Outline of Panel Intervention

The 12th Annual European Financial Services Conference

Financial Markets and the Growth Agenda

Brussels February 20th

Great to be here and speak after Constancio and under the chairmanship of Klintz

Or maybe I should not be happy, as they have said so many important things about the theme we are discussing today, including securitization, that it will be very difficult for me to say something new and interesting. Still I will use my five minutes to just list the basic points I want to make, hoping the debate and the questions will allow me to put more flesh on the bones.

Moving from saving the € to long term growth

In my intellectual paradigm in thinking about the EU, and the €-area in particular, **I have moved**, or more precisely **I am moving**, from a "**Save the €"** to a **"Europe needs growth**" approach.

Indeed I believe the famous prophecy of Monnet, whereby European unity will be built on the cumulation of answers given to recurrent crises, which Tommaso Padoa Schioppa took up as a guiding idea, is being verified again, with the substantial progress being achieved in macroeconomic adjustment and institutional innovation gradually pulling us outside of the crisis and leading us to a more advanced form of union.

This does not, however, mean that all is moving in the right direction in Europe. In particular I see a risk of Japanification, i.e. a long period of anaemic growth that would make problematic the reabsorption of the consequences of the crisis, including the debt burden, and the adaptation to new realities, including Europe´s demographic decline and the growing importance of emerging countries.

Long-term growth depends on many factors, but, as the recent **Green Paper by the European Commission** rightly argues, the structure of the financial system is not the least important of them.

The continental EU (€-area) bank dominated financial system is a problem

From a long-term growth point of view, the dominance of banks in the €-area financial system has always been a problem, but this has been aggravated by the crisis.

Even before the crisis

Even before the crisis, bank dominance raised three problematic issues: a **quantitative**, a **qualitative** and a **risk** one.

The **quantitative** issue is that the growth of the economy is constrained by the ability of the banking system to intermediate funds and there is no obvious mechanism to make the latter consistent with the former. The ability of banks to provide funds to the economy does not necessarily match its investment needs.

The **qualitative** issue is that bank funding is appropriate for certain activities, (like Small and Medium Sized firms, Consumer credit, Mortgages, …) but not for others (large firms, start-ups, Infrastructures,…) for which the financial market is more adequate.

The **risk** issue is that Europe put all its intermediation eggs in the same basket, banking. We learned 60 years ago from Markowitz that diversification is good in investment but it also makes a lot of sense to have different intermediation channels, so that when one is working less well then the other can, at least partially, substitute for it.

Particularly because of the crisis

The **quantitative**, the **qualitative** and the **risk** issues got much worse with the crisis.

The **quantitative** ability of banks to intermediate funds has been severely impaired by the crisis, which has dilapidated their capital and increased the risk of their activity, thus substantially worsening the crucial risk to capital ratio. This is being gradually remedied by the private sector through bank recapitalization and will significantly improve when the ECB will have completed its Comprehensive Balance Sheet Assessment, that will hopefully achieve the double result of leading to better capitalized banks and lifting the opacity that now clouds all banks and affects their ability to intermediate funds. Still, even in favourable conditions, as shown in a paper that Ian Bell, Secretary of the Primary Collateralized Securities initiative, wrote, there will be a big gap, measured in trillions, between the needs of a growing European economy and the ability of the banking sector to fund it.

The **qualitative** issue turned more serious. Take the case of SMEs, which rely on bank funding and find now it more costly and less abundant, in particular in peripheral Europe, with negative implications for investment and employment.

The **risk** issue materialized in full with the crisis: the ability of the financial market to substitute impaired bank funding was limited as far as large firms was concerned and practically zero for SMEs.

Long term factors improving the market component of the financial system

Financial integration post €

Of course, one should not transform a realistic assessment of the European financial system into a hopeless story. The market component of the European financial system, also thanks to the contribution of London, is the **second most developed after the American one**. In addition, the introduction of the € had, as illustrated by the Financial Integration Reports of the ECB, a favourable effect on its **development and integration** until the eruption of the crisis in 2007. The crisis, however, stopped the gradual improvement and even put it partly in reverse, with fragmentation along national borders impacting the development of the market. If, as I expect, the crisis will be reabsorbed, the gradual process of integration and development could start again, but this is in any case a gradual process and the consequences of the crisis will take quite some time to be cured.

Regulatory action by the Commission

Another important factor for the development and integration of the market component of the European financial system is the **comprehensive regulatory action of the European Commission**. Acronyms like MIFID, EMIR, Solvency II and other]may be baffling but they create the regulatory infrastructure for a more developed financial market, within which the private sector could operate, in the pursuit of its legitimate profit motives, but would also *"serve the needs of society"* as the remit of our panel session says.

But these factors are not quite enough

Timing issue

There is, however, a **serious timing issue**: both the recovery of financial integration and development after the crisis and the action of the Commission to provide a solid regulatory infrastructure to market developments will only work gradually. Just to have an order of magnitude, it took more than 15 years, between 1999 and 2006, for financial integration in the €-area to make a real difference in the capital market. No shorter time horizon should be estimated to complete the repair work after the crisis.

Securitization as a contribution to the solution

I am glad you invited me to this conference as **Chairman of the Primary Collateralised Securities** initiative. As you may know, this initiative is trying to surpass the damage that the market for Asset Backed Securities suffered during the crisis by establishing a set of demanding criteria, numbering nearly 150, assuring the **simplicity, transparency** and, prospectively, **liquidity** of securitised assets and attributing a "label" to the assets fulfilling these criteria. So let me tell you what role I see for a re-born Asset Backed Securities market in contributing to surpassing the problems I have identified so far.

A brilliant idea, nearly destroyed by inept/fraudulent implementation

When I was approached to become the Chairman of PCS I had no difficulty in accepting. I had followed the initiative when I still was at the ECB and I had **two basic views** about securitization. The **first** view is that the idea of sharing the work between banks, or other lending institutions, that do all the difficult work of lending money, and the capital market that takes up bunches of loans and refinances them was brilliant. The additional contrivance of **tranching**, whereby securities of different risk and return are created that can match the risk/return trade-off of different investors, added to the brilliance of the idea. The **second** view is that the brilliant idea was nearly killed by **inept** and in some cases **fraudulent** implementation, especially in the mortgage area in the United States. And I do not think I have to add anything to the many horror stories that have been told in this respect. The joint consideration of the two ideas meant that there was a **big potential** in salvaging the brilliant idea from the abysmal implementation, hence my involvement in the initiative.

The crisis revealed the criteria to distinguish good from bad securitization

As I said, due to the terrible implementation, the crisis nearly killed off securitization, but it also generated a lot of information, which can now serve to discriminate **high quality securitization** from what I would call, to be politically correct, "**other**" securitization. Indeed the analysis carried out at PCS showed that securitizations that failed, and deserve the qualification of "other", had one or more of the following characteristics.

Pure Originate to Distribute

When the originators, banks or other institution, had **no skin in the game** the quality of lending dramatically worsened. Sub-prime lending was the egregious example of this.

Leverage (No re-securitization)

The alchemist dream of transforming lead into gold seemed to have come true thanks to the magic of securitization: pooling and tranching left overs from securitizations, with poor credit quality, the gold of AAA securities was created. The reliance on an illusionary precise modelling and calibration showed its intrinsic limit with the crisis.

Embedded maturity transformation

Some securitisations (especially in the Commercial Building segment) had, as underlying, assets with a much longer maturity than the securities. This created an unmanageable liquidity risk: when the security matured, the only option was to refinance it, but liquidity is an intrinsically volatile variable and there was no way to foresee, leave alone guarantee, refinancing at maturity of the securitized asset.

Opacity

Some securitizations provided insufficient information, some others, just because of their über complicated structure, provided such an overwhelming amount of information that even the most sophisticated and largest investors could not manage it.

The ABS which passed **unscathed through the worst financial crisis of the last 70 years** had none of the negative characteristics I mentioned. Consistently, the **150 criteria to obtain the PCS label** make sure that none of these characteristics is in PCS ABS.

Regulation should consistently distinguish high quality from other securitization

The challenge of regulation is to recognize that **the performance and the risk of securitizations are very different** depending on whether they are of **high quality** (i.e. they have none of the negative characteristics I mentioned) or belong to the "**other**" category. Treating all securitization according to the performance of the "other category" would make it practically impossible to restart the ABS market. Treating all securitization according to the performance of the high quality securitized assets would insufficiently protect against the risk intrinsic in the "other" category.

The need of differentiated regulation is recognized in words

At PCS we are convinced that the **intellectual argument that high quality securitization can effectively contribute to fill the funding gap** confronting the European economy and that **it has to be treated differently from the "other" category has been won**. In addition to the important things said by our keynote speaker and chair, the utterances of the President and other Board members of the ECB, the statements by Commissioner Barnier, various analyses published in serious newspapers and magazines show that there is now a consensus that securitization is an essential component of a performing financial system and that a discriminating attitude is necessary in looking at ABS.

Facts are still lagging

Facts, in terms of regulation recognizing the difference between the two types of ABS, are however lagging. The **discrimination between the two types of ABS has not percolated, for instance,** into the Liquidity Cover Ratio, in Basel Capital Charges. An exception is the EIOPA proposal for Solvency II, which explicitly distinguishes between Type A and Type B securitization. The positive impact of this distinction is, however, unfortunately muted by the actual calibration of the capital charges that Insurance Companies would have to put aside against investment in Type A securitizations. The ECB Board member Yves Mersch has aptly said, while not referring in particular to Solvency II, that *" All ABS were perceived as too risky due to the US experience in the subprime mortgage markets. But this regulation is like calibrating the price of flood insurance on the experience of New Orleans for a city like Madrid."*

The overall development of market component of financial market is the goal

Advocates of one or the other cause weaken their case by overdoing it. In a revealing book, Daniel Kahneman, explains a related psychological regularity, i.e.*"The tendency to like (or dislike) everything about a person – including things you have not observed- is known as the halo effect"*. If you want to defend a thesis you will not admit that that thesis has limitations or counter arguments: everything must be perfect with it. Let me try and stay clear of the **extended halo effect** by stressing that I do not claim securitization is **the solution** to the limitations of the European financial system to adequately finance growth. My statement is more limited, **there can be no solution** to that problem **without the contribution of securitization**. The development of a vibrant market component of the European financial system alongside its banking component is essential, and securitization is only one part of that.

But a vibrant securitization market is a low hanging fruit.

But my view is that a performing securitization market is a low hanging fruit: appropriate regulation and inventive market practices, to which I hope PCS is contributing, can deliver quite quickly a significant help for the insufficient funding of the European economy.

Wolf Klinz, Chairing.Constancio: 10 minutes. *Weak growth prospects. Banks business models. Broaden access to finance. SMEs. A few figures will be presented by him.* ***Gerassimos Thomas: 5 minutes.*** *Commission Green paper on long term funding. Will be presented a few weeks after the Conference. 2 issues: 1. develop more capital market funding (also for SMEs); 2. Role of multilateral development banks.* ***Papadia: 5 minutes. Daniel Godfrey: 5 minutes.*** *Role of policy makers. Market failures.*