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- Six years since the onset of the financial crisis in 2008, **output levels in the EU are below those observed before the crisis.** The same is true for employment and investment. Some countries have fared much worse than this average while adjusting their balance sheets and external accounts; that has been accompanied by deleveraging in all sectors, along with changes in relative prices vis-à-vis the rest of Europe in a low inflation environment. All this is taking place at the zero lower bound on the nominal interest rate, where active monetary policy can only be unconventional.
- **The role of financial markets is crucial in this story.** But the distinction of the direction of causality is difficult: is the economy weak because of financial markets or are financial markets weak because of the economy? The question is often put as: **is the problem supply or demand** for, say, credit? If the problem is supply we know for sure one thing: fewer firms will have access to credit, some will be in trouble and will fail due to this fact; after many of these firms fail one can naturally state that there is no demand for credit. That is why it is so important to take care of supply problems. In doing so, policy mistakes should be avoided. **It would be a mistake to simply state that a major policy target is to restart funding.** That would be relatively easy to achieve, by the way: by funding expensive projects with public funds, independently



of their quality. It would also be a mistake to try to boost artificially any specific financial instrument.

- **Instead, the route towards a better financial system is one characterized by a level playing field for all types of finance, with specific choices left to borrowers and savers. The tax system should also not discriminate, i.e., it should treat symmetrically equity and debt, so that firms decide on the funding source regardless of the tax advantage of one over the other. Creating this level playing field will most likely lead to a more balanced and diversified financial system, i.e., with more options for savers and borrowers. This competitive environment is key to maintaining financial markets in constant improvement, characterized by innovation that responds to the insufficiencies of the existing instruments. Ideally, restrictions to the development of any type of finance should always be clearly justified on efficiency grounds.**
- **Along the way, the problems faced by the main source of funding in Europe (i.e., banks) should not be forgotten. Banks do not seem to have liquidity problems; enough steps have already been taken by the Eurosystem to provide liquidity, in such a way that a typical balance of payment crisis was avoided in several countries. But investors are suspicious about the reported balance sheet of banks. Thus, the steps towards the banking union, the big step Europe has taken to deepen financial integration, including the underway comprehensive assessment, must be credible. Losses should be recognized so as to**



definitely resolve the uncertainty and bring back investors. Once this is done overly cautious capital restrictions ought to be relaxed.

- **It is expected that banks in Europe will continue for a long time to be the most important intermediaries between borrowers and savers.** It is not easy to change from a bank-based economy to a capital market-based economy nor it is obvious that this is the best thing to do. European firms will have to go through several changes before such shift (if any) occurs, namely in terms of size, access to information, transparency; in general a different corporate culture will be necessary. **Forcing a shift may be counterproductive.**
- **At the same time, one should think at impediments to other forms of capital relief** along with tools to decrease the perilous geographical concentration of assets in banks' balance sheets; **securitisation is key in this respect.** If the right incentives are given, securitisation markets are the best way to more rapidly guarantee that firms' loans are available for capital markets to invest, decrease the home bias in banks' balance sheets and ensure that credit is channeled to the best projects at the minimum cost. That is, securitisation could also have a decisive role in the integration and deepening of European financial markets, by allowing the transfer of risk from the originator to investors of any type located in other jurisdictions, in the context of a still very fragmented banking sector, lacking for instance relevant pan-European banks.



- **Securitisation is not the silver bullet but it can thus be seen as a seed instrument to reshape the European economy** funding, whereby long-term investors such as insurance companies, pension funds among other real money investors are given a more important role in the funding of the economy, while preserving the clients/banks relationship. These real money investors are natural investors in securitisation since they have long-term liabilities that ought to be matched by long-term investments.
- However, it seems now clear that the changes in the regulatory treatment of ABS in the aftermath of the crisis, which were to a great extent a response to events in the US, may arguably have hindered the development of the European ABS market. These post-crisis regulatory proposed reforms (CRD IV and Solvency II) lead to a substantial increase of the capital charges for investments in securitisations. It is worth mentioning that risk weighted assets calculated on ABS tranches can be several times the risk weighted assets of the constituting pool. Further, the due diligence process that must be put in place to invest in ABS represents a considerable burden. The common practice in the US of full derecognition of assets also led to regulatory changes with impact on the supply side, and may have been a main cause of depression in the European ABS market, which in many cases already had provisions against lack of “skin in the game”. The new regulatory framework made it harder for originators to get capital relief insofar as the conditions that must be



met in order to qualify for a significant transfer of risk (a necessary condition to free-up capital) are now much more stringent.

- This was unfortunate in the sense that **the contribution of this class of securities in alleviating systemic effects**, which should warrant a more reasonable regulatory treatment, **was overlooked**; in at least two ways. First, ABS sales are, from an aggregate perspective, a better way for banks to deleverage vis-à-vis credit supply restrictions. In fact, if many banks deleverage simultaneously by restricting credit, this will have an aggregate impact on the total supply of credit, which might end up in a credit crunch. In contrast, deleveraging through securitisation does not mechanically induce a credit supply restriction, even if many banks do it simultaneously. In fact, deleveraging through securitisation could provide banks with enough funding and capital to enable them to increase lending, or, it could help transforming zombie banks into active players in the economic recovery. Second, there is considerable home bias in the loan portfolio of banks whereas diversification of assets and reserves across the euro area, something which is achievable through cross-border purchases of ABS, could act as an absorber of asymmetric shocks.
- All this suggests that the next **regulatory steps could justifiably give a more favourable treatment to ABS**. There seems to be a consensus among European authorities and market participants that simple, standard and transparent securitisations should have a



beneficial regulatory treatment. **Speed is now warranted**, also given the recent ECB announcement of an ABS purchase programme, so as to **decisively eradicate regulatory uncertainty**.

- This recent **ECB announcement** on the launch of an ABS purchase programme, although decided taking into account monetary policy considerations, is also a **game changer in the reactivation of the ABS market**. It reduces the stigma carried from the aftermath of the financial crisis and it contributes decisively to put securitisation in the policy agenda. The inclusion of mezzanine tranches in the programme can effectively result in capital relief for originators. Also, the existence of a European guarantee scheme (possibly using European funds and with involvement of a supranational institution like the EIB/EIF group and) to help originators achieve a significant risk transfer at an affordable price can be justified under the current adverse market conditions. It is also important to stress that the focus on ABS based on SME loans may be counterproductive. **ABS based on residential mortgages represent the bulk of ABS issuance while capital relief associated with sales of these ABS has also the potential to generate new SME loans**.
- The above steps depend on us as policy-makers. But one should not forget what depends less on us but can have a great impact on the securitisation market. I am talking about rating agencies. It is now clear that rating agencies' models failed in the recent past as a result of wrongly basing their ratings on the correlations observed during good times. In our



opinion, the recent methodological changes, imposing stricter rating caps (above the rating of the sovereign), in particular for EMU countries, amount to treating crisis times as structural changes making the new methodologies based again on extreme assumptions. Thus, the error is the same, this time in the opposite direction.

- Policy-makers timely acknowledged the fragilities in the design of the EMU, identifying the most crucial reforms needed. These will increase the robustness of the euro area economies against adverse shocks. Rating agencies do not fully recognize the ongoing process. Instead, they prefer to change their procedures exactly at the moment in which the institutional framework of the EMU is responding to the very same conditions that motivated such move. In this regard, it is important to emphasize that EMU countries are about to be equipped with a banking union, which will contribute towards breaking the link between sovereigns and the banking/financial system. Further relevant institutional changes include the creation of the European stability mechanism, the role of the ECB in eliminating runs on sovereign debt (through the Outright Monetary Transactions programme) and a comprehensive set of EU regulations aimed at avoiding fiscal and macroeconomic imbalances. **Therefore, rating agencies are moving countercyclically with the EU institutional advances and risk becoming irrelevant.**
- On the methodological side, it is totally obvious that imposing caps in ratings based on the sovereign is



equivalent to constraining the results of whatever quantitative models rating agencies use. This is arbitrary and reduces the information conveyed by the ratings while leading to severe pricing distortions in assets across countries. Investors will require a premium over similar but higher-rated securities while other investors are limited by regulation in their incentives to buy poorly rated securities. Additionally, it should be mentioned that **ABS originated in countries under stress have performed considerably well even during the crisis**. Indeed, ABS default rates have remained low in these countries and at levels comparable to non-stressed jurisdictions (including the US).

- Thus, unless clients and regulators **have (also) access to ratings without the cap, there should be minimal regulatory reliance on the ratings**. In any case, additional transparency on loans, the existence of reliable credit registers or credit score systems should be mentioned as instruments to help market participants understanding better the European ABS risk profile. Additionally, such information could even support entrants into the business of assessing credit risk, which currently lacks competition.
- Whereas the policy conclusions are often hard to come about, one thing seems clear: Europe must avoid ending up with zombie banks as well as with zombie firms. Zombie banks and zombie firms have never been a characterization of a well-functioning financial system and economy. This is to say that Europe must avoid a lost decade; this is to say that



European policy-makers must be intelligent and fight causes instead of consequences. This is to say that Europe will be able to maintain its geo-economic and geopolitical influence.