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Financing Europe's Investment and Economic Growth

The shortcomings of Europe's financial system must be addressed if investment and overall growth are to recover. Fixing the banks is not enough.

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Financing Europe’s investment and economic growth

The shortcomings of Europe’s financial system must be addressed if investment and overall growth are to recover.

- Fixing the banks is insufficient. A broader and more diversified financial sector is needed.
- Within that, providing a range of funding possibilities for SMEs and infrastructure investment is a priority.
- There is considerable scope, and much that can be learned from existing systems.
- Europe’s capital markets warrant being developed, and non-traditional sources of finance tapped.
- Long-term investors need to play a greater, and in some cases a more direct, role.
- The banking ‘sell-side’ can do more to stimulate and underwrite long-term investment.
- Market-based credit intermediation will need to play a more prominent and stable role in financing.
- Securitisation warrants being both revived and expanded.

This paper is to be read in conjunction with the accompanying annexes document.

Introduction

Europe’s financial sector flaws have become clear

The weaknesses in Europe’s financial architecture were laid bare during the Global Financial Crisis (GFC) and its aftermath. Unless they are addressed, they risk constraining the strength of the recovery; and they would leave the financial system more vulnerable to future shocks than are systems in some other regions.

The purpose of this paper is to identify key shortcomings of the European financial system, and to offer broad policy recommendations that, put into practice, would contribute to more efficient, as well as potentially more secure, financing of investment.

After summarising the overall macroeconomic core of the issue, the argumentation is directed particularly at meeting the needs of small- and medium-sized enterprises (SMEs) and of financing investment in infrastructure – two of the most dynamic, but all too frequently constrained, seekers of external funding.

The paper has been prepared in collaboration with the Anglo-French Committee of the City of London and Paris Europlace. The target audience is senior European policymakers.

Salutary episodes

Financial sector defects can exert a heavy price …

The past quarter-century has seen four episodes that offer lessons of fundamental significance when considering the desirable structure of a financial sector, whether in Europe or elsewhere.

Japan’s ‘lost generation’ of the 1990s and beyond. Japan’s remarkable initial post-WWII economic development was underpinned by its “main-bank system”. The funding of major industrial groups was typically provided by a single dominant bank, which also held significant equity holdings in the companies in question. Resort to the capital markets for finance was limited, and bank loans were predominantly collateralised with real estate assets.

The collapse in asset prices and demise of the so-called ‘Bubble Economy’ in the early 1990s saw this system fall into a quagmire of shattered confidence, wholesale deleveraging, minimal growth, and increasingly-persistent deflation.

Moreover, the authorities’ slow efforts to clean up the resulting mess in the banking sector, and the lack of alternative funding conduits for companies, meant that the crisis dragged on into this century. Japan became infamous for its ‘zombie banks’ and ‘zombie companies’.

… as was demonstrated across Asia …

The Asian crisis of 1997. This financial crisis produced economic and social trauma across Asia and beyond, and added greatly to Japan’s already overwhelming problems. The consequences for Asian banks’ liquidity and indeed solvency that resulted from their foreign-currency exposure, the collapse in national currencies, and hence their soaring domestic-currency obligations, were dramatic. Bank lending collapsed.

Crucially, as in Japan, there was no significant conduit other than the banks through which Asian savings could be channelled in quantity to meet investment demand. Hence, as bank lending fell away, so too did investment. As a consequence, economic activity plummeted.

Interestingly and importantly, however, Australia, notwithstanding its close trade links with the rest of the Asia-Pacific, experienced comparatively little contagion from the Asian crisis – probably due in significant part to its comparatively well-developed capital markets.

... after the LTCM episode ...

The Russian default and Long-term Capital Management (LTCM) crisis of 1998. These twin crises caused the US corporate bond market to seize up.[1] Price quotes were difficult to obtain, and positions could not be liquidated. For a period, not even investment-grade bond issuers could find reasonable takers. Bond issuance fell dramatically, to less than a third of its pre-crisis volume. And matters did not start to improve until early 2001, when yields fell sharply following aggressive easing by the Fed.[2]

Even more striking, however, is what did not happen. US business investment did not collapse. Alternative channels, most notably the banks, funnelled savings to investment. This was a more expensive way of financing corporate investment: but it worked.

Previously, in 1990, the process had worked the other way around: when the real estate collapse caused US banks to stop lending, the relatively-new mortgage-backed securities market kept mortgage credit flowing. But for this, the (mild) 1991 recession would almost certainly have been significantly deeper.[3]

... and during the recent global crisis

The 2008 Global Financial Crisis (GFC). Recovery from the GFC is proving fragile, hesitant, and uneven. Only in a minority of the advanced economies has real GDP surpassed its pre-crisis levels. Recovery has been particularly weak in Europe, where in many cases unemployment rates are at, or close to, record levels.

The feeble nature of Europe's recovery reflects the malign interaction of a number of financial and non-financial considerations. The GFC was an exceptional worldwide event from which few countries escaped, and certainly not many of Europe's major export markets. It was also followed, both within the region and beyond, by a period of deep-seated balance sheet adjustment that extends across the board from households to corporates, and from governments to financial sectors.

Although now advanced, this bout of violent deleveraging has still fully to run its course, and it has resulted in a number of secondary consequences:

- Private sector demand for credit is weak and animal spirits are subdued;
- Fiscal policy has been tightened everywhere, extending both to severe public expenditure restraint and more onerous tax burdens;
- Financial sectors have become smaller; and more fragile, fragmented, and risk averse;
- Monetary policy has become much less effective, and orthodox room for manoeuvre virtually exhausted; and
- Investment spending, both public and private, has fallen to a low ebb, threatening in the process to damage long-term growth potential.

Europe's banks are being fixed ...

A key element to overcoming this complex, debilitating malaise in Europe is a comprehensive structural overhaul of its financial sector. A clean-up of the banking sector, extending to greater balance sheet transparency, accelerated write-downs, large-scale recapitalisations, and the resolution of insolvent institutions, is now underway. This will no doubt, over time, promote a return to a safer and more sustainable configuration of banking activities that should in turn help to rebuild investor and consumer confidence.

Even as Europe's banks are being restored to health, however, the consequent downsizing of their balance sheets is raising the spectre – albeit not definitively experienced so far – of the largely bank-based, intermediation channel between savings and investment proving to be insufficiently extensive to support a full recovery of investment demand when finally it returns.

Europe's long-standing and, in the eyes of many observers, disproportionate, reliance on bank intermediation[4] suggests that it would be wise to encourage a more wide-ranging and diversified financial system, better equipped to address a number of important micro issues.

Two implications

These episodes carry two basic implications for the development of Europe's financial systems:

... but the solution does not end there

- **First, *the security case* for multiple channels for financing investment.** When there is only one principal channel through which savings can flow to meet investment demand, an economy is acutely vulnerable to any blockage of that channel. And in turn such a blockage can easily lead to a collapse in borrowing, hence of expenditure, and thereby of economic activity, in a circle that, through financial market turbulence and collapsing confidence, can all too readily viciously feed upon itself.

  Economies are much better served if there are multiple channels through which the intermediation of saving and investment can take place. Former Fed Chairman Greenspan has likened this to having a 'spare tyre'.

A broader-based financial system is required ...

- **Second, *the growth case* for multiple channels for financing investment.** Europe could usefully complement the revivification of its banks by reducing the risk of not being able to finance a proper recovery by developing new channels, and *widening* existing non-bank channels.

In so doing, Europe would adopt a number of the more positive aspects of other financial systems, not least that of the US, so as to achieve a financial system that has both an internationally competitive banking system and a greater degree of overall diversity. At the same time its regulatory architecture would have to evolve considerably in an effort to maximise the benefits and minimise the costs associated with this process.

Two key sectors

This general need for *wider* and *more diverse* channels of funding extends across the European economy as a whole. But the provision of adequate, competitively-priced, stable, long-term funding is particularly important in respect of two key sectors: small- and medium-sized enterprises (SMEs), and infrastructure – sectors that have been starved of credit not just since the crisis, but for some time beforehand too. Best practice here is far from uniformly applied across European countries, and often lags behind that of other parts of the world, including the US.

... especially if the SME sector is to be revived ...

Small and medium-sized enterprises. SMEs are in many ways the mainspring of the EU economy. They make up 99% of all European companies; they account for around two thirds of total value added and employment; and they are at the forefront of much of the continent's technological diffusion, entrepreneurial achievement, and innovative capacity. In acutely-depressed southern Europe, their importance is proportionately even greater.

Existing SME financing arrangements are limited largely to bank lending. Yet, especially in southern and peripheral Europe, the already-limited willingness or ability of banks to provide them with finance on reasonable terms has, since the GFC, been considerably reduced. Providing a diverse, flexible, and sustainable menu of financing options to this key sector would support its expansion and development over the medium term. (For more on SMEs, see the Annex.)

... and infrastructure amply supported

Infrastructure investment. Investment is always important, and in two ways: it contributes to final demand, and it has positive long-term effects on economic growth. But infrastructure investment has even greater beneficial effects, which extend beyond simply adding to the capital stock.

Infrastructure facilitates trade and the division of labour; competition; the efficient allocation of resources across regions; the diffusion of technology; better organisational practices; and access to new resources, both physical and human. And it also stands to be central in addressing the burgeoning global challenges of climate change and encouraging 'greening' of the economy.

However, with governments economising, the banks licking their wounds, and other regulatory uncertainties and market failures stymying the involvement of the private sector in many risky and illiquid projects, both public and private investment spending has fallen away over recent years.

In 2012 and 2013, total investment across Europe accounted for the lowest share in GDP since the 1980s. Enhancing investment in infrastructure will require a range of integrated policy responses. In particular, there is a need for new and alternative sources of funding. (For more on infrastructure, see the Annex.)

Five recommendations

The solution is multi-faceted

Against this background, five overlapping and mutually-reinforcing proposals are suggested:

I. Developing Europe's securities markets and non-traditional sources of finance;

II. Encouraging and enabling a greater, more direct, role for long-term investors;

III. Encouraging the investment banking 'sell-side' to do more to stimulate and underwrite long-term investment;

IV. Enabling market-based credit intermediation to play a more prominent and stable role in financing; and

V. Reviving and developing securitisation.

I. Developing capital markets and non-traditional funding

The challenge in Europe is to effect a transition towards a corporate financing model that is more evenly split between the traditional banking sector and more 'market-based' sources.[5] Managing such a transition is a challenge for markets, policymakers, and investors alike. Meeting the challenge will require the cooperation and mobilisation of all relevant stakeholders spanning government, corporates, and the financial industry.

Capital markets must evolve, including …

In the US, equity and bond financing are a major source of funding to the non-financial corporate sector. In continental Europe, although the equity and corporate bond markets have expanded considerably since the 1990s, they are still comparatively relatively underdeveloped. Bank loans and other advances account for more than 80% of the debt financing of Europe's non-financial corporate sector; corporate bonds account for less than 20%.

In the US, by contrast, corporate bond markets are a much larger share of total debt outstanding – some 50%.[6] Moreover, within the US loans market, around half come from market-based sources such as finance companies.[7] Altogether in the US, the 'formal' banking sector provides as little as 25% of non-financial corporate debt funding.

Stock market capitalisation, at around 65% of GDP in the EU, and 50% of GDP in the euro area, is much as in Japan (60% of GDP), but significantly lower than in the US (105%). The same is true of stock market turnover. The non-financial corporate debt market, at around 15% of GDP in both the EU and the euro area, is broadly the same (proportionate) size as in Japan, but only around half the size of its US equivalent.

Furthermore, European debt markets are dominated by the largest investment-grade corporates. High-yield corporate bond issuance in particular remains modest by comparison with the US. As it happens, 2013 was a record year in Europe, with €70bn of new issuance (equivalent to just under 1% of GDP) and over 200 bonds priced. Yet half of these issues were launched in the UK, Germany, and France. Moreover, the total paled into insignificance next to the $300bn of issuance (around 2% of GDP) typically seen in the US in a single year.

Venture capital

… more venture capital …

Europe's venture capital (VC) markets have not advanced as they have done in the US, and their development would help Europe to finance a pipeline of new innovative companies. The general rule of thumb is that new US firms raise twice as much in each round of financing as do European firms — and twice as fast.[8] While VC investment is just under 1/5th of a percentage point of US GDP, in Europe's major economies it is generally less than one fifth of that. Seed, start-up, and early-stage investment is relatively low. Later-stage investment, in particular, is well below US levels. In Southern Europe, VC investment is low even by European standards. Later-stage investment is strikingly absent.

In some countries, for example Israel, with its strong links to US markets, early- and later-stage investment is much higher as a proportion of GDP than in European countries (and indeed the US itself). European companies too have benefitted from US investment; however dependence on US funding, particularly after the initial seed investment, implies much scope to develop European VC markets. Third or fourth rounds of funding are mostly, if not uniquely, provided by

US funds. NASDAQ listings are a reflection of this, as most competent public funds are based in the US. Perhaps around 15% of NASDAQ-listed companies backed by VC have been founded by French (5%), UK (5%), and German (5%) entrepreneurs.

There have been some more encouraging signs in recent years, however, with the activity of some European firms comparable with their counterparts in the more mature US market. (For more, see the Annex.)

SME equity markets

... more backing for SME growth markets ...

Enhancing existing SME equity markets is also a priority. There are at least 15 equity markets across Europe tailored specifically to the needs of SMEs. They are currently home to over 1,700 companies, valued at over €180bn. The new "SME Growth Markets" category created by MiFID 2 and initiatives such as the European Long-term Investment Funds could usefully be complemented by other measures to make it easier for SMEs to offer securities to a wider investor base at lower cost. Recalibrating the fiscal bias against equity would further reduce the cost of capital. Measures that boost the post-IPO profile and liquidity of quoted SMEs could also be helpful.

The private placement market

... greater resort to private placements ...

A potentially productive initiative, especially for mid-sized European corporates, would be the development of a larger, pan-European, private placement (PP) market.

The regulatory and informational requirements associated with private placements are less stringent than for public offerings, and so can be a simpler and less expensive way to raise finance, while allowing a company to develop a closer and enduring relationship with investors. More private placements would also appeal to entities such as insurance companies and pension funds which wish to match longer-term liabilities with assets with similar characteristics, and investors who are looking for additional issuer and sector diversity.

Approximately 25% of US insurers' fixed income assets are in private placements, and currently the shortcomings of the European equivalent means that some European companies prefer to use the more mature and diverse US alternative. Indeed, in 2013 more than half of the $50bn-odd of securities issued in the US private placement market were launched by non-US firms, of which European entities were responsible for the lion's share.

Within Europe, where Germany has the most established private placement market, not least in the form of "Schuldschein" issues – fixed- or floating-rate notes ranging in size from €10mn to €500mn – it is noteworthy that some 30% of issuance was by non-German companies.

New markets are developing however, notably in France. The Euro-PP, launched two years ago under the auspices of the Banque de France, has drawn up a "code of best practice" with investors and industry groups, with a view to 'industrialising' the placing process, and ultimately creating the conditions for investors to buy and hold such assets.

The scheme was made possible by a change in the French Code des Assurances, and highlights the importance of a complementary, and secure, legal and regulatory framework. A total of $3bn was raised by French companies in 2012 under the US PP scheme, and €774m under Schuldschein. Under the Euro-PP scheme more than €7bn has been raised – almost entirely for French companies, nominated by French banks, and funded by French insurance companies.[9] It is estimated that €12bn could be raised, in line with Schuldschein issuance in 2012.

It would be worthwhile to learn from the US, German, and French experiences with private placements, and to develop more widely in Europe mechanisms to achieve the requisite scale, transparency, standardisation, and know-how to attract investors into the market and make it work both for them and those seeking capital over the long term.

Medium-sized-company debt

... more medium-sized company debt issuance ...

Another important initiative is the opening-up of the capital markets to the issuance and trading of more medium-sized company debt. In the UK, London Stock Exchange operates a retail fixed income market, the Order book for Retail Bonds (ORB). Since its launch in 2010 it has raised £4bn in 41 dedicated issues, and is establishing itself as a flexible funding source for companies with a typical ORB benchmark size of around £50-75 million. A number of trading platforms for medium-sized corporate bonds have also been initiated by various German exchanges, including Deutsche Borse's *Entry Standard Anleihen*; Borse Dusseldorf's *Mittelstandsmarkt*, and Borse Stuttgart's

Bondm. Other countries could with advantage study the UK and German examples, and seek to adapt them to their own exchanges.

New infrastructures may be needed, not least because of balance-sheet constraints on sell-side activity, to ensure an adequate provision of liquidity – perhaps along the lines of the Cassiopeia "bond match" model.[10]

Evolving needs

... supported by education

SMEs almost invariably need help to transition between different types of funding. As they grow, SMEs can use a combination of sources, ranging from seed capital, business angels, venture capital, bank debt, and private and public markets.

However, SMEs often do not know the range of growth-financing strategies that are available to them, nor may they have the confidence or indeed aspiration to explore them. They need practical help in terms of acquiring the industrial, financial, and organisational skills to enable them to attract the widest possible range of investors.

Programmes that fill these 'education gaps' and re-catalyse supportive advisory ecosystems of private, state and institutional investors, advisors, entrepreneurs, academics and science parks could therefore usefully be expanded. The European Commission has identified the ELITE growth coaching programme run by Borsa Italiana (with 150+ SMEs involved) as a model, and this has been imported into the UK.[11]

II. Encouraging and enabling a greater role for long-term investors

Longer-term investors must be more involved

Insurance companies, pension funds, mutual funds, and similar investors, such as large family offices and sovereign wealth funds, have the potential to play a greater role in funding the real economy, both near-term and longer-term. In Europe, insurance and pension companies alone hold around €12tr of assets, equivalent to over 90% of EU GDP, yet they have little exposure to infrastructure or to SMEs.

There are a number of challenges. The first is to open up, or to deepen, more direct channels of intermediation between long-term investors and borrowers. The second is to develop additional indirect channels, for example through the use of simple securitisations or more complex financial instruments.

Moreover, and particularly as regards the development of more direct channels, it would be helpful to encourage more long-term investors to reach the requisite size, and acquire the necessary expertise, to enable them to allocate resources competently to key sectors such as infrastructure and SMEs.

Catalysing their greater involvement in these areas requires that various constraints be overcome, including:

- **The atomistic nature of pension and insurance industries** in many European countries, and the lack of requisite overarching authorities to stimulate or even oblige the pooling of assets;
- **Mark-to-market accounting, liquidity limits**, and a preoccupation with net asset value that often encourage short-termism;
- **Regulatory and political uncertainty** that promotes investor caution and procrastination;
- **The small scale and limited standardisation of many potential investments** – there is a dearth of investment grade debt offerings, for example – coupled with a lack of in-house analytical expertise and available third party advice, limits participation; and
- **Investment portfolios that have latterly been rebalanced** away from equities as a result of risk aversion and directives and guidelines designed to protect these institutions from a recurrence of the problems encountered during the 2008 crisis.

This will require new government initiatives ...

The extent of this list of constraints, and the idiosyncratic nature of the particular issues associated with infrastructure projects on the one hand, and SMEs on the other, requires that the authorities take a multifaceted approach.

At the national and pan-European level, it will be important to re-examine regulatory and legal standards, risk profiles, and market practices, including prudential rules for investors to be able to invest in these instruments.

As the banking sector restructures – although the final details are to date far from clear, not least as regards the separation, or not, of retail from investment banking activities – it will become increasingly important to avoid long-term investors becoming unduly constrained.

Outside the traditional banking sector, Solvency II and other major reforms, such as those recently announced in relation to pension funds, stand to be particularly important. Regulators may need to revisit how they assess risk, and how specific asset classes should be treated, both quantitatively and qualitatively.

That said, a greater involvement of pension funds, insurance companies, and other potential alternative investors in both infrastructure and SMEs would be encouraged particularly by more comprehensive government sponsorship and support. This could include the provision of more project guarantees and stand-by credits; greater efforts to consolidate small pension and insurance companies; the encouragement of aggregated investment funds drawing on the resources of smaller entities; the encouragement of securitisation (see section V below); greater consistency in government investment, macroeconomic, and regulatory policy; and a more supportive tax framework.

Equally, however, much could also be achieved through a series of relatively minor initiatives such as government efforts to develop common definitions for different categories of infrastructure or SME investment and specified industry benchmarks; the encouragement of better data collection and standardised performance metrics for risk and return in both of these areas; and an emphasis on improved pension fund and insurance company governance.

Recent national initiatives have been taken in France and the UK: these include the sovereign fund club of CDC; BPI France guarantee schemes, and the UK Business Bank.

National investment banks

… perhaps even National Investment Banks

There is an argument for putting all these initiatives under the co-ordinating umbrella of a series of 'National Investment Banks', mandated to deliver long-term policy and regulatory stability, and act as a common and easily-accessible repository for project, company, and financial expertise.

Were that to be done, any such institutions would need to be designed so as to avoid becoming unwieldy and inefficient quangos, being captured by narrow political interests, and crowding out private sector financing. Such an institution would have to be operationally independent of government: it could usefully have a charter along the lines of those of independent central banks, for example as regards clarity of mandate, and governance structure.

Naturally, any new institutions of this type would need to co-ordinate their activities with the European Investment Bank and the European Investment Fund.

III. Encouraging 'sell-side' activities

The banking sell side can also play a key role …

By establishing, underwriting, and developing market structures, and promoting liquidity and price transparency, sell-side activities can potentially play an important role in stimulating investment in traditionally more risky and illiquid assets such as infrastructure and SMEs.

The financial sector sell-side has proven ability to;

- Bring together investors and end-users of capital;
- Encourage the requisite scale and standardisation of new financial instruments in order to create more investment grade opportunities;
- Assist in the management and diversification of new risks through, for example, the use of derivatives;
- Take the lead in the development of liquid secondary markets for these assets; and
- Expand in-house expertise in underwriting, listing, and the development of further innovative financing solutions.

… as long as governments allow it to …

The investment banking community is clearly still in 'recovery mode' from the traumas of the 2008 crisis and its aftermath, but its willingness to take on these responsibilities can be expected to revive with time. Governments can, however, accelerate the process by refraining from heavy-handed regulation and taxation of the sector, and by generally making progress in the other four key areas highlighted here. Care will be needed to ensure that any separation of retail and investment-banking activities is well balanced, taking due account of the coverage of existing regulations.

Despite their bad press, bankers often exhibit a striking entrepreneurial spirit, and like nothing better than to explore and exploit new ways to make money. Putting them in a position to do so will no doubt release their innovative qualities. This innovation should however be underpinned by increased incentives for the sell-side to provide and disseminate information in a range of areas. Such research would: contribute to making financial instruments more transparent; create a better understanding of how they function; and thereby contribute to a better analysis of performance and risk.

IV. Market-based intermediation

The size of bank balance sheets, and the risk concentrated on them, will be reduced over time. More 'market-based' sources stand to help fill the vacuum, and the so-called 'shadow banking' sector is set to grow substantially. Collateral is likely to be a key issue going forward. Central banks and other policymakers will need to adapt.

Non-traditional finance

Non-traditional finance options can be developed

Non-traditional forms of finance can provide a further adjunct to the securities markets, particularly for the smallest companies. In the UK, the 'alternative finance sector' has advanced further than elsewhere in Europe, spanning both debt- and equity-based funding initiatives to provide niche working capital to a range of small businesses.

Peer-to-peer lending, 'crowdfunding', and the like offer new, more flexible, and bespoke options that could mature into important alternatives to traditional financing channels. To date, such sources account for less than 5% of SME lending, but are likely to grow rapidly, if they can be satisfactorily regulated, and investor and consumer interests protected in such a way as to inspire confidence.

The so-called 'shadow banking' system

Shadow banking has good and bad elements

As former Fed Chairman Ben Bernanke put it, the shadow banking system:

> "… *comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions, but do so outside, or in ways only linked to, the traditional system of regulated depository institutions*".

The system extends to securitisation vehicles, asset-backed commercial paper conduits, money market mutual funds, markets for repurchase agreements (repos), investment banks, and mortgage companies.

The size of the shadow banking sector in the euro area is probably somewhere between €11tn and €17tn, depending on how it is defined and measured. The shadow banking system is relatively large in the Netherlands, Luxembourg, and Ireland and, outside the euro area, in the UK. Taking the euro area and the UK as a proxy for Europe as a whole, the European shadow banking sector could be larger than that of the US.

As demonstrated over recent years, shadow banks can exert a profound effect on the overall liquidity and stability of financial markets, and provide a keynote alternative conduit for funding. Like the traditional banks, they intermediate credit both directly and indirectly, through maturity transformation, liquidity transformation, the creation of leverage, and by the transfer of credit risk.

These activities are funded mainly via secured funding markets through securitisation, securities lending, and repo agreements, which in turn depend on an adequate supply of good-quality collateral.

The constructive elements can be encouraged

The priority is to encourage the constructive aspects of this system while discouraging the more destructive aspects – not least the regulatory arbitrage and off-balance-sheet activities that generated such malign effects during the 2008 crisis.

Many shadow banking activities represent positive innovations, driven by specialisation and the comparative advantages that shadow banking entities offer over traditional banks. The alternative source of funding enables risk to be diversified away from the formal sector –

particularly important if, or when, traditional channels become impaired. The shadow sector can also offer access to finance for those not served, or served poorly, by the formal sector.

The key challenges are to improve the shadow banking sector's transparency and to define it more clearly, while ensuring that the evolving regulatory limits on its activities enhance rather than stymie its role as a powerful complement to the formal banking sector.

Collateral

Collateral shortages need to be overcome

There is a need in this context to ensure an adequate supply of serviceable collateral. In allowing extended re-hypothecation, good collateral is central to the functioning of the modern financial system. Indeed, it has become akin to high-powered money. Insufficiency can lead to funding stresses that reverberate across financial markets. Since the onset of the crisis in Europe, collateral has increasingly been required in order for both financial and non-financial institutions to be able to access private funding markets.

The primary problem that European policymakers face in this regard is that, as numerous sovereigns have been downgraded, the supply of triple-A-rated assets – the primary source of top-quality collateral – has been reduced. And this at a time when the demand for 'safe' assets has increased dramatically, not least because of new regulatory requirements for financial institutions' capital and liquidity.

This conundrum would be eased by improved public sector debt sustainability in the OECD economies, and the development of new and reliable stores of value in the still-immature capital markets of Asia and beyond. But in the interim the problem could be alleviated through a combination of more high-quality corporate debt; increased securitisation (see section V below); the development of a euro Treasury bill market akin to the US Treasury bill market;[12] and greater efforts to free up the existing silos of collateral that risk aversion has left inert. (For more on collateral, see Annex.)

V. Securitisation

Notwithstanding such success as may be achieved in opening access to the public capital markets, a number of small borrowers will always depend, to a large extent, on loans rather than debt or equity issuance. To attract long-term investors, and to spur loan origination by the (broadly-defined) banking sector, securitisation offers much potential.

Securitisation warrants being enhanced

The European securitisation market, at around €1.5tn, is less than a quarter the size of the US market. From 2000 until 2007, annual securitisation issuance in Europe averaged €265bn, compared with €2.3tn in the US. Furthermore, European securitisations have tended to be retained on bank balance sheets, rather than placed with third-party investors.

Since 2008, securitisation in general has shrunk. But whereas it has contracted by less than 10% in the US, in Europe it has declined by some 30%, and some 60% of 2013 issuance has been retained on bank balance sheets.

Enhancing Europe's securitisation market represents a major challenge, given public distrust and lack of market confidence. (For more on securitisation, see the Annex.)

There are two key related considerations in the development of the European securitisation market:

- **First, it needs to be refocused away from household mortgage finance**. Securitised loans are predominantly originated by the banks, and some 70% are offered to households, of which 60% are residential mortgage-backed securities. European SME securitisation accounts for just 8% of the current total.
- **Second, pooling and standardisation of SME loans is needed** to effect the market's reorientation. This in turn requires creation of a sympathetic institutional framework, and a greater willingness on the part of the investment banks to develop and underwrite these markets. Three innovative initiatives have recently been launched in France: *Fonds Novo; Triparty repo* with Banque de France, *Euroclear* & *LCH-C*; and *Titrisation de créances privies*. (For more on *Fonds Novo*, see the Annex.)

Conclusions

Breadth and diversity are the ultimate aims

Given European economies' extended travails, restoring faith in the formal banking sector as soon as possible is of paramount importance. At the same time, however, there is considerable scope, and much that can be done, to create a more diverse and comprehensive financial system, encompassing more market-based intermediation and a greater and more productive role for long-term investors, and which embraces the best practices of other jurisdictions, not least the US.

The outstanding policy agenda is multi-dimensional and challenging - see the comparative table: *Financial sector indicators: Europe, the US, and Japan*. But only by pursuing a broad-based and flexible approach will existing market failures in Europe be addressed comprehensively and satisfactorily, and the investment and overall macroeconomic potential of the region thereby realised.

Financial sector indicators: Europe, the US, and Japan

	Relative to 2012 GDP, %	EU	EA	US	JAP	UK	FRA	NLD	IRL	DNK	DEU	SWE	BEL	ESP	ITA	PRT	GRC	Source:
1	Bank assets	308	287	91	208	438	362	347	546	377	255	156	275	321	159	309	179	IMF GFSR 2014
2	Assets of banks domiciled in	-	303	96	344	801	366	370	-	-	274	-	-	313	241	-	-	FSB 2013
3	Assets of non-bank financial intermediares	-	184	166	64	354	96	565	-	-	72	-	-	72	40	-	-	FSB 2013
4	Bank credit to private sector	136	134	55	105	188	116	105	198	208	209	136	93	204	122	192	118	CPB 2013
5	Bank credit to non-financial companies	46	54	18	81	31	44	35	61	64	58	53	31	80	57	68	53	CPB 2013
6	Assets of pension funds and insurers	93	80	-	-	178	102	242	180	178	78	107	80	36	36	44	7	Eurostat
7	Stock market capitalisation	65	48	104	61	137	64	84	51	77	46	111	62	43	25	33	18	IMF GFSR 2014
8	Stocks traded	44	28	132	61	101	43	57	6	34	36	72	21	81	38	13	6	World Bank
9	All (public / private) debt securities	189	179	217	246	233	173	297	571	292	127	148	152	183	193	186	96	IMF GFSR 2014
10	Non-financial corporate bonds	15	18	35	17	14	26	25	7	4	13	16	13	3	20	25	4	CPB 2013
11	Securitisation market	12	11	51	-	23	2	44	24	0	3	0	21	18	11	22	14	afme
12	SME securitisation	0.9	1.2	-	-	0.3	0.1	1.3	0.0	0.0	0.2	0.0	4.7	3.7	1.8	3.2	3.7	afme
13	Venture capital	0.02	0.01	0.17	0.03	0.04	0.03	0.03	0.05	0.03	0.02	0.05	0.02	0.01	0.01	0.01	0.01	OECD

Notes: Variables 2 and 3 use FSB definitions of the bank and non-bank sectors. Variable 2 refers to all deposit-taking institutions. Variable 3 refers to all financial institutions that are not classified as banks, insurance companies, pension funds, public financial institutions, or central banks (see FSB, 2013 for more). Variables 4, 5, and 10 are taken from CPB (2013) and are for 2011, with the euro-area average calculated as the simple average of euro-area countries. For variables 10, 11, and 12 European averages are GDP-weighted averages.

- Well above European average(s)
- Above European average(s)
- Around European average(s)
- Below European average(s)

Proposal

The analysis warrants being deepened …

This paper has set out the basic case for the introduction – both to increase security and to fund growth – of a range of policies in respect of financing both SMEs and infrastructure investment. What is needed next, it is suggested, is to examine the range of existing policies, including in France, Germany, and the United Kingdom, in detail.

The purpose would be to:

1. Establish the key features of each policy; and identify specific problems in their functioning;
2. Consider difficulties that might arise in transferring existing policies to other countries in Europe;
3. Suggest detailed strategies that, modified as appropriate, could be transferred from one country to another; and to
4. Outline additional targeted policies that would fill clearly identified but unaddressed gaps.

… by a high-level EU-backed working group …

To this end, it is suggested that an EU-backed international working group would be appropriate, comprising Europe-based specialists who collectively bring knowledge of:

- France, Germany, the United Kingdom, the US, and perhaps Japan;
- The investment banking, commercial banking, and shadow banking sectors;
- Central banking and/ or regulatory practice; and
- SMEs and pension / insurance companies.

… to develop specific policy proposals

The OECD, which has been conducting a multi-decade programme of research into SMEs, and has also recently written extensively on infrastructure funding, could be an important source of information, and perhaps participation.

The first two phases, it is suggested, could be completed fairly quickly, if the working group was adequately and appropriately constituted. While the third and fourth phases could take somewhat longer, experience with the first phase, together with the previous experience of members, should enable progress to be made fairly rapidly.■

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Endnotes

[1] For more detail, see for example Greenspan (1999), BIS (1999), or Wall Street Journal (1998a, b).

[2] Greenspan (1999) observed that "*The problems in our markets appeared too deep-seated to be readily unwound solely by a cumulative 75 basis point ease in overnight rates. Arguably, at least as important was the existence of backup financial institutions, especially commercial banks, which replaced the intermediation function of the public capital markets. As public debt issuance fell, commercial bank lending accelerated, effectively filling in some of the funding gap. Even though bankers also moved significantly to risk aversion, previously committed lines of credit, in conjunction with Federal Reserve ease, were an adequate backstop to business financing, and the impact on the real economy of the capital market turmoil was blunted. Firms were able to sustain production, and business and consumer confidence was not threatened. A vicious circle of the initial disruption leading to losses and then further erosion in the financial sector never got established*."

[3] See for example Greenspan (1999.)

[4] Of total non-financial corporate debt outstanding in 2011, bank loans and other advances accounted for 85% in the euro area and the UK; non-financial corporate bonds just 15%. In the US, by contrast, corporate bond markets are a much larger share of total debt outstanding – some 47% – with bank loans and other advances accounting for the remaining 53%. Note that the US is also commonly cited as having a 70:30 split between corporate bonds and bank loans in total nonfinancial debt outstanding. This is due to the exclusion of the farm and small-unincorporated sectors of the economy. Using the broader definition gives the 50:50 split quoted in the text. See Barclays (2012) and S&P (2012) for more information.

[5] Defined broadly, this includes public and private equity and debt markets and more market-based credit intermediation, including importantly collateralised (or secured) funding markets.

[6] The US is also commonly cited as having a 70:30 split between corporate bonds and bank loans in total nonfinancial debt outstanding. This is due to the exclusion of the farm and small-unincorporated sectors of the economy. Using the broader definition gives the more even split quoted in the text. See Barclays (2012) and S&P (2012) for more information.

[7] Source: IMF (2014) GFSR

[8] Source: The Economist. http://www.economist.com/blogs/schumpeter/2013/09/venture-capital-europe

[9]Source: FT. http://www.ft.com/cms/s/0/337c1dc8-a2f6-11e3-ba21-00144feab7de.html#axzz31b2abCrd.

[10] The objective is to provide liquidity and transparency through: an order book with firm orders; pre- and post-trade reporting; and clearing and settlement solutions.

[11] European Commission Communication on Long Term Financing of the European Economy, March 2014, section 5 page 11

[12] The Treasury bill market in the US amounts to some 10% of GDP. Expanding the euro area market to a similar size would create some €900bn of additional safe assets.

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