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Finance Watch: The Long Term Financing Agenda - The Way to Sustainable Growth? (Novares Monitoring – reproduced with permission)

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Agenda

High-level conference - The long term financing agenda - the way to sustainable growth?

Contents

Key Points

- **High quality securitisation:** Securitisation featured highly on the agenda of the Finance Watch conference, with participants discussing the desirability of promoting securitisation and debating what characteristics high quality securitisation should have. Frédéric Hache (Head of Policy Analysis, Finance Watch) argued that 'tranching', the practice of splitting securities into different classes with different credit ratings from the same pool of assets, should not feature in a high quality securitisation framework. While Hache did not call for an outright ban of the practice, he argued that the practice creates model uncertainty, introduces complex risks and pro-cyclicality, as well as conflicts of interest between holders of the different tranches. Richard Hopkin (Head of Fixed Income, AFME) argued in favour of the practice of tranching, and cited that it is a widely used technique in bank financing, where banks issue equity, subordinated debt and senior debt. Hopkin also warned of the dangers of using the phrase 'high quality', as it could discourage investors from carrying out their own due diligence. He called for a value neutral term to be used instead. Bogdan Patriniche (Lakestone Capital) argued that tranching is only suitable for certain kinds of investors that hold the right kind of risk and liquidity appetite.

- **Capital neutrality for securitisation:** Hache stated that while Finance Watch supports a 'limited softening' of the prudential treatment for high quality securitisation, he argued that there should not be a move towards full neutrality for high quality securitisation. Hache justified the case for maintaining a higher capital charge for securitisations compared to their underlying assets, as securitising assets introduces "additional complexity, procyclicality and interconnectedness" compared to the simple non-transformed assets. Hopkin, on the other hand, argued that securitisation had fared much better in the European Union than the United States during the financial crisis, and pointed to low default rates for European prime residential mortgage backed securities and SME securitisations. He argued that the low defaults rates suggest that securitised products could be treated more favourably, but agreed that there is indeed a reasonable argument against complete capital neutrality.

- **Financial regulation** Dennis Kelleher (CEO, Better Markets) argued that the choice between growth and jobs over stability and financial reform is a false choice used as a weapon in order to defeat reform, and to divide countries and regulators. He argued that that there is no evidence in favour of the argument that increased regulation would prevent banks from lending or hurt liquidity. Kelleher stated that deregulation was the real job killer, and referred to the decades following the Great Depression, when banks were highly regulated, as a prosperous era in which the finance industry and the economy mutually benefited from one another. Kelleher also demanded that the industry should be more transparent with the data it uses to justify claims, and that their analyses should be subject to independent scrutiny and analysis.

- **Collateralisation:** Christophe Nijdam (Secretary General, Finance Watch) stated in his opening speech that while collateralised funds can be useful in uncertain times, he warned that "making collateralised funding the new normal" could result in a more interconnected and more procyclical financial system. Paulina Przewoska (Senior Policy Analyst, Finance Watch) argued that a revival of securitisation through the efforts promoted by the European Commission could lead to a strengthening of the role of collateral in the financial system, as well as the problems associated with it, such as asset fire sales during crises and additional pro-cyclicality. Andy Hill (ICMA) disagreed that securitisation was being promoted for the sake of fuelling the collateral market, as collateral users and takers are incredibly circumspect about what they will accept as collateral. McNulty agreed and argued that Asset Backed Securities only constitute a small fraction of the collateral market. Daniela Gabor (Associate Professor, Bristol Business School) argued that transparency alone would not resolve systemic issues in the repo market, and called for regulation such as minimum haircuts and limits on the re-use of collateral.

- **Securities Financing Transactions:** McNulty agreed that there are risks in relation to collateralisation, and welcomed the EU initiative on the Securities Financing Transactions (SFT) Regulation. Werner Bijkerk (IOSCO) and McNulty both stated that SFTs are a worldwide problem, and so encouraged other regions other than the EU to pursue similar initiatives. McNulty called for regulators to coordinate in order to ensure data consistency between the various SFT initiatives. He also argued that submitting data in an aggregated form, rather than just capturing the individual transactions that took place in a day, may be a more useful form of handing over data to regulators. Bijkerk agreed, arguing that data is not a panacea. He urged regulators to carefully consider what type of data could guide them in assessing financial stability in relation to SFTs. Andy Hill argued that the SFT Regulation could make the cost of bank financing higher, and warned that this could translate into more expensive costs for end-users.

- **Diversity of EU banking models:** Dr Lothar Blatt-von Raczeck (German Association of Savings Banks) argued in favour of traditional, regional and local banks that do not pursue significant amounts of capital market activity. Raczeck argued that the economy is best served by local banks, who hold a proximity to the clients they lend to, and who focus on maintaining lifelong business relations with their clients. He warned that this model has come under growing threats, due to the prolonged accommodative monetary stance of the European Central Bank (ECB), which has discouraged savings, as well as the threat of growing regulatory costs and higher administrative burdens that especially threaten smaller banks. Martin Wolf (Financial Times) warned of the risks of local banking, which remain highly dependent upon local economic conditions, and thereby are exposed to the threat of a lack of diversification. Wolf favoured specialised business banks that focus their lending across wider regions.

- **SME financing:** Luca Bertalot (Secretary General, European Covered Bond Council) referred to SMEs as a new potential asset class for covered bonds. He noted that SMEs have a different nature compared to mortgages, as the latter have the advantage of a guarantee. He argued that SME loans would require a different structure, and called on the European Commission to look at other ways to finance SMEs through direct funds or direct access to capital markets by proposing a harmonised way to finance SMEs.

Summary of Finance Watch conference 4 Feb 2015, The Square, Brussels
"The Long Term Financing Agenda - The Way to Sustainable Growth?" (Novares Monitoring)

Summary

Welcome and introduction

Christophe Nijdam (Secretary General, Finance Watch) welcomed the audience to the Finance Watch conference.

Nijdam stated that it is a pleasure to welcome today a very diverse group of delegates, which includes representatives of civil society, the European institutions, the financial sector, the productive/real economy industry, academics and the press. Such diversity is not only good for democracy; it should also make for an entertaining and lively day of discussions.

Nijdam said that he is the new Secretary General of Finance Watch. Although his last name is Dutch, he is French, an externality of the Brussels "melting pot." He hopes that this will be a "positive externality." While he is definitely a European citizen, he sometimes sees himself as a citizen of the world.

Nijdam said that he is a former commercial and investment banker and spent 13 years as a bank executive at a number of large French banks in France and in the US. This enabled him to see at close quarters the financialisation of the economy in the nineteen eighties and the rise of the dogma about efficient markets.

Twenty one years ago, he crossed to the investor side as a stock analyst, most recently working at AlphaValue, Europe's leading independent equity research firm. His operational experience in bank management and investor's perspective are keys to his strong convictions of the need to reform the financial sector.

In his last role as an equity analyst specialising in banks, he saw that investors who questioned the common view ended up ahead in the long-term. He hopes that Finance Watch's conference today will pay similar dividends as the panellists question a number of common views about long-term financing and growth.

He would like to introduce today's programme by asking the audience three questions - about securitisation, policies for growth, and collateral - and by sharing a few thoughts along the way.

The first question concerns what is this high quality securitisation? The revival of high quality securitisation has been promoted as a cornerstone of the political response. There have been several consultations and definitions put forward, but very little real public debate.

That will be the task for the experts on the first panel. Before that, Finance Watch's head of policy analysis, Frédéric Hache, will present Finance Watch's perspective on good securitisation. And this afternoon, he is delighted to welcome Dennis Kelleher, President and CEO of Better Markets - Finance Watch's US counterpart - to give an American perspective on the US securitisation market since the crisis.

The second question is about the EU's overall approach to diversifying and increasing the supply of finance and credit to the real economy. Is it likely to achieve its ambitious objectives, and have all the options been considered?

One issue is how to channel the growing pile of excess financial capital to where it is needed without creating new dangers. Finance Watch supports the European Commission's view that institutional investors must do more, but only if they use their long-term liabilities to act in a countercyclical manner, for instance, by buying when everybody wants to sell and vice versa.

The crisis showed that institutional investors tend to herd together with the rest of the market, amplifying economic cycles. As Andy Haldane of the Bank of England put it in a recent speech: "Patient capital ought to be part of the solution to the long-term financing puzzle. In practice, it may have been part of the problem." Any moves to promote the involvement of institutional investors should therefore include clear incentives to act, not as short-term traders, but as true buy-and-hold long term investors.

One must also be wary of shifting too much risk to pension funds and of making pensioners the new depositors. If tomorrow a pension fund runs into trouble, it is quite likely that politicians would be willing to bail it out. There is thus a need to pay attention to how much risk pension funds can absorb and be careful not to think that every tool that promotes the role of institutional investors is a silver bullet.

It is also worth noting that several prominent economists and industry figures have cited a lack of aggregate demand as one of the causes of weak growth. Linked to this is the well-documented rise in inequalities as low and middle class households, many already in debt and worried about the future, face a relative decline in their purchasing power. Ahead of the recent Davos forum, leading economists warned that "rising inequality was perhaps the biggest challenge facing industrialised economies."

A recent OECD study put it even more clearly, "higher inequality lowers economic growth. Policies that help to limit or reverse inequality may not only make societies less unfair, but also wealthier."

Nijdam stated that the much vaunted "trickling" wealth effect of inequality did not percolate down into aggregate demand this time around, if it ever did. So it is in the long-term interests of the financial industry itself to recognise this problem, not least to protect its client base.

Another factor to consider is that the Commission's Long Term Financing Initiative promotes the investment banking model over traditional banking. As a former investment banker, before he became an analyst, he understands very well the positive role that investment banking can play. But one might ask which bank business models have focused more on lending to the real economy? Traditional relationship lending, especially by small and medium sized banks, has proven especially valuable in this area and the first keynote speaker, Dr Lothar Blatt-von Raczeck, will say more about this in a few minutes.

He would add that, in relation to investment banking, local relationship banking is also less interconnected, less procyclical, creates less elasticity in the financial system and leads to less correlated balance sheets between institutions.

Finance Watch therefore believes that promoting traditional relationship banking should also be part of the solution. Possible measures could include removing the inbuilt advantage of the internal model approach over the standardised approach in the Capital Requirements Directive (CRD), which favours large banks over small and medium ones, when determining risk-weighted assets. Another measure could be to redesign liquidity ratios to favour stable funding over liquid assets. A last measure that Nijdam suggested is addressing the negative externalities of securities financing.

Nijdam said that he has now briefly commented on investment problems, inequalities and banking models. Martin Wolf, the associate editor and chief economics commentator at the Financial Times, has written a book looking at these and other questions in much greater detail. He is very pleased that Martin Wolf will be joining the conference to speak - and participate in an extended audience Q&A - in the session after lunch.

Nijdam turned to the topic on the plumbing of the financial system, as a revival of securitisation will create more assets that can be used as collateral. Is it desirable, from a stability and sustainability point of view, to increase the central role of collateral and securities financing?

Collateralised funding can be extremely useful in uncertain times when trust can disappear quickly. But making collateralised funding the new normal is likely to create a more interconnected and more procyclical financial system.

Keynote speech

Dr Lothar Blatt-von Raczeck (German Association of Savings Banks) said that over the last few years, attention has focused on crisis management. First, there was the bank crisis, and then there was the sovereign crisis. Unfortunately, the eurozone is not yet out of the woods, and the aftermath of both crises are still being felt to this day. The modest performance of the European economy has forced the EU to look beyond short-term 'fire fighting', to focus instead on how to create long-term growth.

In this context, long-term finance has an important role to play. It will contribute to the investments that are needed for Europe to exit the crisis. To this end, the European Commission published last year a Communication on the Long-term Financing of the European economy. The Communication proposed a number of policy initiatives in order to increase the availability of funding to the real economy. In this context, the new Commission, for whom financing growth is a priority, is going to table a Green Paper on the Capital Markets Union (CMU).

One has to agree that capital markets funding will have a certain role to play in the European economy. Large and medium-sized companies find it easy to draw on capital markets, but smaller firms face difficulties in this regard. For them, capital market financing is too costly, too inconvenient and too complicated. In the Green Paper, the Commission will identify a number of ideas in order to tackle these problems. Securitisations seem to be the most important issue in this context. The pros and cons of securitisation will be discussed by the speakers that will follow. But in order to avoid duplication, he will focus on another topic instead, concerning the access to finance for SMEs.

The European Commission has made some sweeping statements about the state of the European economy. First of all, the Commission argues that EU business have become too reliant on bank lending. Second of all, the Commission argues that bank's ability to extend credit has been reduced by the financial crisis. The consequences of this are that SMEs are unable to attain loans. The Commission concludes thus that policy efforts are needed in order to reduce reliance on bank funding by improving the capacity of financial markets to finance the real economy.

The first argument by the European Commission, concerning the reliance on banks for SME lending, holds true in Europe. In comparing the EU economy with the US, one can see that in Europe, three quarters of SMEs rely on bank funding, whereas one quarter rely on the financial markets. In the United States, the reverse situation is true.

The second statement of the Commission, which argues that SMEs have suffered the most during the crisis, is particularly true in the peripheral countries due to the problem of financial fragmentation within the eurozone. He thinks that this deserves a closer look. These problems are common in Greece, Spain and Italy; whereas in the North, in countries like Sweden, Denmark, Germany and Austria, the situation is much better.

Is this due to financial fragmentation? Banks do have a tendency to withdraw engagement during the difficult times and focus on their home country during crises.

At the European level, the issue of the access of finance for SMEs is not a new one. This is a topic which has been under scrutiny since the year of 2000.

The Commission has launched a number of surveys. One of these surveys dealt with the securitisation issue. The outcomes of these surveys were straight forward. Access to finance for SMEs turned out to be problematic, especially in periphery countries that are now named in the Communication on long-term finance. Yet in Northern Europe, there is less of a problem with access to finance. Why is there this discrepancy?

Two aspects need to be considered when answering this question. First of all, the soundness of the SMEs, and second of all, the business models of the banks to which they turn. No one is able to get a loan from a third party if they are not able to pay it back. It makes no difference if a bank or an investor is funding the loan. If the loan is not repayable, then no loan will be made.

Unfortunately, the economies in the peripheral countries have heavy problems due to a lack of productivity, connectivity and the viability of their businesses. This situation clearly has an impact on their ability to access finance. The SMEs will need to overcome this lack of competitiveness on their own, and neither a bank nor an investor will be able to this job for them.

For this reason, he appreciates the initiatives that the European Commission is taking in order to help the peripheral countries become more competitive.

The European Commission surveys conducted during the credit crunch revealed that access to finance is far easier in countries with banks that concentrate on the traditional business banking model. This means banks which take savings and channel them to businesses. Banks which do stable private and corporate finance and that do not pursue significant amounts of capital market activity. These banks serve the needs of savers as well as the real economy. These banks do sometimes refuse loans to corporate customers. These banks that base decisions on the knowledge of the customer, the long track record it held with the customer, and the deep understanding of the business. This can help discipline uncompetitive businesses, and can lead to a stronger economy in the long-term. In these circumstances, the proximity of banks matter. The economy is best secured by regional and local banks, and those large banks that have no centralised credit units, but give local branches more autonomy.

The business model of these banks is focused on maintaining lifelong business relations with their customers. For these banks, sustainable growth is more important than striking a quick deal. Long-term profitability trumps short-term cash. During the financial crisis, these banks did not withdraw credit from those SMEs that were heavily hit. In Germany, they even increased the loans, giving the SMEs the chance to invest and enhance their productivity. In the EU, nearly 6000 banks are proximity banks and rely on this traditional banking model. They have to remain the backbone of SME finance, these banks which focus on the needs of SMEs.

The question which arises is if the continued existence of these banks can be assured. He thinks that there are two reasons for concern. First, there is the concern of the regulatory burden and the high costs that these banks are facing. Second, the low interest rate policy of the European Central Bank (ECB) is making it difficult to attract savings.

In its Communication on long-term financing, the Commission clearly states that the various regulatory efforts could have an impact on banks' ability to channel funds to the real economy. He shares this concern. The increasingly tight regulatory framework, pushes banks to excessive restrictions. The need for banks to boost regulatory capital, leads to a withdrawal of long-term lending. The new regulation brings high administration costs that makes lending more expensive. He welcomes that the Commission is promising to do its best to improve financial resilience while avoiding excessive restrictions on maturity. But the regulation is 'one rule fits all' and neglects the specific conditions of thousands of banks that apply the traditional banking model.

Low interest rates can involve substantial collateral damage if they persist for too long. This applies to traditional banks especially. This discourages savings. It also decreases margins. Politicians are making bank lending more difficult through regulation.

The ability of the financial system to channel funds will be essential in securing the European Union on a stable long-term growth path. It is justified to look at alternative sources of finance, but this should not distract from recognising the fact that SMEs do not just need bank lending, they need an expansion of lending.

He thinks that the traditional business model has proved its efficiency to finance and SMEs during the crisis. This model must not be jeopardised. To promote long-term financing, CMU players are needed as well as those banks that focused on SMEs. Absent such a strategy, the economic recovery will be compromised.

He thanked the audience and is pleased to participate in the debate today.

Presentation

Frédéric Hache (Head of Policy Analysis, Finance Watch) said that the topic he would like to discuss today is the revival of securitisation, that is seen as the cornerstone initiative of the forthcoming CMU and a key element to revive growth in the European Union.

Hache said that he will present briefly how Finance Watch looks at this issue and what questions deserve a public debate in Finance Watch's view, in order to introduce the forthcoming panel.

Even though securitisation played a significant role in the onset of the financial crisis, he believes that everyone can agree that securitisation is a useful financial technique that is part of the toolkit to finance the real economy.

Securitisation offers indeed many benefits. It offers access to a cheap form of funding, frees up bank regulatory capital, and enables borrowers to access a wider range of investors. Finance Watch also recognises that post-crisis securitisation is very different from its pre-crisis form.

However since securitisation includes a very wide range of structures, the key question really is what type of securitisation Finance Watch wishes to see re-emerge.

First a number of impediments have been identified to the revival of the securitisation market. Some of these impediments are however positive developments that do not need being addressed, such as the disappearance of leveraged money investors, or the increased share of deposits funding banks, that has reduced the need for market-based funding.

Several reasons are frequently mentioned to revive securitisation in Europe, including facilitating SME access to finance, pursuing EU financial integration, boosting European banks profitability, and increasing institutional investors' role in financing the real economy.

Yet on the first argument that securitisation will be beneficial to SME access to finance, some stakeholders argue that SME securitisation will be too complex to work due to the absence of a unified definition of what is an SME and due to the differences in bankruptcy laws between Member States.

They also argue that it would be too costly for SMEs due to the need to remunerate a number of intermediaries and to provide an attractive return to investors. Therefore if SME securitisation is not viable economically without subsidies, one might wonder whether it is a sustainable financing alternative for SMEs.

Secondly, on the argument that SME loan securitisation will address geographical fragmentation in access to finance, there is a need to also be cautious. The argument is that securitisation will offer SMEs access to a broader range of investors and thus further pursue EU financial integration, with SME ABS playing the role that Sovereign bonds used to play pre-crisis.

However, harmonising SME definitions and bankruptcy laws between Member States will take years.

Until this happens, the European Union will not be able to create pan-European pools of SME loans, and SME securitisations are likely to be based on national loan pools. In turn, it raises the question of whether it is credible to expect that investors will not differentiate in times of stress between SME loan securitisations of a troubled Member State and SME loan ABS of say Germany, just as they did between the Sovereign debt of Greece and German Sovereign debt?

In other words, while one the main purposes of the forthcoming CMU is to address intra EU fragmentation, one might ask the question of whether reviving securitisation is likely to address this issue?

Lastly, some wonder whether introducing a tight framework for high quality securitisation might create competitiveness concerns vis-a-vis the US.

Finance Watch believes that the commercial success of the Undertakings in Collective Investment Securities (UCITS) framework outside the European Union is a strong evidence that investors value a sound and tight framework, and that soundness and commercial success go hand in hand. As it is also acknowledged that investors' negative perception of securitisation is one of the main impediments to its revival, a tight framework would help restore investors' confidence.

Hache returned to the topic of high quality securitisation. He stated that while there is a consensus on the fact that it should be part of the funding toolkit, there is no consensus yet on the type of securitisation that should be promoted.

A lot of work is currently being done to define simple standard and transparent securitisation that will benefit from a much softer prudential treatment. A first definition was provided at the end of last year within the Solvency II Delegated Act. The European Banking Authority (EBA) also recently put forward another possible definition and the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) are currently consulting on another definition.

While these definitions of simple securitisation have much in common and share many excellent criteria that Finance Watch fully supports, Finance Watch believes that an additional one is necessary: tranching. Hache rhetorically asked if tranching should be part of high quality securitisation?

Hache reminded the audience that tranching is the practice of issuing against a pool of loans with several types of securities with different seniorities: an equity tranche that will first absorb losses on the whole pool, then a mezzanine tranche, etc. up to senior tranches.

While this technique enables to transform BBB loans into AAA securities, it creates a number of concerns.

First, tranching creates model uncertainty and manufactures complex risks that are very hard to assess. As an example senior tranches are not risk free but are correlated catastrophe risk. Buying them is equivalent to selling insurance against hurricanes, where one earns a little premium all the time, but are exposed infrequently to very high losses.

However, unlike hurricane insurance where the risk can be mitigated through diversification as it is unlikely that major hurricanes will happen in several places at the same time - the risk of senior tranches is correlated, similar to an insurer faced with hurricanes happening the same month in every country where he has sold insurance policies. This is obviously a much more serious risk.

Professor Embrechts, who will be on the panel this morning, could also describe the incredible difficulty of pricing mezzanine tranches.

It has also been shown that tranching amplifies the impact of mistakes in the assessment of underlying default risk and correlation. Tranching also creates additional procyclicality and conflicts of interests between holders of different tranches. Lastly, tranching attracts less informed investors who are more likely to neglect tail risks and buy assets that they do not understand.

Interestingly, a recent Bank for International Settlements (BIS) paper found that "even when securitised assets are simple, transparent and of high quality, risk assessments will be uncertain due to tranching."

For all these reasons, Finance Watch therefore believes that tranching should not be part of a high quality securitisation framework. That is not to say that it should be banned, but merely that the additional level of complexity and uncertainty that tranching creates do not justify a significant softening of its prudential treatment. It is also important to remember that originally securitisation was "pass through", that is only transferring risk to outside investors without transforming it.

On the flipside, as tranching enables to create different risk profiles that match investors' preferences, some fear that real money investors would have no appetite for non-tranched securitisation.

This is an important and legitimate question that needs to be addressed.

Finance Watch believes that the purpose of regulation is to provide the right incentives and not necessarily feed the market's current appetite. More importantly, non-tranched high quality securitisation would still be able to obtain investment grade ratings, and provided the risk-adjusted return is attractive, Finance Watch believes that the market would develop a strong appetite for these securities.

The current environment of very low interest rates and excess financial capital looking desperately for yield should also contribute positively.

A few institutional investors that Finance Watch talked to share this view, and it will be interesting to hear the opinion of Patriniche on this topic in the forthcoming panel.

Hache said that once a definition of high quality securitisation is agreed upon, the question is then what to do with it: how much softer should the prudential treatment of this securitisation be?

A first key question is whether one should maintain the non-neutrality of capital charges or whether one should move towards full neutrality as some advocate.

Non-neutrality refers to the fact that the total capital charge for a securitisation is higher than the capital charge for the underlying assets, had they not been securitised. Non-neutrality was originally an explicit intention of regulators to reflect the higher complexity of securitised exposures.

So the question is: should securitisations have a capital charge similar to underlying non-securitised asssets or retain a higher one?

Another question that is currently being raised is whether the prudential treatment of high quality securitisation should fully converge towards that of covered bonds.

Finance Watch supports a limited softening of the prudential treatment of high quality securitisation, but strongly believes that one should not move to full neutrality nor to a full convergence towards the prudential treatment of safer assets like Danish covered bonds.

The reason for this is that securitisation, even high quality, simple and transparent will create additional complexity, procyclicality and interconnectedness compared to simple non-transformed assets, that justifies maintaining a distinction from a macro-prudential perspective.

Session I - Good Securitisation - What is it?

Prof Paul Embrechts, Professor of Mathematics at ETH, Zurich
Luca Bertalot, Secretary General, European Covered Bond Council
Bogdan Patriniche, Managing Partner, Lakestone Capital
Richard Hopkin, Head of Fixed Income, AFME
Anna Brunetti, ThomsonReuters

Anna Brunetti (ThomsonReuters) introduced the panel to the audience. Brunetti began by addressing a question to Richard Hopkin. She asked why the regulators are focusing so much on securitisation at the moment.

Richard Hopkin (Head of Fixed Income, AFME) said that it was Oscar Wilde who said that one thing worse than being talked about, is not being talked about at all. Securitisation was seen to be at the heart of the financial crisis, and people were reluctant to speak about the subject. He thinks that it is positive that finally Commission President Juncker and others are now talking it about. He sees this as a positive development.

He would like to make some opening remarks. First of all, securitisation in Europe has performed extremely well in terms of credit performance and in terms of liquidity performance. The default rate among European prime residential mortgage backed securities, since the middle of 2007 to the end of last year, amounted to 14 basis points. The equivalent in the United States is 24 per cent. The figure for SME securitisation shows higher defaults compared to mortgages, but will within tolerance, within the rating criteria, and absorbable. From a liquidity point of view, securitisation traded more tightly and with less volatility than unsecured debts, sovereign debt and bank debt. He thinks that securitisation has performed well.

It is important to keep this in mind and not to conflate what went wrong in the United States. What happened during the subprime mortgage crisis was a disaster of systemic proportions made worse by US abuses of securitisation techniques, such as Collateralised Debt Obligations (CDOs) and Structured Investment Vehicles (SIVs). These were products that delivered too much leverage to the banking system. These instruments were examples of bad behaviour and misapplication of securitisation techniques. In the United States, there was a reckless use of securitisation and securitisation-like techniques. He reminded the audience that it is important not to conflate this with what happened in Europe.

Throughout the crisis, there have been nearly 7 to 8 years of good performance data. The EU business model is different than what was practiced in the US. The problems that occurred in the US were not witnessed in Europe. Looking forward, securitisation has a key role to play in the future of European financial markets. Securitisation takes a pool of illiquid assets on a banks balance sheet and transforms them into securities that can be traded with capital markets participants.

It has been generally acknowledged that Europe is overly dependent on its banks, and that it needs to develop its capital markets. He knows that Finance Watch does not agree with this. But there is a broad policy consensus that Europe needs to broaden its capital markets. Hopkin thinks that this can be achieved through securitisation, alongside similar products like covered bonds, and unsecured borrowing.

Brunetti said that the Commission is working on the CMU. She addressed her question to Luca Bertalot. Could he tell us how the project of high quality securitisation fits within the broader picture of the CMU.

Luca Bertalot (Secretary General, European Covered Bond Council) said that this forum is important for the Commission. He has the privilege to visit the European Member States on a regular basis. He sees how the real world outside of Brussels is suffering. The financial services industry needs to provide a response, and the European Commission does as well.

He thinks that a new world has arrived with the inauguration of the new Commission in November. Everything is changing. The Commission has a new plan. There is now a new banking system in Europe, with the introduction of the Banking Union since 4 November 2014. The Asset Quality Review (AQR) was an important exercise to put all the banks on the same footing.

Bertalot said that he is sceptical concerning debates on SMEs and securitisation. He thinks that there is a lack of details. He wonders if SMEs between Member States can be easily compared. Do they have the same financial needs? He thinks that Europe is a complicated macroeconomic area.

Bertalot noted that a new monetary policy is emerging in Europe as most countries are entering into a period of deflation. It is cheaper for citizens to get loans. The question is how the EU financial structure can be calibrated. He thinks that the CMU Green Paper will bring new understanding. What will be the role of the banking industry in the CMU? What will be the role of the non-banking sector in the CMU? Securitisation is an important tool that can be used by the bank sector. A toolkit for securitisation needs to be provided to the European Commission. He thinks that covered bonds can play a role too. The European Commission needs to define high quality securitisation.

Bertalot said that there are a lot of working groups trying to analyse the details on this. And the details are important. Bertalot said that he wanted to give a concrete example. In Denmark, a strange economic situation has occurred, as interest rates for covered bonds are entering into negative territory. What is going on here? Investors are have to pay in order to be able to hold bonds. This has never happened before. What will the reaction of the industry be to this? How will the industry be able to provide cash for the real economy?

In the comings weeks, a lot of events will be held where he will try to answer questions about the role that securitisation can play. He thinks that Lord Hill has a large responsibility. It is the role of associations like Bertalot's to give answers to questions. He thinks that this is a new world.

Brunetti agreed that it will be important to define high quality assets. She noted that the European Banking Authority (EBA) has come up with a proposal for simple and transparent securitisation. There has also been a paper from the International Organization for Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS) concerning simple and comparable securitisation. What criteria are needed in order to ensure simplicity? These regulators tend to shift away from a reliance on credit ratings, and focus on increasing transparency and introducing disclosure requirements, in order to allow investors to have an increased understanding of the product they are purchasing. What is the rationale behind the definitions? What needs to be achieved with this definition?

Bogdan Patriniche (Managing Partner, Lakestone Capital) said that there are several definitions of high quality securitisation that take into account the experiences of the subprime mortgage crisis and the fact that the European Union is moving towards a single integrated Banking Union. High quality securitisations must be composed of standardised assets that are easy to understand, that are transparent, and not opaque, and that allow investors to ascertain risk without having to carry out too much sophisticated analysis.

Are credit ratings a panacea against risk and complexity? One of the key statements made by Finance Watch is that non-tranching is a way of ensuring that products are not too complex.

Patriniche began by commenting on the role of rating agencies in securitisation. He thinks that many people used credit ratings in order to avoid having to understand the securitisation transaction or complexity of it themselves. He would argue that rating agencies should be there in order to complement or supplement, or provide an alternative view to the analysts' own assessment of the product.

He thinks that tranching in securitisation enhances and allows for a broader range of investors. In itself, tranching is not going to make the world better or safer. The key question is if non-tranching would make securitisation more suitable and easy to understand. He thinks that whether tranching is suitable or not depends on the type of investor that is involved. The respective tranch that one is buying into needs to be suitable to the investor in terms of risk appetite and liquidity and investment objectives and returns.

Returning to the original questions, he thinks that securitisation will play an enormous role in accelerating the CMU initiative. He agrees that the European economies would benefit from mixing the reliance on the banking book with more on the trading book of banks. Relying on the trading book of banks will bring discipline and will bring more to the market.

Brunetti asked if Hopkin held a different opinion on the subject of tranching. Is it possible to create a market for non-tranching securitisations? Should this be pursued? Is there any benefit in pursuing this?

Hopkin said that he does struggle to understand this animosity against tranching *per se*. He said that he has a number of problems with the Finance Watch paper that was published on this subject in November. He does not know why tranching is regarded as bad in the context of securitisation, but not in the context of how banks finance themselves. A bank issues equity instruments, subordinated debt and senior debt. This is tranching. Corporations also do the same. Why is tranching a problem in securitisation, but not anywhere else? That is the first issue he has.

The second issue he has is that if this is such a good idea, then why has there not been much more of it already. The definition of securitisation in CRD IV uses tranch-based lending. There is a range of types of structured finance using securities. Some types of secured finance, such as covered bonds, fall outside the securitisation regime. He thinks that there is already an inbuilt incentive in the system to not be a securitisation.

In Solvency II, for example, the way that the capital regime works, is if one takes a pool of mortgages, and the pool of mortgages have a loan to value ratio of below 70 per cent. If they are securitised, and a triple AAA branch is created from these, then one has to hold 10.5 per cent of capital against it. This is for an asset class that is seen as having a zero default rate at the senior level in the last eight years. However, if one just buys the mortgage pool and takes the cash pool, then Solvency II requires zero capital to be held against it, for the exactly same mortgages.

He is not opposed to non-tranched securitisation. But if people are trying to identify securitisation as non-tranching, then it is not securitisation at all.

Brunetti said that this is an interesting point. Perhaps Paul Ambrechts can help the audience understand what kind of risks that tranching introduces to securitisation and the modelling complexity that goes along with tranching.

Paul Embrechts (Professor of Mathematics, ETH Zurich) said that the comments he is going to make are relevant and motivated by securitisation, and will also apply to finance and insurance. He has worked on various methodologies and many securitised products. He is an academic. He would like to talk about model uncertainty. Embrechts said that he wants to start his speech by referring to a quote from Nobel laureate economist Joseph Stiglitz. In 1992, Stiglitz wrote an article called 'It doesn't take Nostradamus'. In this article he questioned if the growth in securitisation had been a result of more efficient transaction technologies, or due to a relaxation of the underwriting standards of loans. He argued in his article that it is the latter possibility that must be entertained, rather than the former. Embrechts thinks that this is a hefty statement. Stiglitz emphasised in the paper that securitisation can give rise to perverse incentives. Embrechts thinks that this has been witnessed during the financial crisis. What happened in the US markets damaged the European markets. Products cannot be ring-fenced within nations. Stiglitz wrote in 2008 that the calls for mortgage securitisation reached deaf ears. He would like to see appropriate regulation.

Embrechts thinks that regulators should be interested in nominal values. He is often ridiculed about this. But if markets grow in size to sixty trillion, to six hundred trillion, then there is an issue. This is a warning sign he would like to post.

The financial world has become more complex, and it will continue to change. Cryptocurrencies and negative interest rates will make the world even more complex, and the electronic age is around the corner.

People warned early on in 2001 that the regulatory framework of Basel II was insufficient to deal with systemic risk. He wrote a paper on this in 2001. Model uncertainty is at the technical core of the issue that is being discussed today. It is clear that if tranching is introduced, that this results in more complexity. Risk-weighting assets has a model assumption underlying them. He thinks that they play a role.

Brunetti asked what should happen once safe securitisation has been defined. Should high quality securitisation receive better preferential treatment? When regulators decide that capital charges on securitisation should be higher than the charges would be on the underlying assets, this was motivated by political considerations. Is it fair to revisit this question now and to move to neutrality?

Bertalot said that covered bonds are accused of being very privileged in this way. When there was the first crisis, the covered bond markets had a lot of heterogeneity. One of the key elements before the crisis was to have a common definition of what constitutes a covered bond. In order to define clearly what the key features and macroprudential features of this product were. At the time a lot of countries were interested in covered bonds, so it was important as an industry to give clear guidelines to the market about the key parameters that could be the basis for building a crisis management tool. So legal protection and transparency were safeguards that were put in place. There are no tranches in covered bonds. All of these macroprudential elements were clear to the market, and were implemented in a homogenous way in Europe and now also outside Europe. This is the basis for the regulatory recognition. He thinks that it is very important to give a clear definition of what high quality securitisation is, and then to grant a privileged recognition to it. He thinks this is something the industry has to do, to decide about what is in and what is out.

This is also an important debate after the crisis in the context of the G20, if the risk-weighting is appropriate or not. Last July, the EBA came out with a paper that the risk-weighting for covered bonds is absolutely valid and appropriate. He is aligned with the position of the EBA on this. It is important to identify what the key safeguards and macroprudential characteristics are. Then the industry will have to find the right solution.

He thinks that elements are moving from the covered bond field to the securitisation field. He thinks that it is important to deal with the discussion about tranches. He thinks that it is important to have a homogenous set of assets. It is also important to reduce reliance on weightings.

He thinks that the banking industry needs to be prepared for the next crisis. Covered bonds need high quality assets. All these instruments need to be available as soon as possible. Concrete definitions are needed in order to allow the European authorities to award privilege. He noted that there is no credit register. He thinks that a credit register is needed. An investor has to be able to understand the characteristics of an underlying asset.

Brunetti asked what the benefits of securitisations are. Do the benefits exceed the risks? What are the benefits that have been ignored in the past?

Hopkin said that the previous analysis by Embrechts is interesting. Hopkin thinks that there is a reasonable argument against complete capital neutrality for securitisations. There is a reasonable case to be made that it should not be completely neutral. Hopkin returned to the argument that tranching is pursued in other areas in finance, and he does not think that it is fair to single out securitisation in this regard.

Hopkin urged the panellists to stop using phrases like 'high quality securitisation'. He has heard people use this phrase in the discussion today. He thinks that one should not assume that a securitisation is safe if it has been defined as a high quality securitisation. The high quality label is the equivalent of a credit rating. The BCBS stated in its consultation that the purpose of these criteria is to help and assist investors with their due diligence. However, it is not meant to serve as a substitute for due diligence.

Brunetti said that the International Monetary Fund (IMF) recently published a paper that regulation should not seek to eliminate risk, but should aim to make risk more transparent. This goes back to the broader question that she she referred to earlier. Do the benefits of securitisation exceed the risks?

Patriniche said that the answer to this question is a resounding yes. The benefits outweigh the risks. He thinks that creating a unified capital market and introducing securitisation for SMEs will be a big benefit. It would help banks move from the banking book to a much more transparent trading book. He thinks that it would reward those who are virtuous. He thinks that risks need to be mitigated, but he is resoundingly in favour of securitisation.

Q&A

A member from the audience said that SMEs are different from one another and need different financing sources. He thinks that the CMU will only marginally improve diversity in funding for SMEs. He is not sure that securitisation has the public support.

Brunetti said that regulators have been trying to boost the securitisation of SME lending. There are several obstacles to boosting this. Some consider it too expensive. What does the panel think about this?

Bertalot said that SMEs are a new potential asset class for covered bonds. SME loans have a very different nature compared to mortgages, because mortgages have guarantees. SME loans require a different kind of structure.

He thinks that the Commission should look at other ways to finance SMEs with direct funds or direct access to capital markets. The Commission needs to fine-tune and propose some kind of agreed and harmonised way to finance SMEs.

A member from the audience said that the Commission is on a historic mission in order to reestablish growth. The CMU is part of the Commission's answer to this problem. What are the institutional changes that will be required in order to put in place the CMU? Should there by a super regulator along the lines of the Banking Union?

Hopkin said that he does not think that a super regulator is required for the capital market in the same that it exists for the Banking Union. Within the Banking Union, there are hundreds substantial banks. Whereas in the capital markets, there are thousands of different players. His position is that there is no need for the type of regulator that she describes.

Brunetti said that Hopkin is not in favour of the term high quality securitisation, yet the industry is pushing for the favourable prudential treatment of such securities. How does this story fit together? She also has a general question. What indication is there that securitisation can help address the problem of financial fragmentation in the eurozone?

Hopkin said that he not against the idea of identifying high quality securitisation, but he is against the use of the phrase 'high quality'. He thinks that a neutral description is needed. He thinks that the regulatory treatment of what is defined as a high quality securitisation needs to be designed in order to ensure that there is not a huge cliff effect. He thinks that if these securitisations are referred to as high quality it will discourage investors from carrying out due diligence.

Patriniche said that securitisation is a tool. To a certain extent, it will help to increase the integration or reverse the fragmentation of European financial markets. Having said that, there are other elements that could also reduce fragmentation, such as structural reforms, or reviewing insolvency laws, reforming bankruptcy systems, creating credit registers. All of these have to work together.

A member from the audience said that regulators want banks to maintain risk and to have 'skin in the game', in order to avoid the problems of the past with the 'originate and distribute' model. Yet, on the other hand, it would be beneficial to have banks transfer the risk and to disperse it. How can these trade-offs be squared?

Hopkin replied that EU banks have always had skin in the game in securitisation. This is why when the regulation came in 2011 there was no great outcry from the industry about the need to keep skin in the game. The rules have changed in the last three years, but the key principle is that EU banks always have had skin in the game. Mortgage lending has been regulated. The EU banking model is different to that in the United States.

Session II - Different Paths to Jobs and Growth

Martin Wolf CBE, Chief Economics Commentator, Financial Times, London
Richard Spencer, Head of Sustainability, Institute of Chartered Accountants in England and Wales, ICAEW

Richard Spencer (Head of Sustainability, ICAEW) said that it is a delight to introduce Martin Wolf to the audience today. Spencer said that Martin Wolf is the Chief Economics Commentator of the Financial Times and was a Commissioner on the Independent Commission on Banking in the United Kingdom.

Martin Wolf (Financial Times) said that he has been asked to talk about finance in the context of the eurozone and the challenges that the eurozone is facing. Wolf said that he would make reference to what he wrote in his book, *The Shifts and the Shocks*, which sought to provide a comprehensive analysis of what happened to the global economy and the financial system, and how those two aspects of economic system worked together in order to create the huge financial crisis which has been unfolding in the last eight years. Wolf noted that this financial crisis is sometimes referred to as the 'Transatlantic financial crisis'. Some have referred to it as a global crisis. Interestingly, it is the Americans that just refer to it as the 'American financial crisis'.

He wants to relate his discussion to the problems of the eurozone, and some of the lessons that can be drawn from this crisis. This is not something he has written about much, but it is a topic that is referred to in his book. Wolf said that one of the biggest problems is the extraordinary over-reliance on debt contracts and bank-generated debt contracts, in particular, in managing financial intermediation within the economy. It is quite clear the leverage ratio for the economy, and the amount of debt in the economy, reached levels relative to economic activity before the crisis that had no historical precedent. That had a lot to do with what went wrong, and this is what has made it difficult to escape the crisis.

One of the big questions that arises when thinking about the future of finance is whether this reliance on traditional debt contracts is a good idea, and if this type of finance can be changed in certain respects. The general question confronting the eurozone is the question of how to share risks within the economy. The central question is how the eurozone should share risks if the world ends up in a different place from what financiers thought it would look like when they created the original loan contracts. This is one of the fundamental aspects of the financial system.

In his book, Wolf said that he discusses American ideas on how to change the financial structure in order to have more instruments that have equity-like characteristics. Wolf is not referring to strict equity instruments, but instruments that are structured in such a way, so that in the event that something goes wrong, the pain is borne by both the creditors and the debtors automatically. In creating these types of instruments, one immediately avoids debt crises in the process, as well as mass bankruptcy crises, and all the other problems associated with them. Risk-sharing needs to be automatically built into the contractual form.

As he will argue, that challenge is much more significant for the eurozone than it is for financial systems in most other monetary systems. The reason for this is that some of the automatic adjustment mechanisms that are available for managing untoward events are lacking in the eurozone for the moment.

There are two standard adjustment mechanisms to unexpected shocks that the eurozone does not have. The first mechanism is exchange rate adjustment. In most other countries, when something goes wrong in the economy, investors will not wish to hold assets from that country, and it will put a negative pressure on the currency of that country. But this is one adjustment valve that does not exist in the eurozone. Within large federal unions, such as the United States, there is also a second line of automatic adjustment, which is a fiscal union. This is not a generous fiscal union compared to those that exist within European Member States, or compared to other countries such as Australia and Canada. However, the US financial system does bear a great deal of the shock when something goes wrong. The fiscal union in the United States also backs the entire banking system. The eurozone is thus a fixed currency union that lacks a fiscal union.

Wolf argued that one of the most important question that needs to be answered is how the financial sector can be constructed in order for it to bear risk if something goes wrong. At the moment, the eurozone financial system is not constructed in this way. A small part of the cross-border flows within the eurozone was made up of equity financing, including Foreign Direct Investment (FDI), whereas nearly all of it was composed of debt contracts. The cross-border debt contracts took two forms - through bank lending, and through government bond financing. Both of these types of lending have the same characteristic; that if something goes wrong, then the pain falls to the debtors, and this creates crisis.

The reliance of eurozone countries on bank lending repeated experiences that had occurred in emerging countries in the past. Short-term bank funding runs cross-border rapidly once a bank decides that the entities they have lent to are no longer sound. A big challenge for the eurozone is to create a less vulnerable financial system that is less vulnerable to this characteristic.

Wolf argued that it will be a big challenge to make the eurozone work in the absence of a fiscal union. He assumes it will not emerge from the crisis for the foreseeable future. The financial sector has to be able to risk-share more effectively than it has been able to in this crisis.

The result of loading up all the costs on the debtors could mean that the eurozone will remain stuck in a state of chronic long-term demand deficiency.

This huge global demand crisis, which the eurozone is at the core of, resulted from special macroeconomic conditions in the late nineties and early noughties, sometimes referred to as the global savings gut. An extraordinary credit boom was created during this period. The boom helped to resolve the problem of insufficient demand in the developed world, until everything blew up with the financial crisis.

In the late nineties, there was the Asian financial crisis. Wolf pointed to this event as a decisive global moment, because it was the moment at which the main emerging economies, who had the best investment opportunities, decided against relying on capital from the financial sector. The Asian economies decided instead to run large external surpluses, and to accumulate large foreign exchange reserves, in order to be able to remain immensely 'long' in reserve currencies.

The emerging world became a massive current account surplus region. China accumulated colossal reserves. At the same time, two other things happened. A number of EU countries, such as Germany, also moved into current account surpluses, and wished to export capital to the rest of the world. Wolf stated that during this time world foreign exchange reserves increased compared to GDP by a factor of six. As any economist will know, it is clear that the global balance of payments have to add up, and it added up by other countries running massive trade deficits. Deficits which were fuelled by the relaxed monetary policies of the Federal Reserve and the ECB. This worked through the building up of credit bubbles associated with property. This happened in both the peripheral countries in the European Union, and the United States. All of these countries went into economic crisis simultaneously. Capital flows between countries seized up almost entirely, other than in the United States, which has the advantage of seigniorage.

Credit stopped flowing to these countries. In the case of the UK, there was a massive current account adjustment. In other countries, the economy went into crisis. The ECB helped to pick up some of the pieces, and the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) were created. While the crisis has stopped, the demand that was generated by the credit bubble has now disappeared. Today, in the eurozone, real demand is 5 per cent lower than it was during the first quarter in 2008. Wolf said that the Gross Domestic Product (GDP) of the eurozone has not fallen as much as the eurozone was able to attain demand through exporting to other countries and maintaining a current account surplus.

Wolf said that the divergence between the United States and the eurozone is dramatic. The big question for him, is how the eurozone gets back to being an economy that generates demand in line with its potential supply. This is a major macroeconomic challenge. It is not clear how this is going to be fixed. For this reason, the ECB is pursuing extraordinary monetary policy. But most people believe it will not have the desired effect.

A partial solution to this dilemma is to continue growing the external surplus. However he does not think that this is not going to work. Most of the economies in the EU do not have the same economic strength as Germany. In order to attain one per cent growth on this basis, the current account surplus would have to rise by 100 billion euros. It is not a policy that would be supported by the United States.

The eurozone governments are also not able to expand through fiscal policy. European Commission President Juncker has put forward a trivial central eurozone investment budget with his proposal for an Investment Plan. However Wolf argued that this Plan will not have much of an effect. Wolf thus suggested that it will have to be private sector investment that carries the eurozone forward. Investments are especially needed in the peripheral countries.

A core part of getting the economy to grow again is to have an enormous expansion of private investment. This will require structural reform. However private sector investment should not be funded in the same way that it was in the build-up of the financial crisis. The eurozone has to devise a way in order for surpluses to flow from the countries which save to savings-deficit countries, in a way that does not engender bank runs or the financial collapses that resulted in the last crisis.

How can an investment boom be generated? This problem has not been addressed yet in the eurozone. His concern is that because it has not yet been addressed, the ECB has had to pursue extraordinary measures. If an investment boom is not generated, Wolf is afraid that political problems could emerge within eurozone countries.

Spencer said that Wolf has become a more radical voice as the crisis has unfolded. In his book, Wolf talks about the orthodoxy of economics generally being nonsense. Does the European Union need to change its current political structures in order to effect economic change? Are the current political structures preserving economic orthodoxy?

Wolf said that it is difficult to consider how radically politics has to change in order to make sensible reforms work. He does not think that it is sensible and moral to recommend a revolution as a strategy. Revolutions always disappoint. He thinks that incremental reform is needed.

It is evident that what happened in the thirties led to a series of political and economic catastrophes. People learnt to develop new political regimes that contained most of those dangers, and ensured a stable and dynamic economy in which the fruits were widely shared.

In the last thirty years, the European Union operated within the old economic orthodoxy. This orthodoxy was that open economies, with a liberalised financial sector that is allowed to innovate and develop on its own, with a stability-oriented monetary policy focused on controlling inflation, would allow the world economy to be stable, dynamic and efficient. But this orthodoxy has not rung true. Nearly the entire developed world is suffering from a lost decade.

One has to think about incremental reform that will get the world economy out of the current mess, and shift the way that systems work. This is a pressing need. His job is to put forward radical ideas. He does not expect, as a political outsider, that his views will be implemented. He is not naïve, but he hopes that putting forward these ideas on the financial system will make it easier for policy makers to consider moving in a more radical direction. He does not want a revolution. But he does want more than what there is in place in the eurozone now.

Spencer said that the Greek elections represent an institutionalised rejection of austerity. Where does this leave Europe? It is difficult to see how the crisis will unfold. Will Europe consolidate into a federal state? Is there an alternative to federalism? Or will Europe just continue to 'muddle on'?

Wolf said that he is concerned about where Europe finds itself now. Twenty-five years ago he did not believe in the need to create the euro. But this is an irrelevant subject now, as it has been created, and the European economy will have to continue within the context of the euro.

How can a continent-wide currency union, with a common central bank, but with separate fiscal policies, and no fiscal union, that suffers deep structural problems such as an ageing population and a lack of internal demand, continue to work?

There are those who believe that global demand will help increase demand in the eurozone. But he thinks that this is a fantasy. He also thinks that it is unlikely that the fiscal rules will be changed. Wolf also does not believe that Quantitative Easing will transform the economic situation. The channel through which it may help is by devaluing the currency.

He does not see how the crisis can be resolved. He thinks that the political pressure will continue to grow in southern Europe. The dangers of this are obvious. He is much better at diagnosing the problem, then providing a feasible way out. But one has to be realistic. The effectiveness of a central bank is going to be quite limited.

Before the financial crisis, the US consumer helped to drive global demand. However, the US will not be able to do this again from now on, as the US financial sector will not be allowed to reign free as it did in the nineties and early noughties. The increase in US demand will not be enough to raise demand in the rest of the world.

He would have liked to see a massive increase in the role of equity and other contracts. He thinks that the Greek proposal for GDP-linked bonds makes sense in the eurozone context. It is a way for creating risk-bearing finance within the eurozone system.

Spencer asked if there is a risk of the eurozone splitting.

Wolf replied yes. He thinks that the only reason that peripheral countries are still within the eurozone is because they fear the consequences. Wolf said that he does not think that the political centre will hold. He does not think that the recent Greek elections are a special situation. There is a potential for worsening political conditions in the peripheral countries. If the ECB Quantitative Easing does not work to dispel deflationary tendencies, then the ECB could either decide to give up on the programme, or it could decide to triple it. There is a point at which the German public will stop and say - 'enough of this'. He thinks that while the political centre in Germany is unbelievably strong, it may not last forever.

Spencer said that there are ideas floating around about stripping banks of the ability to print money. He said that Positive Money is doing work on this. Does he consider this a possibility?

Wolf said that this is not a crazy idea. The economists who put this idea forward first were the right-wing economists. This is not a left-wing proposal. Ludwig von Mises was opposed to fractional reserve banking. It was the Chicago School. Why did they think that this makes sense?

Having a situation in which, essentially, money is being created by a credit system that is loosely controlled by the central bank, creates fragility in the financial system. Can this system be replaced? He thinks that it can.

He recognises that this is not going to happen soon. His idea is to persuade a small country to have a go at it, such as Iceland. He is in contact with Icelandic politicians. The idea is to have a payments system separate from the credit system. This will identify what the core fragility is.

Spencer said that Finance Watch advocates greater capitalization of banks and a move towards more local banking, who hold a stronger understanding of the environment that their clients are operating in. Spencer noted that Wolf sat on the Independent Banking Commission. What is his view about the Vickers regulation?

Wolf said that there are no perfect solutions to the financial sector instability problem. It is inherent to it. There are a series of difficult trade-offs. He will not go into his more radical proposals. First of all, he does share the view that there is a strong case to move towards a system with higher equity ratios. The leverage in the system is frightingly high. The costs of moving from a 20 to 1 leverage ratio to a 10 to 1 leverage ratio in terms of higher costs of funds are not that large. The costs are modest, but they do exist. Doing this makes a lot of sense. If this can be done, then some of the regulation, which he considers modestly crazy, could be gotten rid of. He thinks that would be a good thing.

He very much agrees with Andy Haldane, who published an interesting paper at Jackson Hole on 'The dog and the frisbee', in which he basically pointed out that, with the rulebooks that are being generated, is impossible to imagine how banks can be effectively operated. Haldane argues to just make them more robust, and leave fractional reserve banking. Wolf thinks that reducing leverage has to be part of the solution, if a market-oriented system is desired.

He believes in the diversity of banking institutions. Local banks vary in their effectiveness. The advantage is that they have local knowledge, but they are exposed to local economic conditions. If there is a depression in the local economy, then it is going to affect the local bank's entire portfolio. This happened during the Great Depression in the United States. Local banks are exposed to the threat of a lack of diversification.

Local banks also have a terrible tendency to come under the control of local politicians. That worries him. Wolf said that he is in favour of smaller and specialised banks. He pointed to Handelsbanken as a specialised bank. He is interested in banks that are focused on lending to businesses across wider regions. But he does not think that a world made up of only local banks will make for a more stable world.

There is an enormous discussion in America about too big to fail. He agrees that it is a problem. However, if banks were divided into smaller entities, and the smaller banks all take on the exact same risks, then a systemic crisis can also occur. Wolf argued that sometimes crises do not happen because of perverse incentives, but because investors all make the same mistake together. This happens when a whole group of investors think that a single asset will never go bust. American friends of his before the crisis always told him that housing is a safe asset, but that turned out not to be the case. There was a whole host of small banks in the United States that thought that housing assets were safe. If all local banks thought that housing assets were safe, then this would still lead to problematic consequences.

Q&A

A member of the audience asked if the Commission agenda for CMU is a positive agenda. Lord Hill is going to say that this is going to boost growth and employment. Wolf talked about transforming incentives for investment in the private sector. Lord Hill will claim that this is what the CMU and securitisation is all about. Will it work?

Wolf said that he has some sympathy for securitisation, but it cannot solve the problems that exist in the eurozone today. Incentive problems in securitisation need to be addressed. He has not looked at the Commission agenda on high quality securitisation in detail.

The key question for Wolf is if the eurozone is in a credit-constrained world, where private firms are unable to attain credit, or if the eurozone economy is stagnant at the moment, and no one wishes to spend money. If it is the latter, then fixing the intermediation system through enhancing securitisation is not going to fix much. If it is the former situation, then securitisation can help.

He thinks that securitisation can help, but it needs to be accompanied with fixing the demand problems in the eurozone. This is not going to be fixed quickly, though the ECB is attempting to do so.

A member of the audience said that natural resources are being depleted. Given this context, is more growth needed? What does he thinks about lowering interest rates to even lower rates than they currently are, for instance, five per cent.

Wolf said that if there was a zero growth world, one would assume that interest rates would be negative. If one moves to a negative growth world, then negative interest rates would make sense. To have large negative interest rates, money would need to be demonetized. One would have to require everyone to hold electronic money in order to prevent people from holding cash. The vault business would explode if negative interest rates were introduced. There is a limit to how low negative interest rates can go, because at a certain point people would begin to barter. Depository receipts would be traded as money.

The question of negative growth raises a series of questions. What is not clear to him is how growth can be stopped. In the last hundred years, innovation has allowed citizens to do more with the resources they have at their disposal. Wolf argued that it might not be a winning political project.

Presentation

Dennis Kelleher (CEO, Better Markets) said that the US and the EU are at a crossroads of low growth. He will mostly focus on what is happening in the United States. Kelleher wanted to pay his compliments to the European Parliament for having the foresight to support Finance Watch.

Brussels is fortunate to have Finance Watch. There is nothing wrong with the private sector pushing their agenda, but an independent voice is needed that provides expertise based on the public interest. This is what Finance Watch does.

When one side dominates politics, the outcomes are not optimal or desirable. Economic might has too often overcome the public interest. The private sector is always advocating for policies that benefit the bottom line. Unfortunately, that too often results in their voice being overheard at the expense of other independent voices.

He is not saying that the private sector or the banks acting in their own self-interest is necessarily a bad thing. They are entitled to state their views, and their input is often helpful and indispensable. However, private sector firms will always argue out of self-interest in order to help their bottom line. That kind of one-sided debate is not good for anyone, not even the biggest banks themselves.

Why is it that a more open and public debate could even be in the banks' self-interest? Because the outcomes from a one-sided process lack legitimacy and are fragile and unsustainable.

Another key problem with the current debates in banking, is that the facts are frequently ignored or spun away. Kelleher said that he refers to this as the 'fog machine', where massive amounts of money are used to 'conceal' rather than 'reveal'.

Kelleher listed a number of facts that have frequently gone unmentioned since the crisis. First of all, the financial crisis of 2008 was one of the worst crashed since the Great Crash of 1929. Only massive and unlimited bailouts amounting to trillion in dollars prevent the collapse of the global financial system. Those bailouts prevented many banks from going bankrupt in the United States, including Citigroup, among other banks. These banks would be mere shells of their former selves, or would not exist at all, had it not been for the bailouts by governments.

This financial crisis resulted in the worst depression since the 1930. It is astonishing how often these basic facts are not mentioned or absent from the discussion. This is dangerous. Without these facts, there is no context. Those facts are crucial to determine what is at stake in the financial reform debate. Given these facts, no one should be surprised that the costs of the crash are severe and long-lasting. The 1929 crash is the benchmark for the circumstances today.

Kelleher said that Better Markets did a study that showed that the financial crisis cost more than 12.8 trillion dollars. This study was based on conservative assumptions, and was measured based on just the lost GDP to the United States based on the government projections available in 2012. The data since then makes clear than the ultimate costs of the crisis will be even much higher than that. Kelleher said that these high costs are assuredly true for the EU as well.

Those costs continue to increase. The unprecedented monetary policy actions by the Federal Reserve and the ECB have been and continue to be a response to the calamity caused the crash of 2008. No one should forget that these actions are the on-going response to the crash. Those numbers, however large, are just numbers. They can never reflect the human suffering that has been inflicted, with millions of people losing their jobs. Yet, vey rarely is this mentioned in this debate.

When people talk about financial regulation, the discussion is frequently redirected to bank complaints about the cost of regulation to them. As a result, the banks and their allies, are always arguing that regulation should be subject to cost-benefit analysis. This sounds nice, but in reality it is an industry cost only analysis that fails to take into account the cost to the public. Better Markets has produced a study which focused on the misuse of cost-benefit analysis in the context of the Securities and Exchange Commission (SEC), that is available on the Better Markets website.

Fourth, the so-called choice between growth and jobs and financial reform and stability is a false choice used as a weapon, not only to defeat reform, but to divide countries and regulators. The claim is that regulation will prevent banks from lending and hurt liquidity. Not only is this not true, the evidence does not support it. Either way, is it telling that the lobby claims are frequently not backed by data. Frequently, this is the case, even when the lobbyists are in the best position to provide this information, which they often uniquely possess.

The industry should be required to provide proof and data. Then those claims must be subject do independent scrutiny and analysis. If sufficient data is not provided to enable independent verification, the presumption must be that there is no data, or that the data does not support their claims. Studies based on undisclosed data must be regarded as unreliable.

Regarding claims about regulation interfering with growth and jobs, history demonstrates the opposite. As Wolf alluded to, after the Great Crash of 1929, banking and the broader financial industry were subjected to the heaviest regulation in the history of the world. The bank lobby at the time said that this regulation would kill jobs, growth, free markets and capitalism. But what really happened?

Nearly 70 years of growth and prosperity followed. The finance industry flourished as well. There were ups and downs, but nothing like the recent financial crisis happened. This all changed after deregulation of the financial sector. The industry was entirely de-regulated or the Government mostly pursued light-tough regulation. Seven years after full deregulation was completed in the United States, the worst financial crisis emerged since the Great Depression. He admits that this is an over-simplified story.

Financial regulation is often referred to as a job killer. But deregulation is the real job killer, and one of historic proportion. The decades following the Great Depression are proof that regulation can be good for jobs and growth. The crash was caused by too little, not too much regulation. He is skipping the issue of how much regulation is needed. However, in terms of regulation being the job killer, that argument has been put to rest by the facts. In addition to being historically false, the entire growth versus stability debate has been framed by a series of false choices and false trade-offs, pushed by the too large to fail banks, and accepted far too uncritically by too many people. The false choices have been detailed by Bob Jenkins. He is a decades long industry professional, and a former member of the Bank of England's Financial Policy Committee (FPC), and he is now a senior fellow for Better Markets. His short speech, a debate framed by fallacies, should be read and re-read by everyone involved in this damaging debate that falsely requires one to choose between regulation and growth. Importantly, he also destroys the arguments that the governments have to choose between domestic financial stability and the competitiveness of their financial sectors. This is to say that there is no race to the bottom has no foundation in facts, and it arises form the false framing and an uncritical acceptance of false choices. Jenkins' speech can be found on the Better Markets website.

Deregulation is never truthfully and clearly labelled in the United States. It hides and masquerades as reforms and technical corrections. As an example of this, Kelleher referred to a Bill that was presented in the House of Representatives, titled 'Promoting Job Creation and Reducing Small Business Burdens'. In reality, this Bill was a re-packing of 11 deregulations Bill that had been considered in the last year. It is well known that such Bill titles and the claims within them often get media representation and public views without scrutiny. It is imperative that all such claims are robustly supported by data.

It must be remembered that sustainable and real economic growth will come from ending the finance driven boom and bust economic cycles. Financial stability, clear rules, oversight and the rule of law is a necessary foundation for achieving this. It is the only way to get the too big to fail banks back into lending, rather than high-risk trading that threaten jobs.

If done right, financial reform and stability will result in more competition, better diversification, lower prices and more jobs, with economic growth and greater safety as a whole. This must be done transparently. Financial reform must be inclusive, only that will allow public oversight and accountability that will build confidence. Public faith in elected officials and regulators will continue do decline otherwise.

Session III - Re-plumbing the financial system? The ubiquitous use of collateral

Werner Bijkerk, Head of the Research Department, IOSCO
Dr Daniela Gabor, Associate Professor, Bristol Business School
Andy Hill, Director Market Practice and Regulatory Policy, International Capital Market Association (ICMA)
Kevin McNulty, Chief Executive, International Securities Lending Association
Paulina Przewoska, Senior Policy Analyst, Finance Watch

Paulina Przewoska (Senior Policy Analyst, Finance Watch) introduced the panellists. Collateral has fuelled most financial transactions in the last years. The crisis evidenced problems in relation to collateral and Securities Financing Transactions (SFTs) including excess liquidity, weak funding structures, fire asset sales, and additional pro-cyclicality. A revival of securitisation is likely to strength of the role of collateral in the system. It might also promote a development of SFTs. Przewoska said that the financial system is built on collateral, but making it the new norm might be unhealthy and make the system more pro-cyclical. She asked the panel if the role of collateral in the financial system needs to be reformed.

Kevin McNulty (Chief Executive, International Securities Lending Association) said that yes is the answer for him.

Why is collateral important? It is not a novel concept. It is not new to anyone. For instance, people are used to putting up their house as collateral for a loan. His view is that collateral is important to financial markets in order to create financial stability that would otherwise not be there. He thinks a system of intermediation is needed, and for that collateral is needed.

He thinks that there is not one single answer here. Diversification in terms of how financial markets develop is important. One tool should not be promoted at the expense of another. McNulty said that the alternative to collateralising is unsecured finance, which comes with its own set of issues. Unsecured markets would result in other risks being brought to the table.

He agrees that there are risks and issues that need to be mentioned in relation to collateral, and the regulation that is being introduced is resolving some of the concerns that have been aired in the past.

Andy Hill (Director, Market Practice and Regulatory Policy, ICMA) said that effective, liquid capital markets are a public good that supports jobs and growth. Is there a need for reform the way collateral is used? He does not think there is a need for radical reform, but there is a need to talk about it, and the reasons why collateral is used. Collateral is used because there was a loss of trust after the financial crisis.

Collateralisation allows people to trade. It allows for secured funding. It gives access to credit that people otherwise would not receive. It allows for derivatives trading. It is how monetary policy is transmitted. Collateral provides safety and liquidity. It helps provide better capital markets. The nature of collateral needs to be understood.

If one looks at the financial crisis, the unsecured lending markets closed, whereas the repo-markets continued to function.

He also does not agree that the idea behind promoting high quality securitisation is to fuel the collateral and repo markets. He does not think that is true. He thinks that there is enough high quality and liquid assets out there. He also does not share the idea of collateralisation having negative externalities and introducing pro-cyclicality.

Daniela Gabor (Associate Professor, Bristol Business School) said that financial markets in the future will revolve around collateral. Regulation is requiring derivative traders to hold more collateral. With more asset managers and more market-based finance, collateral will continue to become more important. But she is not necessarily in favour of the idea that collateral makes the financial system safer.

The repo market borrows collateral against cash. Since 2008, the Financial Stability Board (FSB) and central banks around the world have identified the repo markets as central to the 'shadow banking' system. Many academics have described the collapse of Lehman Brothers as having triggered a run on the repo market. The repo market is in the shadows because it falls outside of the scope of capital and liquidity regulation. She questioned why such a systemic market is allowed to grow hidden from the regulators. Regulators are aware of the risks in the repo market, as central banks use them in order to implement monetary policy.

Since the Asian financial crisis, central banks around the world became concerned about the role of collateral. Central banks convened a working group on collateral which concluded that during crises, financial institutions which are dependent on collateral funding may end up having liquidity problems, in the way that does not happen in the traditional banking sector.

Werner Bijkerk (Head of the Research Department, IOSCO) said that collateral was used and caused problems during the financial crisis. Collateral is leverage, and it frees up funding. He disagrees with Gabor that the regulators know what they are talking about in relation to collateral. He does know think that the regulators truly know the level of risk transfer that takes place on a global scale due to collateral, as the data is not disclosed by the banks. He does not know who the big players are in collateral, and how much collateral is being re-used or not. He also does not know the amount of collateral upgrade transactions that take place. Banks are best place to assess this data. While he likes collateral, he fears risk transfer, especially if he does not know what the risks are.

Przewoska asked if the initiatives at European level, such as SFT Regulation, are a move in the right direction.

Bijkerk said that these efforts help. However, it is not a regional problem, it is a worldwide problem. He is happy that progress is being made.

McNulty said that long-term investors, like mutual funds and insurance companies, lend their securities for a fee. There is a lot of benefit from this.

The FSB has identified the regulation of collateralisation as a high priority. He agrees with this. He is also pleased that the EU is taking initiative with the SFT Regulation in order to get something done. He thinks it is good that the EU is driving forward on this. The problem will be if similar regulation is not introduced in Asia and the United States as well. He is hopeful that the EU move will trigger developments in the rest of the world.

McNulty said that the regulators do not yet know what is going on the repo market. There are on-going initiatives for better transparency. The ECB has its own initiative and the FSB has an initiative. All the banks are supportive. No one has an issue with transparency. But the initiatives need to be coordinated to ensure data consistency. It would be helpful if the regulators had a better idea on what they were looking for, as it would make it easier to provide the information that they require.

Gabor said that the regulators anticipated the contagion that repo markets would create prior to the financial crisis. She finds it unfathomable that the regulators identified an area of systemic importance, but then did not insist upon regulation.

Przewoska said that risks have been identified and there are proposals now to regulate SFTs. The FSB is pursuing on-going work on introducing haircuts and on capping the re-use of collateral. Is there a case for implementing a cap on the re-use of collateral?

Bijkerk said that he would like to see the risk transfers involved before he can answer this question. He thinks that supervision should be enough. He is not in favour of writing rules just to show the public that work is being done. Once he sees the risk transfers, then it is possible that he could assess that SFTs are not that risky. More work needs to be done on getting the information before the rules and a monitoring system can be created.

Gabor said that transparency alone will not solve systemic issues in the repo market alone. Research shows that there is clear relationship between repo market leverage and the fire sale of assets and liquidity problems. Gabor said that the repo market in Europe is not unregulated, as the rules of the repo market are designed by private sector operators. The problem is that private operators do not take into account the potential for systemic risk in the repo market.

It is important to ask if one needs to rethink how collateral markets are reformed. It will not be enough to simply regulate the institutions on a micro-level. She thinks that the markets need to be regulated. Minimum haircuts and limits on the re-use of collateral need to be introduced. Regulation should focus on the market. If it does not focus on the market, and one simply regulates the institutions, then new institutions will simply emerge which do not fall in the regulatory perimeter. It is important to focus on the initiatives to regulate the repo market. There should not only be minimum haircuts, but ceilings should also be introduced on haircuts. She does not think that simply increasing transparency will be enough.

Hill said that if minimum haircuts are introduced, then maximum haircuts are already needed. Hill said that, on a conceptual level, it is important to understand the difference between 're-hypothecation' versus the 're-use' of collateral, as well as to understand the differences between the American and the EU repo markets. In the United States, if one pursues rehypothecation, then the assets still belong to the client. There is a good argument that the re-use of those collaterals should be monitored and limited. But the European repo market is different. Legally, the repo market is constructed, so that when a security is lent, then the person has full title ownership over the security. So he takes a clients' asset, gives them cash, and he is entitled to do whatever he likes with the asset. If he defaults on the asset, then his client can keep the cash. He thinks it is absurd in this case to regulate it. He does not think that people would be in favour of monitoring the use of bank notes in the same way. For instance, if a rule was constructed which would put a limit on the amount of times that a bank note can be re-used. He thinks that some of these proposals are absurd. Conceptually, when talking about limiting re-use, it is important to talk about who owns the asset and if they are fungible.

McNulty said that there are no comparable proposals to cap re-use. The FSB announced in November that they would set up a task force on collateral re-hypothecation or re-use. He thinks it is important to look at what the FSB concludes. They will produce tools by the end of this year. The FSB have been thoughtful about how they have looked at the collateral market. He thinks time must be given to them to do their work. There are some practical issues, as Andy Hill referred to.

There seems to be three areas that might cause concern. One is to do with the interconnectivity that re-use creates. Every time there is re-use, it creates a connection. There is a danger that there could be more than one claim on a security.

Przewoska said that SFTs essentially leads to the industry creating money. She thinks that the FSB work is a good start. If this FSB initiative is successful and regulatory measures are introduced, then banks have argued that it will hamper their ability to create liquid assets. As a result, the banks argue that it will hamper lending to the real economy.

Hill said that he tends to believe that if the cost of bank financing is higher, then this translates to more expensive costs for the end-users.

He said that he does not have a problem with good regulation, but he worries that regulating the repo market in order to indirectly regulate something else, is not optimal. Hampering the repo market would have indirect consequences. If the regulation is intended to target the leverage of hedge funds, then he thinks that it is the hedge funds that should be regulated. He thinks that haircuts in the repo market would be bad regulation.

Gabor said that the institutional structure of the European repo market is made up of large banks. The statistics from the International Capital Markets Association (ICMA) suggests that the largest banks carry out 80 per cent of transactions. The question of liquidity is complicated. It is important to remember that regulators encouraged the development of the repo market.

Przewoska asked if Asset Backed Securities (ABS) will prove to be the next EU 'safe asset'.

McNulty said that it was interesting that Finance Watch tied the discussion with ABS and SFT together. Securities lenders dealt with ABS during the financial crisis. But ABS products were a very tiny portion of what was being lent. This was deliberate. The institutions that were lending securities were not comfortable with lending ABS. Whether future ABS will be used as collateral or not will depend on whether they are deemed sound or not.

Hill said that he disagrees that ABS are being created to fill a collateral need. He thinks a lot of collateral users and takers are incredibly circumspect about what they will take. He does not think that ABS fulfils this role.

Gabor said that the launch of the euro was accompanied by what she would call a European repo market. There was consensus that the euro area needed a European repo market that would integrate national fragmented markets. This would allow the transfer of collateral across borders with no restrictions. Why did the EU pursue this? The Commission considered it important because it created a single financial market place. Developing a European repo markets was also important for the ECB to fulfil its price stability mandate. Regulators were helping to create a European repo market. Since the crisis, there has been a breakdown of the European repo market. Before 2008, the European repo market would treat any eurozone sovereign bond that was issued as equivalent collateral. But since then, that has no longer been the case.

Q&A

A member of the audience said that the discussion has focused most on the potential for a systemic crisis to emerge, but not about the costs and returns of collateralisation to the real economy. McNulty alluded in his comments to a decision from the European Securities and Markets Authority (ESMA) which require that 100 per cent of the profits of SFTs are returned to the funds. However, if he buys shares directly, a lot of them are put into Omnibus accounts without his knowledge, and none of the profits are returned to the investor.

McNulty said that if one invests in UCITS funds, then investors get more information about the securities lending of the fund, and the return has to be returned to the fund itself. He does not think that what the audience member referring to is true. Investors who buy shares and holds them through a broker or a bank should not be in an SFT programme. This is bad practice, and would be considered outside of regulation in the UK. If he has examples of that happening, he would be interested to know. He is not aware of this happening himself.

A member of the audience asked if there are any useful lessons that can be learnt from the European Market Infrastructure Regulation (EMIR) or the Central Securities Depositories Regulation (CSDR) about how transparency can contribute to helping analyse systemic risk. What are some of the pitfalls that should be taken into account from these two Regulations in relation to SFTs?

Hill said that regulators need to be realistic in terms of the type of information that they can receive, and the regulators need an understanding of what kind of information that they are looking for.

McNulty said that EMIR was the instrument that produced the requirement of transaction reporting for derivatives. The SFT Regulation would do the same for collateral. A lot of detailed data was collected in relation to EMIR. He questions if this is the best way to provide information to the regulators. He has been engaging with the regulators about the best ways to transfer data. Rather than just capturing individual transactions, it might be preferable to take a snapshot of all the transactions that took place in a day. This would be easier to aggregate for the regulators.

Gabor said that true transparency is needed. Information should not just be shared between regulators and markets, academics also need access to this data, in order for academics to be able to provide and objective account of the market.

Bijkerk said that a global EMIR is needed. Bijkerk said that data is not a panacea, and the regulators need to think carefully first about what is required before all of the information is handed over.

Closing Keynote Address

Lord Jonathan Hill (European Commissioner for Financial Stability, Financial Services and Capital Markets Union) commenced his address by welcoming Christophe Nijdam into his new role as Secretary General of Finance Watch. His is an important job for an important organisation. The European Commission needs Finance Watch to bring together a range of groups' interests in financial regulation. The European Union needs Finance Watch's input to the Commission's work. Lord Hill said that his Commission colleagues have appreciated Finance Watch contributions to the Commission initiatives, expert groups and consultations over the last few years.

Lord Hill argued that the Commission needs to hear the views of different parts of the market, and different sections of society. There is a need to remember that the finance industry is here to serve consumers, savers, businesses and the wider community. He stated that this is why Finance Watch is one of the first organisations with which he met when he first became Commissioner.

All of the people present today want to encourage a financial sector that is built on strong foundations, that has the right values and which can underpin the economic growth that Europe so badly needs.

Many in this room were involved in the development of the new rules introduced over the last five years to govern the financial sector. The people in this room helped shape regulation that was essential to respond to the financial crisis and to help restore financial stability. It was a remarkable achievement, made more so by the fact that it had to be done while the fires of the financial crisis were raging.

The European Union needs to remain focused on the threats to financial stability, because financial stability remains the prerequisite to growth. That is why he is committed to finalising rules on bank structural reform, Money Market Funds (MMFs) and benchmarks, and to bringing forward new proposals to deal with risks arising from entities other than banks when they need to be resolved.

Lord Hill stated that it is important to recognise that the nature of the threat that Europe faces today has changed. Today, the lack of growth is the biggest threat to stability. GDP growth across the EU is anaemic, standing at only 0.3 per cent. There are nearly 25 million people unemployed. In many countries, there are genuine fears for a lost generation. And where the lack of growth and opportunity persists a sense of hopelessness is creating a deeply worrying and corrosive cynicism about the ability of democratic politics to deliver. So there is not only an economic, but a democratic imperative to get the European economies growing again. This is needed in order to build trust and restore hope for 500 million Europeans.

What is needed is both financial stability and growth, and growth must be sustainable. That is the new Commission's number one priority. It is why President Juncker's first act as Commission President was to launch the 315 billion euro Investment Plan. Jobs and growth will not come from the politicians, but from the Single Market and through trade.

This Plan can help by taking away some of the risk of investing in long-term projects; by supporting viable projects that might otherwise not have found investment; and by encouraging Member States to remove red tape, regulatory bottlenecks and other barriers to investment. Providing the right conditions for the economy to get moving again.

The relentless focus on jobs and growth also determines how Lord Hill is going to approach decisions which he will need to take as a European Commissioner. He will look at all regulation through the prism of jobs and growth. Given that the worst of the financial crisis is behind the European Union, one should not expect to have to legislate so much in the future. It would be correct to say that there is no need to anticipate anything like the volume of new legislation that the crisis called for.

After those five busy years of trying to 'moor the boat in a storm', there is also a need to question if the regulatory work which has been pursued has always struck the right balance between reducing risk and encouraging growth. If the evidence shows that this balance is not right, if the rules are not proportionate to the risks presented by different types of operator, then the European Commission should be ready to look at regulation again.

Lord Hill continued by stating that he knows that the issue of sustainable growth has been at the core of today's conference. Sustainable growth means an environment in which companies can expand, entrepreneurs can reach new markets and businesses can create more and better jobs. So that young people can have hope for their future and everyone can thrive.

A well-functioning, stable financial system is an essential pre-requisite for growth. The European Union cannot make the economy stronger by making EU financial services weaker. The European Union needs to move from a position where the industry is seen as being part of the problem to one where it is seen as part of the solution.

How can this be achieved in his mandate? How can financial services contribute to growth? Lord Hill argued that there are two important ways in which financial services can help.

The first is through a sound and stable banking system; one that is able to lend, keep people's savings secure, process payments and generally deliver the services that consumers and businesses need every day. A huge amount of work has already been done to make sure that the right framework is in place to make that happen.

He will continue to work hard to make sure that things stay on the right track. This means delivering detailed rules so that the reforms of the banking sector can be put into practice in day-to-day operations, and looking at how the rules are being implemented and applied on the ground.

He wants to ensure compliance does not become a box-ticking exercise, but a real change in culture. Lord Hill said that where wrongdoing is found; if professionals are found to have defrauded or deliberately misled unsuspecting customers, the system should come down on them like a ton of bricks.

The second way is through well-functioning capital markets. These can spur growth through boosting confidence in Europe as a place to invest.

Well-functioning capital markets also help encourage greater diversity in funding, which reduces concentration of risk so they not only free up capital for growth but also support and strengthen financial stability.

After all, it's important to remember that "capital markets" are not some abstract construct - they are someone's pension savings, someone's 'rainy day' money which is channelled to growth.

Building a Single Market for capital will help money flow through the EU to where it can be most productive. Its aim at its most simple is to link savings with growth. This is a project for all 28 Member States.

His ambition is to help unlock the capital around Europe that is currently frozen and put it to work in support of Europe's businesses, particularly SMEs.

Lord Hill stated that he would like to take this opportunity to explain briefly what CMU is intended to be. And, perhaps equally, what it is not.

With the CMU, the European Commission wants to remove the barriers that stand between investors' money and investment opportunities; clear obstacles that are preventing those who need financing from reaching investors; and make the system for channelling those funds - the investment chain - as efficient as possible.

The free movement of capital was one of the four fundamental principles on which the European Union was built. But fifty years on from the Treaty of Rome, there still isn't a fully functioning Single Market for capital. The market remains fragmented, largely along national lines. Overcoming that fragmentation could have significant benefits.

Just to take one example, if European venture capital markets were as deep as the US, as much as 90 billion euros more in funds would have been available to companies in the period between 2008 and 2013. Think of all the innovation that that could have sparked; all the new products and services that could have been dreamed up; all the new jobs that could have been created if that funding had been there.

The Commission's goal with the CMU is to make Europe more attractive to inward investment. The Commission also wants to create more financing opportunities for SMEs and infrastructure projects. Spread risk more effectively to those who can bear it. And deepen integration across borders within the EU, increasing competition.

Lord Hill reassured the audience that the CMU is not an attack on banks. It is not about punishing one sector of the industry to reward another. The Commission recognises very clearly the role that the banking system plays in Europe's economy and the contribution that banks make to local communities. Indeed the Commission envisages banks continuing to be an important distribution channel for market funding. CMU is rather about growing the overall pot so that everyone benefits: banks, capital markets and, most importantly, firms who find more sources of funding. And it is about giving choice to companies on where and how they want to get financing.

Equally, CMU is not another Banking Union. It will be very different from, but complementary to that project. Banking Union's focus was on breaking the link between bank failures and sovereigns through a single system of supervision and resolution in the euro area. That will provide a platform of stability and confidence to underpin development of a CMU across all EU 28 Member States.

CMU is a response to a different problem - that of high levels of savings not finding its way to productive use in the economy.

CMU is also not just for the big players or big companies. Quite the opposite. It is about giving smaller businesses a wider range of options for their financing, so they are not only reliant on their local bank branch, but can consider options like listing on a growth market or attracting equity investment from outside their home countries. And it is about offering attractive alternatives to retail investors who want to save for their retirement and want to spread the risk between a number of different vehicles. The European Commission thinks it will be a great opportunity for the smaller players, on both ends of the investment chain.

And finally, the CMU will not mean a return to the bad old days of misregulation and excessive risk-taking. It will be built on firm foundations of financial stability, namely the consistent implementation and enforcement of the Single Rulebook that has largely been put in place in recent years. The European Commission want to enable the economy to capitalise on a more diverse, more transparent and more resilient range of funding while remaining alert and vigilant to emerging risks.

So how, concretely, will the CMU be built? Well, it will not happen overnight. It is a long-term project that will require sustained effort over many years. And it will need to be approached from many different angles - securities laws, investment restrictions, tax treatments, insolvency regimes. These are all issues that the European Union has been grappling with for decades. But the urgency of Europe's economic need is more pressing than ever so the European Union should not shy away from addressing each of these issues.

In the meantime, the Commission has identified a number of areas where early progress can be made in the coming months to encourage investment and overcome obstacles.

The first will be proposals to build a market for high-quality securitisation. Highly transparent, simple and standardised securitisation instruments can help free up banks' balance sheets so they can lend to households and businesses. Again, the Commission has no intention of returning to the unhealthy practices of the past. So far as the highly complex, opaque and risky securitisation instruments such as subprime instruments are concerned - the door will remain firmly closed. But there is a need to be clear on where the problem was. The flawed products that were the catalyst for the financial crisis in the US must not be allowed to return.

However, European securitisations actually fared very well in the crisis. So why is it that securitisation levels in the US have completely recovered while EU securitisations remain depressed? This is having a negative effect on the European economy. If SME securitisation could be returned - safely - even to half way back to the levels they were in 2007, this could be equivalent to some 20 billion euro of additional funding.

The European Commission is not alone in being interested in breathing new life into the securitisation markets. Both the ECB and the Bank of England have consulted recently on high quality securitisations. They too are interested in making sure new securitised products adhere to higher standards. And it is a subject being discussed at the international level.

Lord Hill said that he understands Finance Watch's concerns regarding the potential for increased risk if there were to be a revival of securitisation, and he shares its view that vigilance is needed towards this and other emerging risks. One of the steps the Commission is taking to help safeguard against these risks is through the SFT Regulation. This Regulation will increase transparency, so that investors and regulators understand how and where such transactions are being used, allowing the European Union to act if needed.

The European Commission intends to review the Prospectus Directive to make it easier for firms, particularly smaller ones, to access markets and reach investors across borders, while making sure that investors get all the information they need about what they are investing in.

The European Commission will also start work on improving the availability of SME credit information to help bring loans to smaller firms. The Commission will be supporting the take up of the new European Long-Term Investment Funds (ELTIFs) to channel investment in infrastructure and other long-term projects. In this regard, the Commission will move fast on the legislative measures that are needed to implement the legislation on these new funds. The Commission will also assess whether it would be appropriate to extend the advantages currently available for national regimes to ELTIFs and will be encouraging EU institutions like the European Investment Bank (EIB) to use ELTIFs to channel investment.

And the Commission will be supporting the industry in its development of a pan-European private placement regime. Private placements can offer firms a cost-effective way to raise funds; can broaden the availability of finance for medium to large unlisted companies and could potentially support infrastructure projects.

He thinks that most Europeans share the same goal, namely to create a supportive environment in which funding can start flowing again and be put to productive use. One in which EU businesses, especially the small ones, can grow and expand. And above all, one that will encourage job creation.

The CMU will be one element in building that more growth-enhancing environment. It will help promote investment in the economy. To have a long-term impact on the ground, that extra investment needs to be accompanied by sustained efforts by Member States to implement the structural reforms their economies also so desperately need.

The European Commission is only at the beginning of the process of developing the CMU. Lord Hill said that he will be travelling around Europe in the next couple of months, meeting as many interested parties as possible to hear their views.

And the Commission will be launching a Green Paper on the CMU plans within the next few weeks. The banks and the financial industry will have a crucial contribution to make. So he strongly encourage all of the people in attendance, to contribute so that the Commission can get as rounded a picture as possible of the priorities and concerns of all users of the financial system.

For the European economies; for its democracies; it is imperative that growth returns to Europe. It is up to the Commission to prepare the ground, provide a supply of water, and ensure that when the seeds are planted, they can flourish.