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Policy Brief

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A holistic approach to ECB asset purchases, the Investment Plan and CMU

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Summary

To stimulate and finance investment in Europe the three "policy stars" of Europe need to be aligned: the Capital Markets Union initiative, the €315bn Investment Plan, and the ECB's €1,100bn asset purchase scheme. They jointly face a unique set of issues. First, the resilience and the cyclical performance of the European bank based system needs to be improved. Second, the "right" markets need to be developed for banks to outsource risks without jeopardising financial stability. Third, cross-border risk-sharing urgently needs to be rebalanced, because it has become, in the wake of the Great Recession, overly reliant on debt instruments as opposed to equity. We argue that to achieve alignment between initiatives, an overall strategic vision could:

- Set an explicit, holistic strategy, ensuring that the instruments in the Investment Plan receive appropriate regulatory treatment within the CMU, and are eligible to the ECB's purchase programme and collateral.
- Set a strategic objective for the euro area financial structure. It could be a "spare wheel" model where (i) banks would remain predominant (with capital markets as a countercyclical "spare wheel"), and (ii) banks would outsource risk through covered bonds (with untranched securitisation acting as the "spare wheel").
- Proactively promote equity instruments in all three policy initiatives for more sustainable cross border risk sharing.
- Promote a new business model for "credit assessment" with a value chain featuring the credit information collected by commercial and central banks.
- Re-orientate the ECB's purchases away from sovereign debt instruments towards the instruments that will finance the Investment Plan, those of the so-called "agencies", and private sector assets.
- Formally involve NPBs in the Investment Plan, preferably in the equity of the EFSI Fund.
- Improve the governance of public investment ex ante via independent, supra-national investment committees, and ex post via strict disciplinary measures.
- Be pragmatic but tangible in the objectives set for the Capital Markets Union (focus on cross-border insolvencies and improve national business environments).

1 Policies and diagnosis

1.1 The three policy stars

Following the financial crisis, Europe is suffering from a significant investment deficit: since 2011, public sector investment has dropped to less than 2.5% of euro area GDP, down from about 4.5% during the previous 30 years (Fichtner *et al.* (2014)). The private sector tapered down investment even earlier in the crisis, with private investment falling to below 19% of GDP in 2008, more than 3% points below its average over the previous 15 years. Growth will suffer in Europe over the medium term unless the shortfall in investment is addressed (IMF (2014)).

Investment Plan on the table...

On the back of the pressing investment needs, the long awaited Investment Plan for Europe was finally announced at the end of 2014. The three pronged strategy encompasses: (i) the creation of a Strategic Fund (the European Fund for Strategic Investment, or EFSI); (ii) a project pipeline; and (iii) the promise to take "measures" to create an investment friendly environment on the continent. Mr Juncker deserves considerable credit for making a significant expansion in public and private investment (and the partnership between them) a cornerstone of his European Commission presidency. But a lot of the (vital) detail still needs to be hammered out. The Plan, which has a stated objective to mobilise (at least) €315bn by the end of 2017 to invest in the real economy, lacks fresh public money, fails to re-direct existing EU funds such as the Structural and Cohesion Funds, and does not mobilise fully the firepower of National Promotional Banks. As for private investors, three key issues still need to be clarified for the plan to be attractive. First, the conditions under which public guarantees will be exerted. Second, whether or not the EIB would lose seniority on investments made under the Plan. Third, the nature and conditions of the 'first loss' capacity within the fund.

'economies with high bond share and significant bond-loan substitution recover from recessions faster'

...Capital Markets Union in the making

The Capital Markets Union (CMU) is still in its infancy. However, in its 2015 Green Paper (EC(2015)), the Commission has suggested five key areas to prioritise: the development of high quality securitisation to free up bank balance sheets to lend; a review of the prospectus directive to make it easier for smaller firms to raise funding, including cross-border funding; the improvement of the availability of credit information on SMEs; the development of a pan European private placement regime; and the support of the European long-term investment funds instituted at the end of 2014.

...and a significant ECB asset purchase programme underway

The third of the big three policy actions is the ECB's €1100bn expanded asset purchase programme (APP) formalised in January 2015 (ECB, (2015)). It encompasses the purchase programmes for asset-backed securities and covered bonds launched previously, as well as purchases of euro investment-grade securities issued by euro area governments, agencies and European institutions. It is intended to be carried out until the ECB is satisfied with the inflation path.

1.2 The European financial structure as it stands

Mobilising finance to increase investment in Europe requires a good understanding of Europe's financial structure. This involves acknowledging the fact that (i) Europe is engaged in a debt-deflation deleveraging phase, with (ii) accompanying disintermediation, the full extent of which is as yet unknown. In this context, allowing MFIs to outsource risk (covered bonds and securitisation) will be a key factor for any initiative to successfully finance investment.

Bank-centric more than debt-centric

The European financial system is bank-centric as opposed to the US. In the EU, the banks' balance sheets total more than 300% of GDP, whereas in the US they come to less than 100% (see table 1). Recognition of this fact is key to ensuring the success of the Investment Plan and other initiatives to kick-start investments in the EU through an easing of financing conditions. Longer-term initiatives, such as the CMU, should also take full note of this.

The debt financing of non-financial corporates in Europe is dominated by bank loans, whereas in the US corporate bonds are of almost as much importance as loans

Table 1 – Financial balances of the euro area and US banking sector as of March 2014

(*Percent of GDP*)

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

Source: European Central Bank (ECB) and Federal Reserve.

Chart 1 – Differences in financial strutures are there to stay

Chart 1.a – **Euro area nonfinancial corporates still biased towards loan financing...**

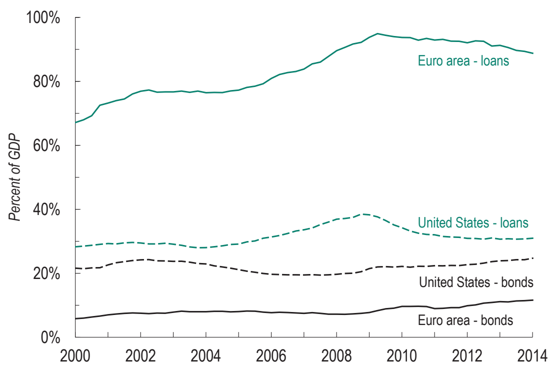
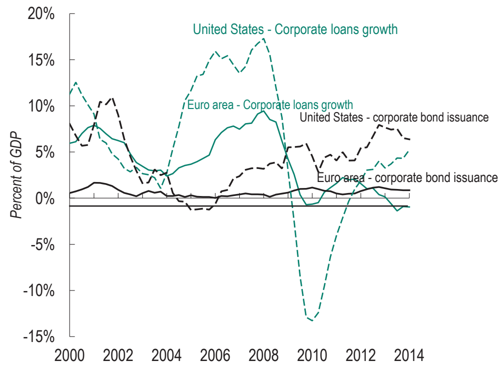


Chart 1.b – **...and differences between the US and the euro area set to persist**

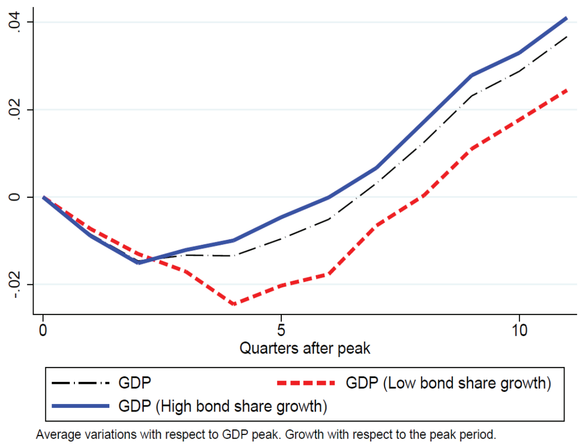


Source: European Central Bank (ECB) and Federal Reserve.

(see chart 1a). Take note that corporate bond issuance in the US increased in the most critical phase of the financial crisis, making up for the fall in corporate loans (see chart 1b).

The composition of corporate debt between bank and other sources of finance has been shown to be time-varying (Adrian *et al.* (2012), Becker and Ivashina (2014)). In hard times, the issuance of market debt helps firms to mitigate the contraction in the supply of bank debt by troubled banks (Allard and Blavy (2011)). In addition, economies with high bond share and significant bond-loan substitution recover from recessions faster (Grjebine *et al.* (2014), see chart 2). This seems to us a desirable property.

Chart 2 – Economies with a high substitutability of bank and bond financing recover faster

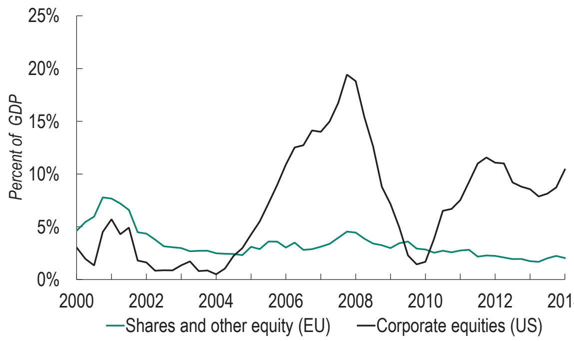


Source: CEPII, Grjebine *et al.* (2014).

Equity still tiny

Equity financing in the EU is tiny in terms of new external financing (see chart 3). Net new equity issuance is very limited (Berg *et al.* (2015)), as equity financing primarily comes from retained earnings and valuation adjustments.

Chart 3 – Equity issuance of nonfinancial corporations in the euro area small compared to the US



Source: .European Central Bank (ECB) and Federal Reserve.

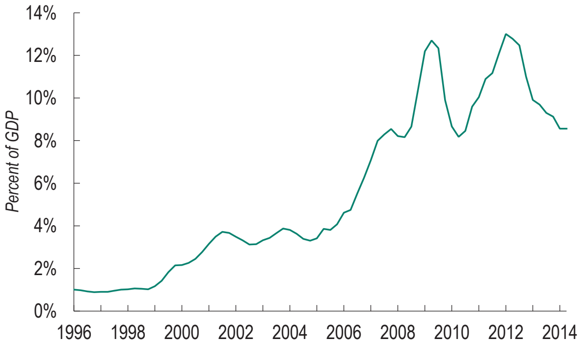
Given all of the above, Europe is likely to suffer much more than the US from the process of bank disintermediation, a process which is likely to continue over a good number of years. New players have emerged and will continue to do so, and this should be encouraged, but it is unlikely that they can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

Outsourcing risk: securitisation and untranched securities still underdeveloped...

Another characteristic of Europe's financial structure is the limited development of securitisation relative to the US (see chart 4).

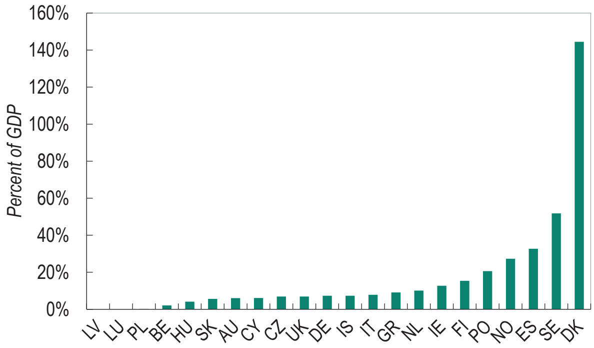
The financial crisis clearly illustrated the vulnerabilities of the complex and opaque securitisation markets, and, more generally, of the off-balance-sheet model of financing that developed and prevailed in the United States. The CMU's stance on securitisation resembles a high wire act. On the one hand,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

Chart 4 – Securitisation has remained muted in the euro area



Source: . European Central Bank (ECB).The series presented here is the issuance of securities by euro area financial institutions other than MFIs. It encompasses securitisation and is shown here as a rough upper bound for securitisation in the euro area.

Chart 5 – Covered bond markets are heterogenously developed (outsanding amounts)



Source: European Central Bank (ECB) and Federal Reserve.

We see indisputable merits to the development of what is now generally referred to as "high quality securitisation". The idea being that in the future, securitisation markets would support financial stability rather than pose a risk to it (see, *e.g.*, Segoviano *et al.* (2015), EBA (2014)).

But securitisations are legally defined as tranched securities, where the different tranches take different degrees of risks. Securities that finance a pool of loans, but where there are no risk tranches, are not considered securitisations. They are therefore not subject to the same draconian regulations, including prohibitive capital requirements for the issuer. Untranched securities could, therefore, even within the present regulatory regime, offer some possibilities. A number of government or central bank sponsored initiatives are already underway (Berg *et al.* (2015)).

'Current account imbalances continue to matter due to a composition mismatch'

…while covered bonds are more widely used

By contrast to securitisation, the covered bond market in Europe is large, but its importance across countries differs (see chart 5)[1].

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

It is interesting to note that, well before announcing, and then implementing the Public Sector Purchase Programme (PSPP) in March 2015, the ECB embarked on a series of Covered Bonds Purchase Programmes: the CBPP which launched in 2009 and ended in June 2010; the CBPP2, launched in 2011 and ended in October 2012; and the CBPP3, launched in September 2014. These programmes were well intended, but as of end 2014 they had failed to raise sufficient volumes to generate a sufficient quantity of liquidity. To give an order of magnitude, the outstanding amounts of covered bonds standing on the Eurosystem balance sheet were (as of early April 2015): €26bn (CBPP); €11bn (CBPP2); and €65bn (CBPP3). These programmes might stimulate the development of covered bond markets by mechanically creating demand for those assets, although they would probably also affect, even if only temporarily, their liquidity.

1.3 Cross-border risk sharing in Europe: the diagnosis

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

Reliance on debt instruments is excessive

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

In theory, with free capital mobility, geographical savings/investment mismatches should not matter too much. But intra-euro-area current account imbalances continue to matter due to a composition mismatch: during the pre-crisis years, the external funding of the

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

Table 2 – **Financial balances of Euro-zone nonfinancial corporates as of March 2014**

(Percent of GDP)

	EU18		US	
	Assets	Liabilities	Assets	Liabilities
Deposits	22	0	15	0
Bonds	3	12	1	29
Loans	32	89	1	38
Shares and other equity	95	161	27	15
Other	41	39	75	45

Source: European Central Bank and Federal Reserve.

investment boom in the euro area periphery quasi-exclusively relied on debt flows from core countries (primarily through bond purchases and inter-bank lending) as opposed to direct and portfolio equity investment (see table 2). This reflects the behavioural biases of both groups of countries.

In periphery countries, policy-makers have been more prone to protect and promote their 'national champions' than to attract foreign equity capital.

In core countries, and especially in Germany which is the largest contributor to the overall savings surplus, savers are averse to equity investments, preferring to put their savings into bank accounts or life insurance (which invest predominantly in debt instruments). As an illustration, annual average net financial flows from core euro area countries (Austria, Belgium, Germany, France, Finland, Luxembourg and the Netherlands) to the peripheral countries (Cyprus, Estonia, Greece, Spain, Ireland, Italy, Malta, Portugal, Slovenia and Slovakia) over 2004-2006 amounted to €138bn net debt (portfolio debt and other investment, that is mainly bank loans) and a negative €10bn of net equity (direct investment and portfolio equity).

'the ECB is indispensable to the success of the Investment Plan and CMU'

'synergies would be enhanced by formulating an explicit, holistic strategy'

The lack of cross border equity induces vulnerabilities

This excessive reliance on cross-country debt flows has had several adverse implications. It has made euro area economies more vulnerable to liquidity strains and 'sudden stops' in the financing of their current account imbalances. It also resulted in a segregated cross-country risk-sharing. Last but not least, it ultimately resulted in renewed fragmentation along national borders, thus perpetuating savings-investment mismatches.

2 Aligning policy priorities

The policy priorities to be aligned are the three big European economic initiatives currently in place – the Investment Plan, the CMU and the ECB's €1100bn QE programme. These should foster short and long-term growth and ultimately create jobs and improve well-being, by making the supply of credit to the real economy more resilient to economic shocks and cycles. But as we highlight below in our policy priorities, in isolation these initiatives will not be enough: an holistic approach is needed to create and exploit synergies between them. If the three policy initiatives are taken in isolation, valuable firepower would be foregone.

2.1. Formulate an holistic strategy for the CMU, the Investment Plan and the ECB

We see the involvement of the ECB as being indispensable to the success of the Investment Plan and CMU. This should not be an issue as the objectives of the Investment plan and CMU are in line with the Eurosystem's own mandates and objectives – to pursue price stability in support of European economic policies creating the opportunity for synergies to be exploited.

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

More generally, synergies would be enhanced by formulating an explicit, holistic strategy, ensuring that the instruments intended to generate the leveraging in the Investment Plan receive appropriate treatment in the regulatory context of the CMU, and in the ECB's purchase programme and collateral framework (albeit without crossing the line into monetary financing or preferential treatment).

2.2. A strategic goal for the European financial structure: the "spare wheel" model

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

Bond markets, the "spare wheel" of banks

Given the above, rather than "forcing" a given financing structure onto the European economy, the policy aim of the Investment Plan and the CMU should be to ensure its cyclical flexibility, *i. e.*, the development of "elastic" markets for corporate debt securities, capable of acting as a buffer to cyclical credit contractions. A desirable outcome would be for the EU to have what Greenspan famously called a "spare wheel", a corporate bond market that could step in when the banks are down. To help develop elastic corporate bond markets, the large fixed costs to enter them would need to be reduced. This could be done by reducing the initial documentation and ongoing information requirements on corporates. The corporate bond market could also be boosted by the standardisation and dissemination of information on credit quality, as argued below.

Untranched securities, the "spare wheel" of covered bonds

The strategic vision for the euro area's financial structure also needs to encompass the ability of MFIs to outsource risk. Covered bonds have proven to be successful in providing additional external financing, eliminating the 'originate-to-distribute' dangers of securitisation and preserving the corporate governance features of relationship banking.

There would be benefits therefore in prioritising the development of covered bond markets in places where they have not yet taken off. Cross-border harmonisation is unlikely to be feasible, however, as long as national insolvency and tax laws differ substantially, and since this is unlikely to change in the short term, if ever, we favour other ways to encourage the development of covered bond markets.

One option would be to earmark funds from the Investment Plan to guarantee loans going into covered bond like structures. Loan-to-value levels could be lifted through EU guarantees that go beyond existing LTV limits. Such guarantees could also be used to make funding possible for immaterial assets through covered bonds or covered bond-like structures. This would allow companies without fixed assets to benefit.

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

2.3. Promote equity instruments for more sustainable cross-border risk-sharing

Cross-country risk-sharing has worsened inside the euro area and the predominance of debt instruments in cross-country asset holdings has resulted in autarchic risk taking. The presence of political, regulatory and economic obstacles means that market solutions to rebalance the asset profile of cross-border portfolio holdings are unlikely to emerge spontaneously.

More centralised solutions combining private and public funds might be warranted to act as a catalyst. A priority for the Investment Plan (in particular, its third pillar, that aims to improve the cross-border environment and eliminate barriers to investment) and for the CMU should therefore be to proactively encourage cross-border direct investment and portfolio equity investment. As we argue below, there is even a case for the ECB playing a role in this.

2.4. A new value chain for credit assessment featuring commercial and central banks

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

'an ideal value chain (...) would encompass credit assessments by (...) originators and (...) national central banks'

Alongside commercial banks, some central banks – for now mostly national central banks – also collect invaluable granular information about borrowers or potential borrowers. The Banque de France's FIBEN database is a good case in point. If disseminated, this information could in many cases be used as a substitute for rating agencies, and a complement to the information collected by commercial banks on smaller borrowers. It has a public good dimension that would justify its dissemination. And while the historical conditions that led to the constitution of such detailed registers might be difficult to replicate on a large scale (the Banque de France was able to develop FIBEN thanks to its very dense network of local branches and for monetary policy purposes), at least sharing the underlying methodology that was used to develop the registers could be useful. The Eurosystem is in fact contemplating collecting granular credit data at the euro area wide level so Europe might be heading in this direction (ECB (2014).

An ideal value chain for the production of credit-worthiness information would encompass marketable credit assessments by credit originators that are keeping skin in the game and publicly available registers collected by national central banks.

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

One example illustrates how efficient central banks can be in this respect. The first example is the "Euro PP" initiative for private placements that began in February 2015, and which benefited from the support of the Banque de France. While still small (€12bn had been issued between end 2012 and beginning of 2015), the Euro PP project has now established model agreements, creating a robust market framework as the PP market expands (see FBF (2015)).

2.5. ECB's asset purchases: less sovereign debt but more macroeconomic risk on the balance sheet

The ECB's actions can be tied in with the aims of the Investment Plan and the CMU through the quantitative easing programme in a way that is line with its mandate. This can be done by a reorientation of purchases towards asset classes other than sovereign debt instruments.

Of course, sovereign bonds were a natural target for the ECB's Public Sector Purchase Programme (PSPP) that started in March. Markets for investment grade sovereign instruments are often deep and liquid. By purchasing them, the ECB will compress bond yields, reduce interest rate risk along the yield curve and generate spillover to other markets.

We would argue that against the background of the Investment Plan, the ECB should make purchases of instruments issued by "agencies" and European institutions the centrepiece of its programme. While the initial terms of the programme did explicitly include instruments issued by entities such as the European Investment Bank or, surprisingly, CADES (France's agency to amortise the country's social debt), such purchases are capped to no more than 12% of the total. There is an obvious case for the ECB to significantly increase that share.

'the ECB should make purchases of instruments issued by "agencies" and European institutions the centrepiece of its programme.'

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

Purchasing equity – even unlisted or private – and other non-debt instruments issued by the non-financial corporate sector would achieve several key aims. It would channel central bank money to economic sectors where it is needed. It would position the central bank as a long-term risk taker to sustain long-term growth. And it would increase the money supply without interfering too much with the banking sector. If conducted in a market neutral way, such purchases would also be less distortive than bond purchases, assuming debt is more mispriced than equity. And last but not least, it would keep the central bank away from sovereigns, thereby shielding the central bank from monetary financing governments. All of these factors seem to match the ECB's preferences fairly well, whilst being supporting of investment.

2.6. Formally involve NPBs in the EFSI

Another way to restore investment in a way that is compatible with good governance is through a coordinated expansion of the NPBs' activities. The Investment Plan offers a unique opportunity to do this with a Europe-wide, rather than national, vision in mind. A natural route would be to organise, around the EFSI, a Eurosystem of NPBs (Valla et al (2014)). The system would have the capacity to channel the euro area's excess savings towards investment in the right places throughout the continent. Ownership and governance would be set up to ensure the investment process was ring fenced from national political agendas not linked to the promotion of long-term growth. Involving private shareholders as well as public ones would make sure that the system acted independently from political processes.

2.7. Improve the governance of public investment

To restore public investment to levels that enhance long-term growth, governments should be encouraged to reverse recent trends and boost their public investment budgets. The European Commission has understood this need and has announced that member states' contributions to EFSI will not be counted when deficits are assessed for compliance with EU budget rules (under either the preventive or corrective arm of the stability and growth pact), and, moreover, that the "investment clause" will allow for temporary deviations from agreed fiscal adjustment targets to accommodate these contributions (see EC (2015)). This is an encouraging step.

However, we consider that *governance shortcomings* have not been addressed: nothing has been said about rules guiding new public investment decisions. There is a strong case for establishing *ex ante* independent, supra-national investment committees, and *ex post* strict disciplinary measures, to ensure mistakes of the past are not repeated (when public money was wasted).

2.8. Assign realistic but tangible reform objectives to the CMU and Investment Plan

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

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

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