Financial Reforms in the EU: a critical appraisal

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Possible abstract (1)

A critical analysis of capital market integration in the EU and, in particular, the eurozone, identifies four key phases. Until the late 1990s financial integration policies neglected capital markets and concentrated almost exclusively on banking. From just before the Lisbon agenda, a second phase began. This was inspired by the perceived efficiencies of the US capital markets and took the form of a "Financial Services Action Plan" which attempted to take advantage of the new monetary union to achieve a high level of financial integration. The spirit of the policy measures involved was strongly deregulatory. Following the global financial crisis, a third phase began, which attempted to establish a more tightly supervised and regulated financial regime at EU level…..

Possible abstract (2)

….A fourth phase might be signalled by the launch of the Capital Market Union, which aims to build a stronger financial basis for the investment growth now seen as urgently necessary for a full recovery of the eurozone. However, the key problem in building a CMU is the chronic shortage of high quality securities resulting from fiscal restraints in Germany, from the financial relegation of the weaker economies and from the absence of a significant budgetary authority at eurozone level. In the money markets the shortage of collateral is obstructing the workings of the credit system, while the absence of safe financial assets is impairing the activities of institutional investors and restricting the supply of investment finance.

Basic position

If the Europeans fail to develop large, liquid capital markets they will simply drive every issuer and investor on the planet into the North American ones.

Phases in EU financial integration

- Until late in the 1990s, exclusive concentration on banking
- Around 1999 and as part of the Lisbon agenda, FSAP and VCAP - the era of naïve liberalisation
- From 2007/8 onwards, the EU as key regulator
- From 2015, the CMU - key problem, lack of high quality securities

The Four Phases

1. Varieties of capitalism?
2. The Hooligans
3. Locking the stable door
4. Finance without a safe asset

Varieties of capitalism?

Bank dependence persists

(Liikanen Report, p12)

Table 2.3.1: Size of EU, US and Japanese banking sectors (2010)

	EU	USA	Japan
Total bank sector assets (€ trillion)	42.9	8.6	7.1
Total bank sector assets/GDP	349%	78%	174%
Top 10 bank assets (€ trillion)	15.0	4.8	3.7
Top 10 bank assets/GDP	122%	44%	91%

Notes: Top 6 banks for Japan.

Source: European Banking Federation (2011).

But eventually seen as a problem

- Issue of **scale** in the era of globalisation
- Commodification; Socialisation
- Historical financial models of Europe as a cluster of particularisms
- Scale linked to **standards**

Globalisation as commodification, P Lysandrou - Cambridge Journal of Economics, 2005

Grahl, J. (2001) Globalised Finance and the Challenge to the Euro, New Left Review

Varieties?

Neither “institutional complementarities” nor “path dependence” compatible with the rapid move to a security-based model.

Key example: pension reform and abolition of capital gains tax in Germany

Streeck, Alle Macht dem Markt?

Phase 2: the hooligans (aka D.-G. Internal Market)

Hooligans' charter:

> Business and citizens in the European Union need a regulatory environment which is clear, effective and workable in a rapidly changing, global market place. This is a key element if the European Union is to become the **cheapest and easiest place to do business** in the world (European Commission 2001, emphasis in original)

Hooligans (1)

Frits Bolkestein:

Arch hooligan

> “Ladies and gentleman, as parents tell their children, you won't get any pudding if you don't eat your spinach.”

Hooligans (2)

Charlie McCreevy:

Apprentice Hooligan

"...our priority is to cut red tape for business and get rid of outdated requirements which stifle entrepreneurs."

Hooliganism in action

- Bolkestein directive: choose your regulator
- draft takeover directive - minority shareholders rule OK - free fire zone in the EU
- the drive against “goldplating” - don’t let consumer interests hold back the market
- Mortgages - what Europe needs is subprime mortgages

Green paper on mortgages (2005)

‘Many….. express the view that the further integration of the EU mortgage markets could be considerably enhanced by the emergence of a pan-European funding market’ (p13)……..

Or to be precise...

US experience suggests that –

- Legal or other restrictions to banks' geographical expansions will reduce the efficiency of the mortgage-lending industry.
- Steps to create a single EU mortgage market would increase incentives to develop automated systems to process loan applications, which would reduce origination costs.
- Removing restrictions on maximum mortgage interest rates would **allow a subprime mortgage market to develop**, thus expanding total mortgage lending. (London Economics:168, emphasis added)

But in the White Paper (December 2007)

…... ‘recent events in global mortgage markets have confirmed the pertinence of the approach proposed’ (p10).

Débacle - what the hooligans said

(D.-G. Internal Market press release 27/02/2008)

‘The origin of the current financial turmoil came from the US sub-prime mortgage sector and a large portion of the European financial sector is not directly affected by the turmoil at this stage. Where financial institutions have sizeable direct exposures to the US sub-prime market, or indirect exposures through structured products, the affected entities have well diversified portfolios and large capital buffers.’

The reality

(Gros & Micossi 2008):

‘the dozen largest European banks have now on average an overall leverage ratio (shareholder equity to total assets) of 35, compared to less than 20 for the largest US banks.’

The reality (2)

Münchau, FT 26/04/2009

The most shocking news from last week's excellent **global Financial Stability Report** from the International Monetary Fund was not the headline estimate of total bad assets. That number stands at $4,100bn (£2,800bn, €3,000bn) and will almost certainly be revised upwards. Much more shocking was that the lion's share of these assets belong to European, not North American, banks. Of the total $4,100bn, the global banking system accounts for $2,800bn. Of that, a little over half – $1,426bn – is sitting in European banks, while US banks account for only $1,050bn.

Phase 3 - locking the stable door

41 Directives and Regulations since the financial crisis.

Key themes include:

- new structures
- the global agenda on banking
- boundary problems

New structures: the European system of financial supervision

Three new authorities (ESAs)

- European Banking Authority
- European Securities and Markets Authority
- European Insurance and Occupational Pensions Authority (note possible overlap of the last two since savings schemes often have an insurance format)

New structures: the European system of financial supervision

Macroprudential:

European Systemic Risk Board - based in Frankfurt and presided by Mario Draghi - in essence an informal modification of the ECB mandate

Structural Change - demotion of the hooligans

New D.-G.FISMA for Financial Stability, Financial Services and Capital Markets Union

English Commissioner, former Tory minister

Structural reforms of banks

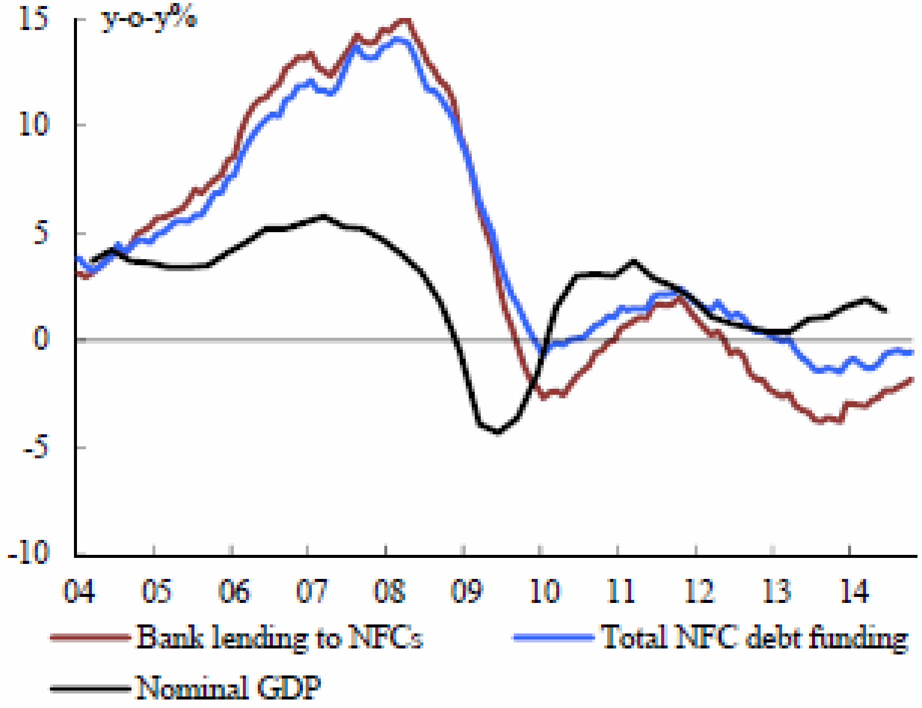
- Inspired by Liikanen report
- Applies only to TBTF banks
- Ban on proprietary trading
- Separation of other trading and investment activities

Structural reforms of banks

- Jacques de Larosière, LSE 10/06/15
- “Structural aspects of the banking business models were not the cause of the crisis.”
- “It is better to let banks define their own business models in a sound regulatory framework, than for regulators to prescribe detailed structural rules.”

Lending to Corporations: still mostly bank credits

Graph I.16: Economic and credit cycles for NFCs, euro area

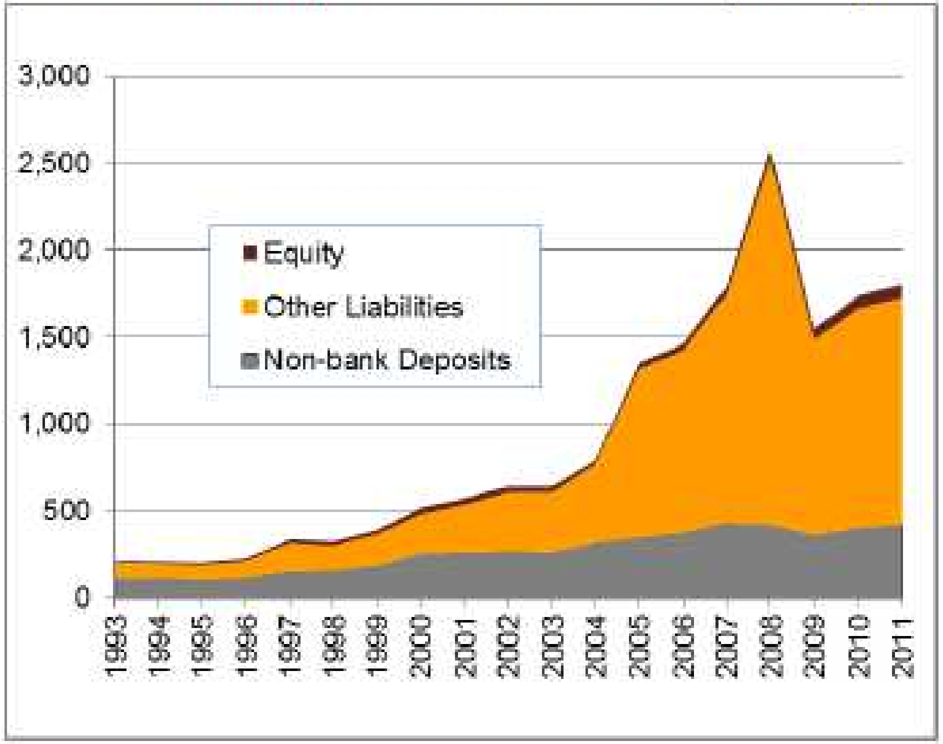


Source: ECB, own calculations

Spot the equity (1)

(Liikanen report, p49)

Chart 3.4.18: Barclays – Evolution of liabilities (€ billion)

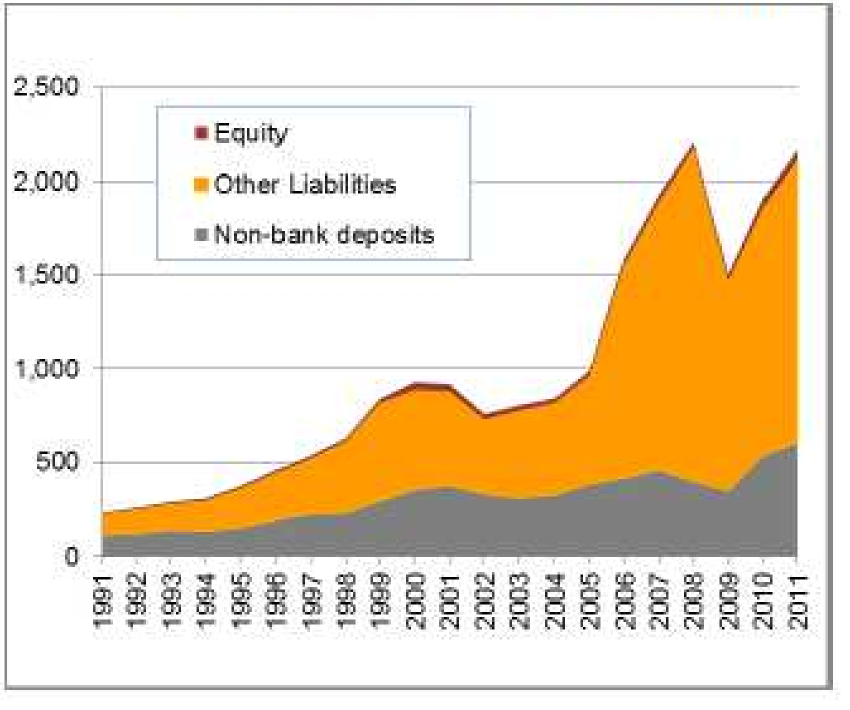


Source: Data from published accounts.

Spot the equity (2)

(Liikanen report, p49)

Chart 3.4.19: Deutsche Bank – Evolution of liabilities (€ billion)



Hellwig on the reform agenda

"On the one point that really matters, equity requirements for banks, progress has been modest, to put it diplomatically….. In relation to total assets, the equity of large European banks has gone from between two and five percent of total assets to between three and six percent of total assets….

Hellwig on the reform agenda (2)

"…..The proposals for structural reform have been shaped by nostalgia and illusions: nostalgia for the good old times in the US when the Glass-Steagall Act was in place, and illusions about the feasibility of eliminating the need for taxpayer bailouts."

Hellwig on structural reform

“Governance: In our wealthy societies, financial institutions at the retail level collect more funds than they can invest within their own domain. They channel them to other financial institutions. In the run-up to the crisis, governance for this process was badly flawed, in separated as well as integrated systems. We should focus on how to deal with this governance problem.”

Taxing the financial sector

Wrong choice made - an unworkable FTT introduced instead of a very feasible financial activities tax - see Grahl and Lysandrou 2014

Locking the stable door

Key problem:

new constraints and restrictions on banks and a suggestion that banks' security market activities should be restricted

but small, weak and illiquid security markets

Phase 4 - where is the investment coming from?

Increasingly the priority shifting from stability to investment and growth. The capital markets union expresses this aspiration but are there any instruments to bring it about?

The drop in investment

Eurozone: Fixed Investment/GDP

2007	23.1
2008	22.9
2009	21.1
2010	20.6
2011	20.7
2012	20.2
2013	19.6
2014	19.5

The capital markets union

GREEN PAPER

Building a Capital Markets Union

- Brussels, 18.2.2015
- COM(2015) 63 final

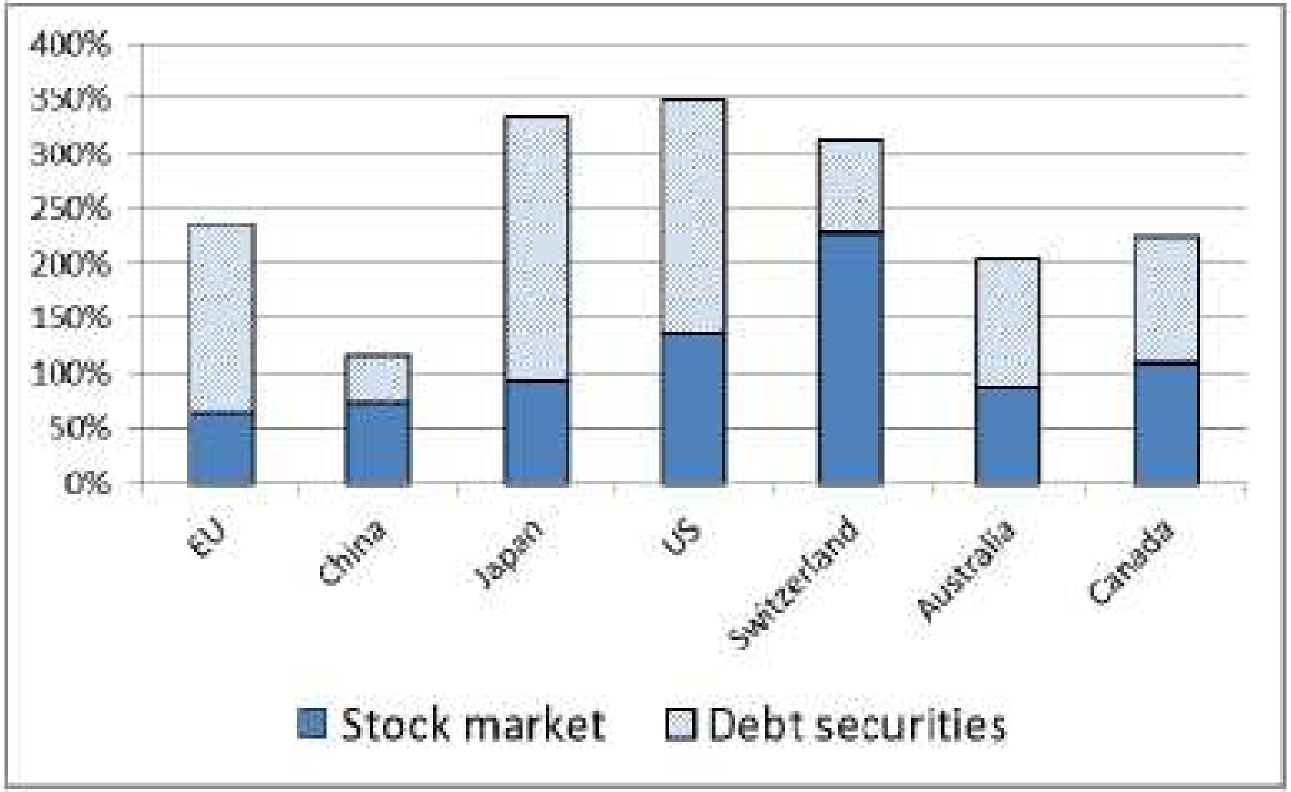
“Compared to other parts of the world, European businesses remain heavily reliant on banks for funding and relatively less on capital markets. Stronger capital markets would complement banks as a source of financing, and would:

- unlock more investment for all companies, especially SMEs, and for infrastructure projects;
- attract more investment into the EU from the rest of the world; and
- make the financial system more stable by opening up a wider range of funding sources.”

US medium-sized companies, the engines of growth in many countries, receive five times more funding from capital markets than they do in the EU.

If our venture capital markets were as deep [as those of the US, JG], as much as €90 billion of funds would have been available to finance companies between 2008 and 2013. If SME securitisations could be returned – safely – even to half the
levels they were in 2007 compared with today, this could be equivalent to some €20bn of additional funding.

Chart 2: Stock market capitalisation and debt securities (% of GDP)



Securitisation is back

Securitisation issuance in Europe in 2014 amounted to some €216 billion, compared to €594 billion in 2007.5 A sustainable EU **high quality securitisation market** relying on simple, transparent and standardised securitisation instruments could bridge banks and capital markets.

Are these instruments sufficient?

“... in the next months, we will:

1. develop proposals to encourage high quality securitisation and free up bank balance sheets to lend;
2. review the Prospectus Directive to make it easier for firms, particularly smaller ones, to raise funding and reach investors cross border;

Are these instruments sufficient?

3. start work on improving the availability of credit information on SMEs so that it is easier for investors to invest in them;
4. work with the industry to put into place a pan European private placement regime to encourage direct investment into smaller businesses; and
5. support the take up of new European long term investment funds to channel investment in infrastructure and other long term projects.

Obstacles

"These include, for example, the historical preference by business for certain means of financing, the characteristics of pension provision, the application of prudential regulations and administrative hurdles, aspects of corporate governance and company law, data gaps and features of many tax systems, as well as inefficient market structures."

Obstacle not mentioned

Chaos in the eurozone

And do they really have a banking union?

...the Banking Union's focus on breaking the link between bank failures and sovereigns in the euro area will provide a platform of stability to underpin the development of a Capital Markets Union across all EU Member States.

Cf. Schäuble - tomorrow a banking union of steel but today, only of wood

Banking union of wood

"...the Board is directly responsible for the resolution planning and resolution of entities directly supervised by the ECB (significant banks) and cross-border groups, while the national resolution authorities are responsible for all other entities."

Banking union of wood

“The IGA (intergovernmental agreement) scope is strictly limited: it will cover the transfer of the contributions raised by the national resolution authorities to the national compartments (which will be merged after a transitional phase of 8 years) of the Single Fund; the mutualisation (60% over the first two years and 6.7% in each of the remaining six years) of the funds available in the national compartments…”

Good securities disappear

Negative yields

Relegation of non-German debt

Negative yield bunds

http://ftalphaville.ft.com/2015/03/16/2121855/bund-cookies/

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EURO ZONE

Germany	AAA	s	Aaa	n	AAA	s
Luxembourg	AAA	s	Aaa	n	AAA	s
Finland	AA+	s	Aaa	s	AAA	s
Netherlands	AA+	s	Aaa	s	AAA	n
Austria	AA+	s	Aaa	n	AAA	s
France	AA	n	Aa1	n	AA+	s
Belgium	AA	n	Aa3	n	AA	s
Estonia	AA–	s	A1	s	A+	s
Slovakia	A	s	A1	s	A+	s
Ireland	A	s	Baa1	s	BBB+	s
Slovenia	A–	s	Ba1	n	BBB+	n
Malta	BBB+	s	A3	s	A	s
Spain	BBB	s	Baa2	p	BBB+	s
Italy	BBB-	s	Baa2	s	BBB+	s
Portugal	BB	n	Ba1	s	BB+	n
Cyprus	B	s	Caa3	p	B–	n
Greece	B–	s	Caa3	s	B	s

Source: Ratings agencies

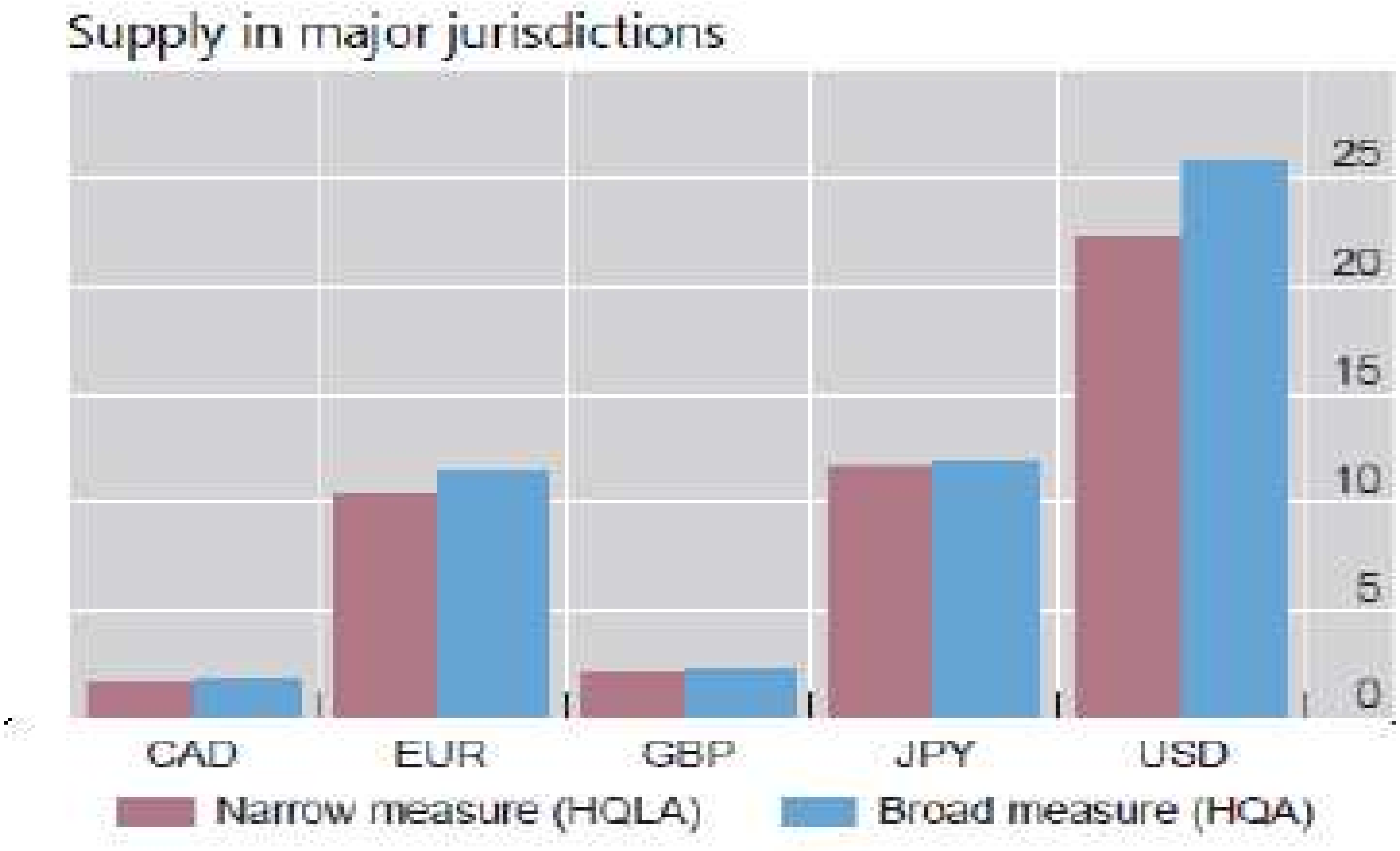
Two problems

1. Collateral shortage
2. Fund management impaired

Collateral shortage

- LSE
- The Economics of Collateral By Ronald W. Anderson and Karin Jõeveer
- FINANCIAL MARKETS GROUP
- DISCUSSION PAPER No 732

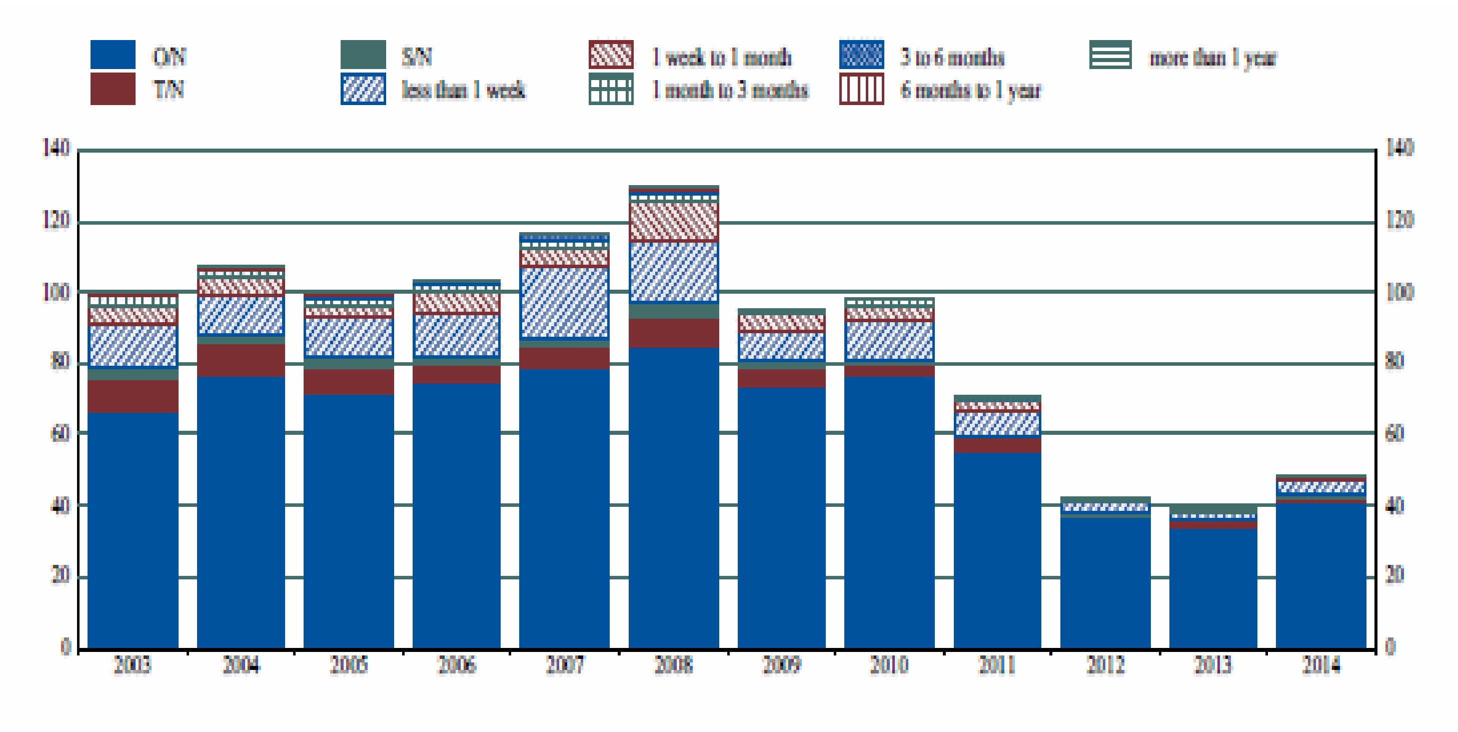
Europe short of collateral? CGFS estimates of high quality securities (from BoE, speech by Andrew Hauser, 11/06/13) $ trillions



Demand and supply trends for high quality collateral (from BoE, speech by Andrew Hauser, 11/06/13)

DEMAND FACTORS		SUPPLY FACTORS	
Market trends	Move away from unsecured Flight to safer investments/collateral Demographic shifts in longer term investment demand	**Sovereigns**	Fewer AAA, but... ...much higher issuance
Regulation	Basel LCR Mandatory OTC clearing Margins for non-cleared OTC Solvency 2 Restrictions on collateral re-use	**Private Sector**	Packaging 'safe' assets Large corporate shifting from banks to capital markets Collateral management efficiency
Central banks	QE / Large Scale Asset Purchases	**Central banks**	Higher reserves creation (combined with wider eligibility criteria)

The collapse of unsecured lending (ECB money market survey, October 14)



Note: The panel comprised 101 credit institutions.

ESRB study: assets used as collateral

Table 3: Collateral received and posted by collateral asset type (€ billions)

Collateral	Collateral received	Collateral posted
Government debt	2,602	2,632
Covered bonds	111	180
Debt instruments issued by FIs	305	392
Debt instruments issued by non-FIs	128	120
Asset-backed securities	94	250
Loans	0.8	206
Equities	605	523
Other	126	274
Total	3,971	4,576

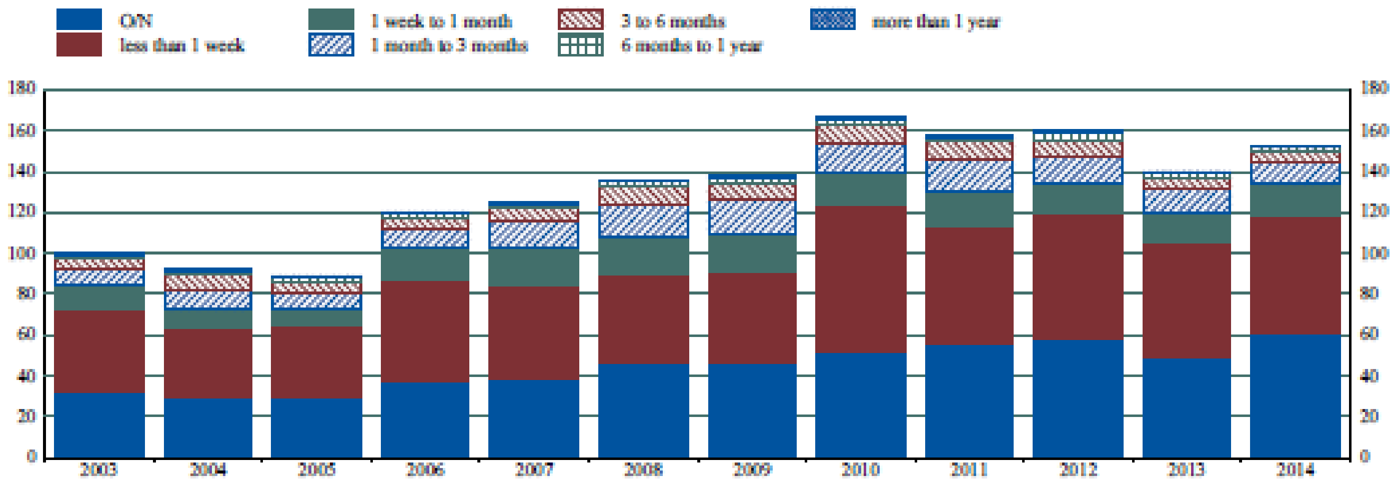
LSE study: shortage versus misallocations of collateral

- Allocation problems grow with information sensitivity of valuations.

Heavy use of dollar collateral (ECB money market survey, October 14)

6.8 FOREIGN EXCHANGE (FX) SWAPS AND FOREIGN EXCHANGE (FX) FORWARDS: TURNOVER ANALYSIS

Chart 92 Cumulative quarterly turnover in the FX swaps and forwards segment
(index: FX swaps volume in 2003 = 100)



Consequences of a lack of safe securities

Calculation much more difficult;

Portfolio adjustment more difficult - illiquid and less widely recognised assets have to be traded

Pressure on institutional investors

"At zero interest rates, it is very difficult for the industry as a whole to remain solvent. In anticipation of the difficulties ahead, German insurers have begun to diversify into other assets, such as property or private equity, taking on more risk in the process."

Wolfgang Muenchau, FT 9/03/15

The plight of the fund managers

- “The policy regime has now made it mathematically impossible for fiduciaries to meet the beneficiaries’ future needs through the prudent buying of securities…. They can spend the next few quarters buying five year Bunds with negative yields, and then go home to curl up in a foetal position every night.” John Dizard FTFM 16/03/15

Is QE feasible without assets to buy?

…….more than €200bn-worth of German bonds must be bought during a period when net issuance is estimated at just €6bn. Some of the biggest holders of German debt — pension funds, life insurers and other central banks — are unlikely to want to sell.

Is QE feasible without assets to buy?

"With German bonds of maturities up to seven years already trading at negative yields, the Bundesbank could also be constrained by an ECB cost ceiling, which bans purchases of bonds with yields below minus 0.2 per cent. Some think the German central bank could reach ECB-imposed limits, which would mean it cannot buy more than a third of its sovereign's bonds." FT 11/3/15

Historical analogy?

Harold Underwood Faulkner, American Economic History, 8th edition, pp153-4

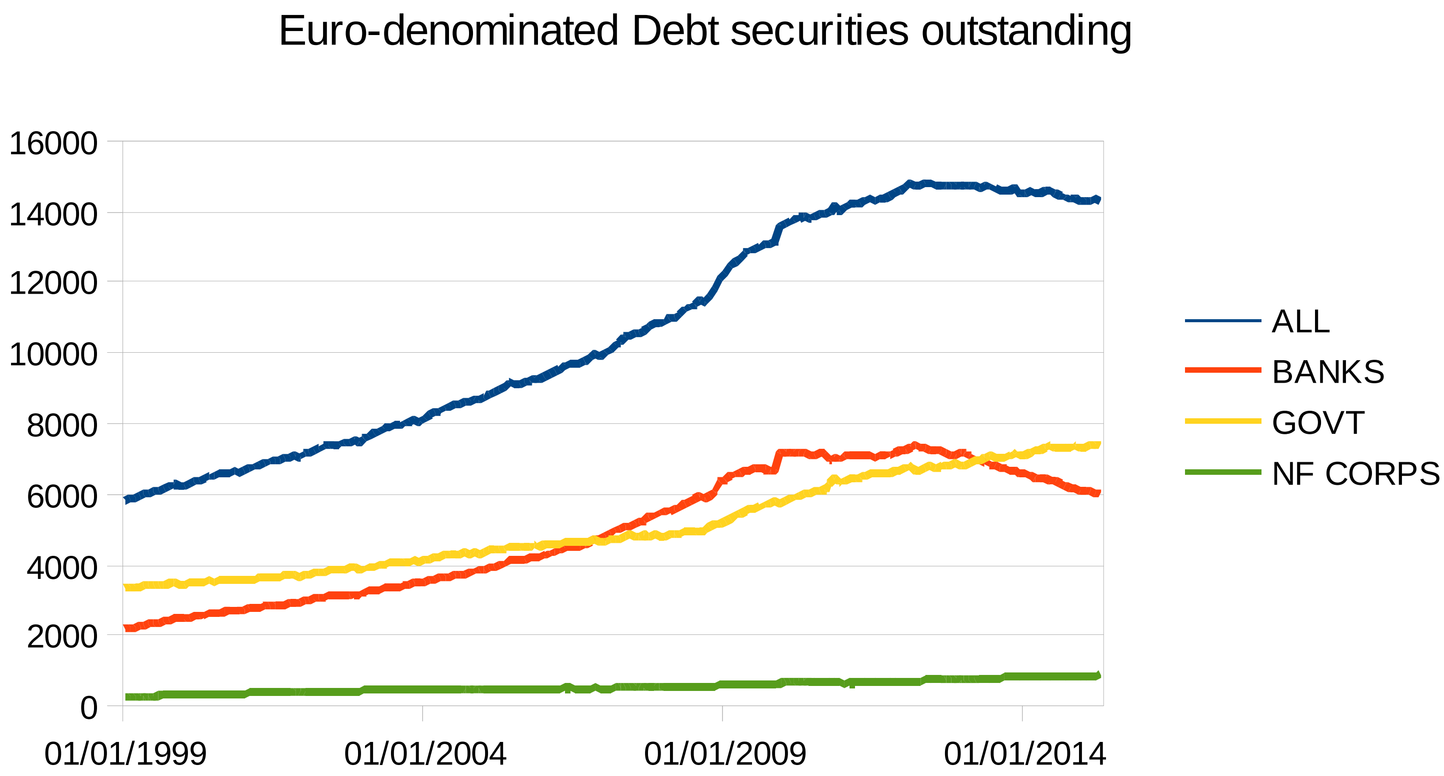
"…the proposal that the federal government assume the state debts aroused violent controversy. It was justly charged that the speculator was favored at the expense of the patriot, and some states at the expense of others. Certain southern states, where the debts relative to the population were less than in the North, strongly opposed assumption of state debts, and many who had parted with their depreciated paper for a song bitterly resented the payment at par to speculators."

Historical analogy?

Harold Underwood Faulkner, American Economic History, 8th edition, pp154

"Hamilton finally prevailed against bitter opposition (1790). His arguments were both economic and political. Refunding and assumption would establish the credit of the federal government, consolidate behind it the commercial and financial interests , and provide sound securities which might answer the purposes of money in business operations."

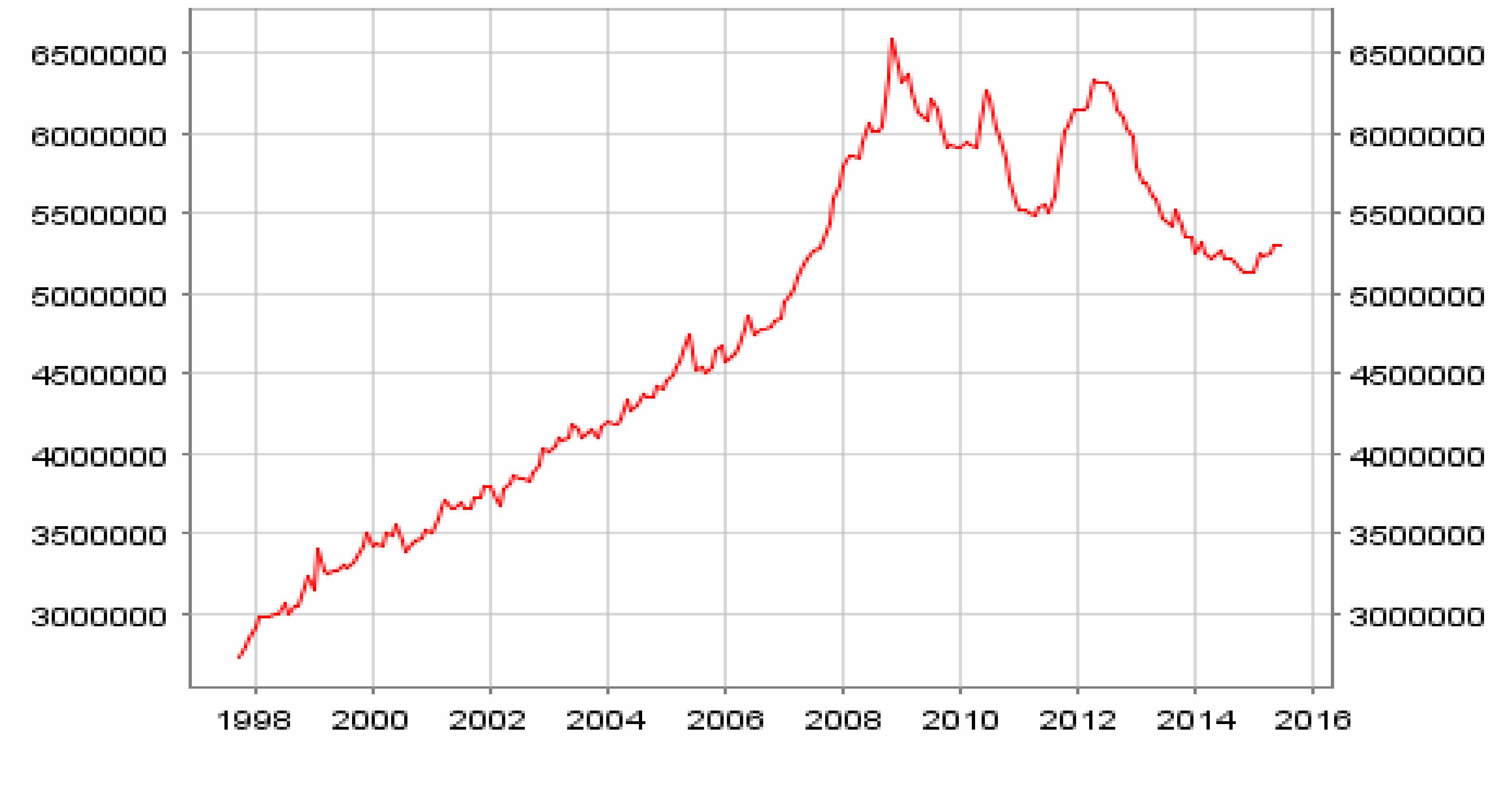
Financial Stagnation: Bonds



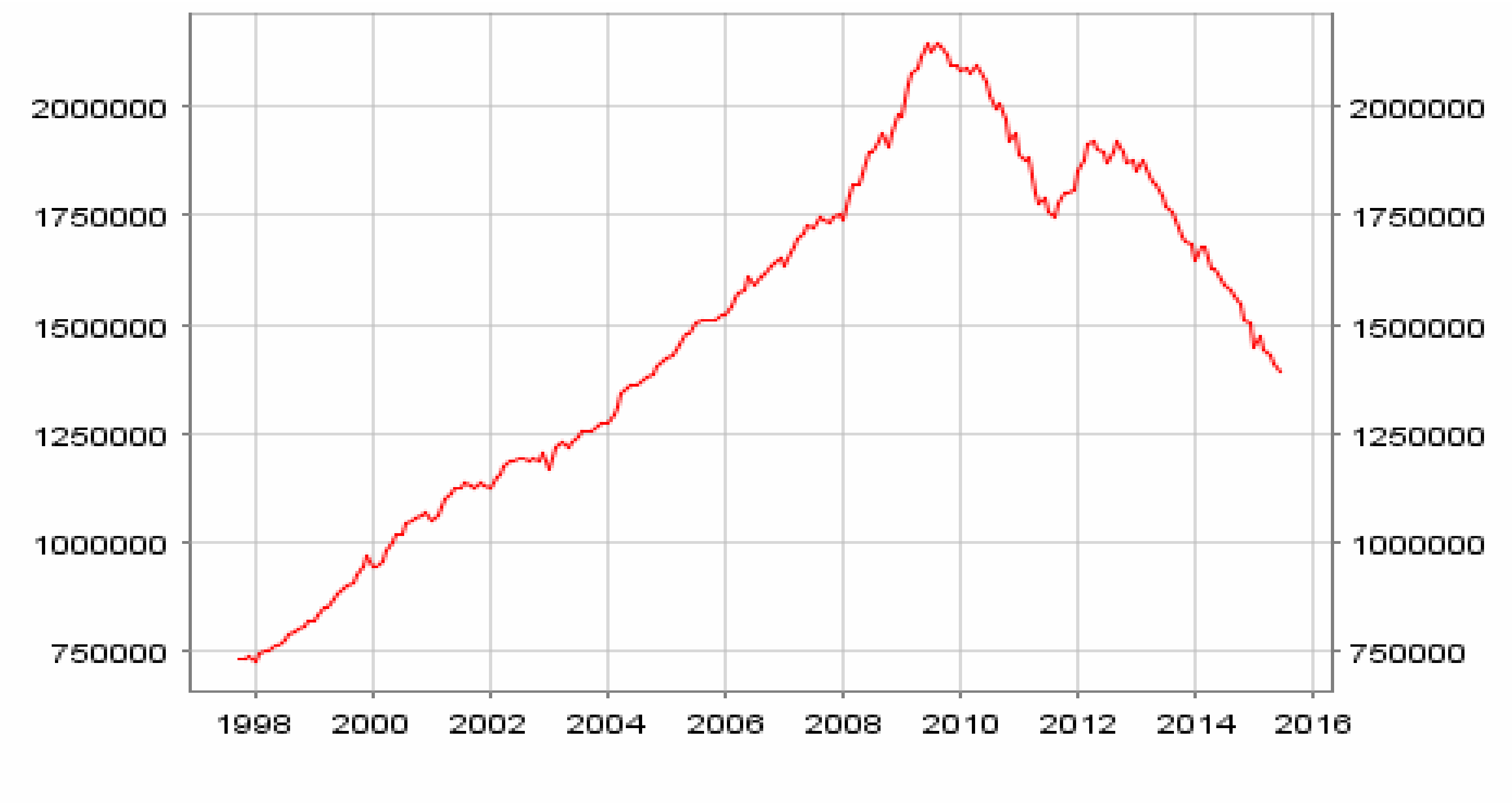
Financial Stagnation: Banks

- In spite of LTROs, QE etc….

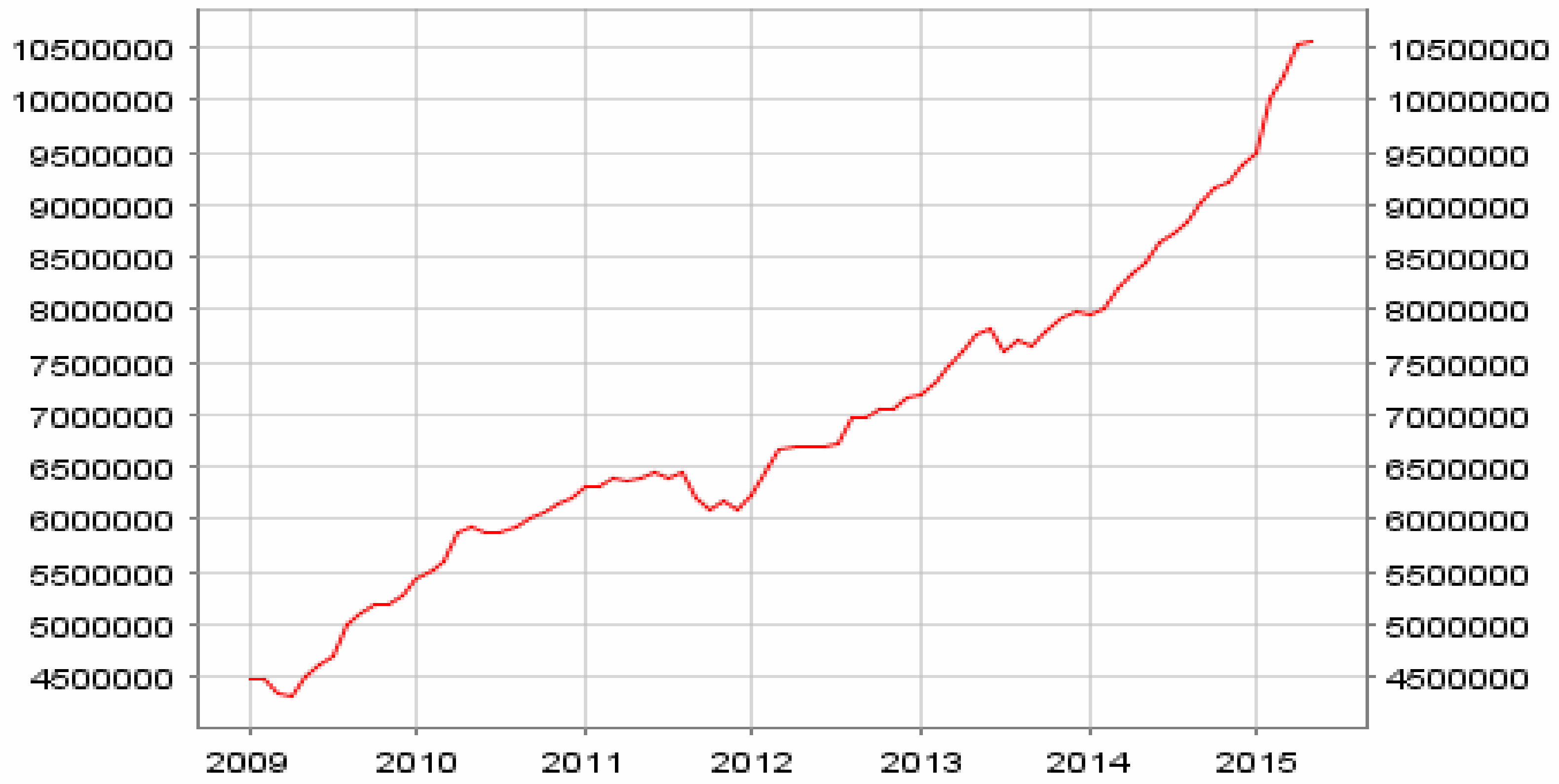
ECB data: total loans of eurozone banks



ECB data: eurozone banks' holdings of debt securities

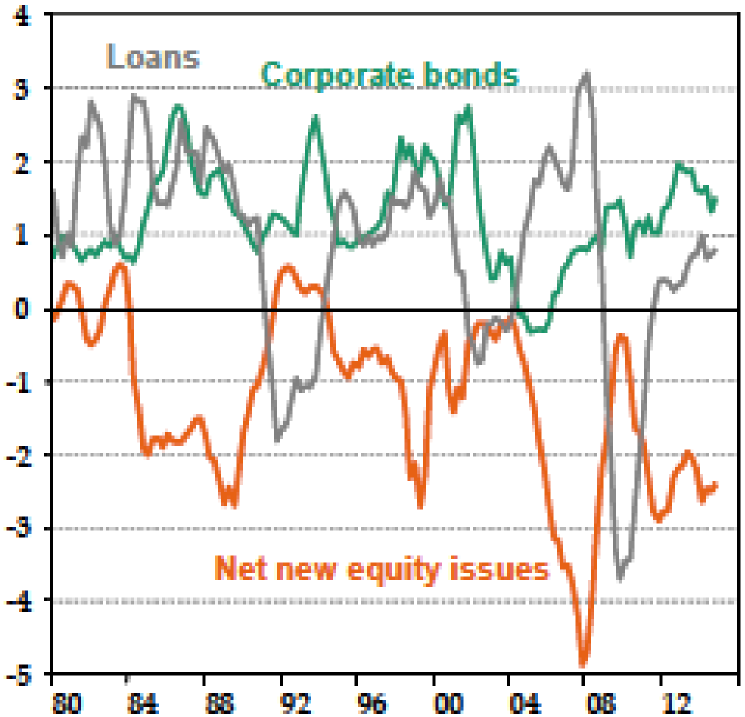


But institutional investors may be in better case: ECB data: total assets of eurozone investment funds



Financial Stagnation: comparison with US

Figure 1. Net financing sources of US non-financial corporations (% of GDP)



Sources: Federal Reserve and Thomson Datastream.

Financial Stagnation: comparison with US

"... the weakest financial link in the eurozone is not so much its stock market, but rather the virtual absence of a market for private-sector bond issues…. The biggest difference between Europe and the United States, both from the standpoint of monetary policy and private-sector funding, has to do with the role played by the bond markets: in the US, businesses and households alike tap this market for a substantial portion of their financing, either directly or indirectly via securitisations." Brender, Pisani, Gros