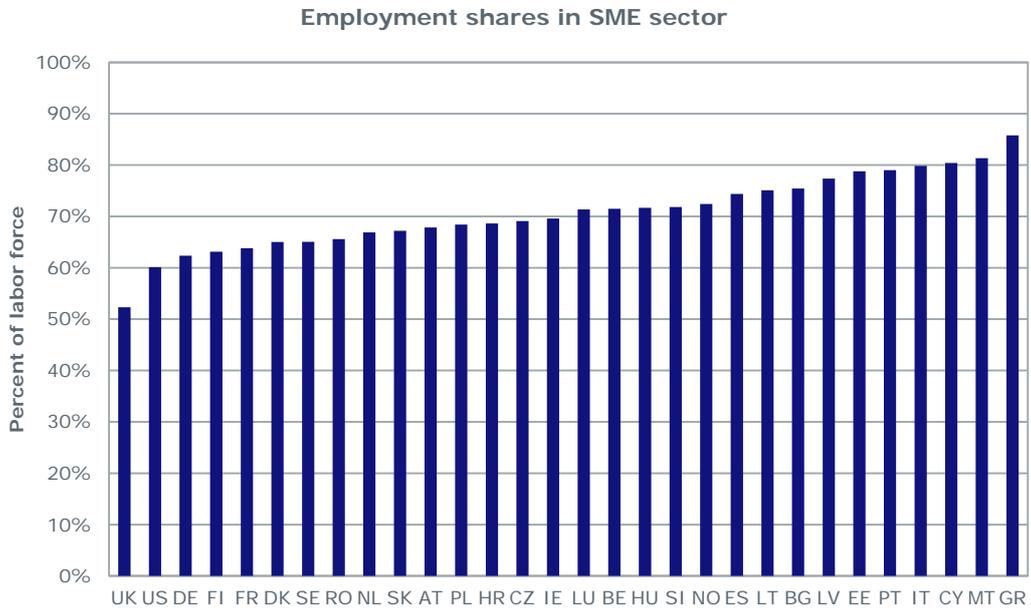


Chart 6:

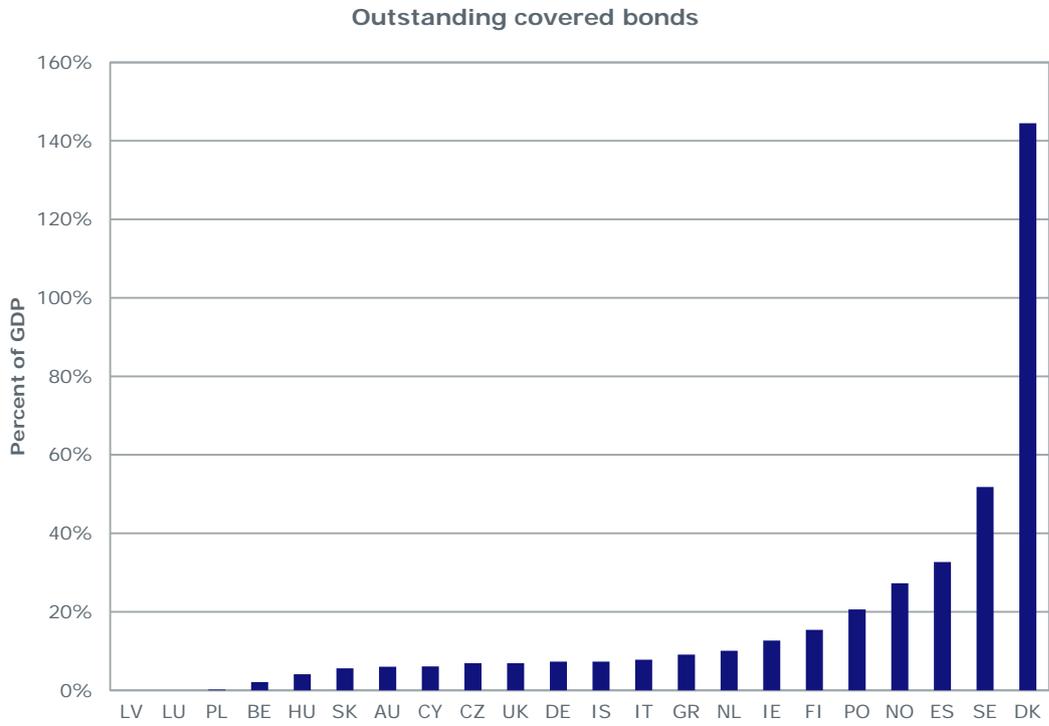


Chart 7:

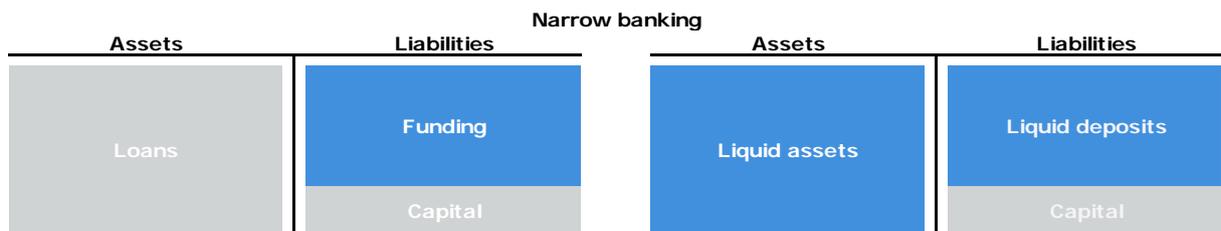


Chart 8:

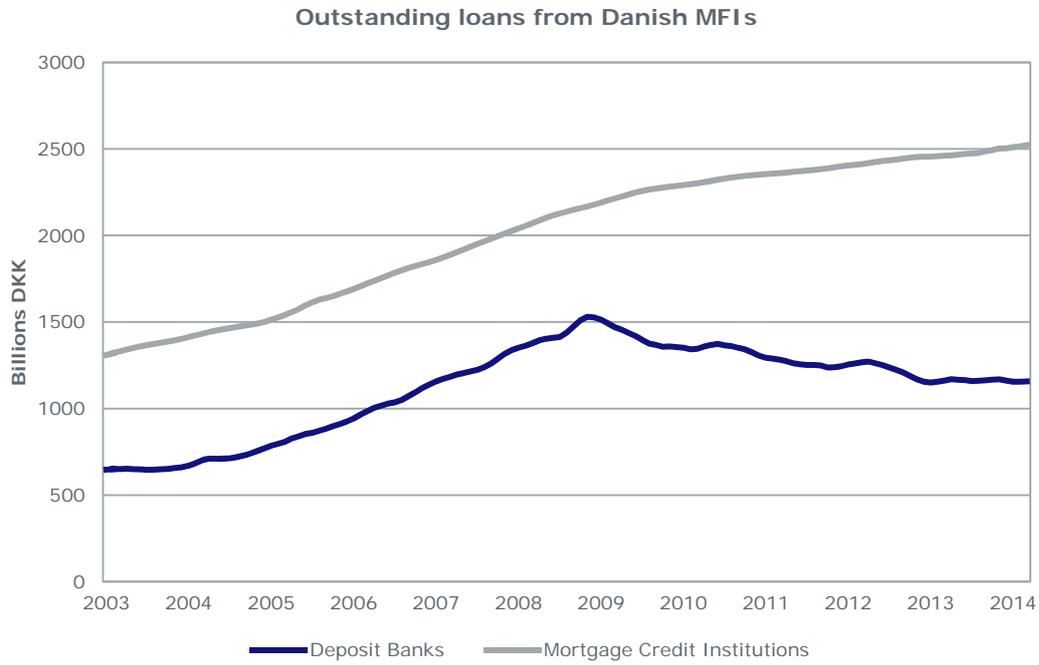


Chart 9:

