Executive summary from “A missed opportunity to revive “boring” finance?”

A position paper on the long term financing initiative, good securitisation and securities financing published by Finance Watch in December 2014 (available online at www.finance-watch.org)

The long term financing initiative is part of a broader set of initiatives from the European Commission aimed at promoting sustainable growth and job creation. While other projects such as Europe 2020 will define which measures and investments are necessary, the long term financing initiative **complements them and focuses on how these projects are financed.**

Many of the proposals are very promising, such as promoting seed capital, crowdfunding or deepening bond markets. Others however might create systemic risks and **we chose to focus this paper on the financing channels that, in our view, raise some concerns.**

More broadly the long term financing initiative also promotes capital market financing and investment banking over traditional banking.

This is consistent with an often heard consensus view that Europe is over-reliant on bank lending and that due to new regulation banks will have to lend less in the future. Additionally, according to the consensus narrative banks caused the crisis and we therefore need less banks and more capital markets, in order to diversify and increase access to finance while making the financial system more resilient. **We find this, however, to be a simplified narrative and believe that:**

1 There are structural causes holding back growth and job creation such as the rise of inequalities.

Therefore while it is important to prevent credit supply restrictions, policies aimed at creating sustainable growth should address this issue and not only focus on the availability of financing.

2 Bank lending does not have to decline as a consequence of deleveraging or regulation.

It is also not clear that the European economy is more reliant on banks than the United States.

3 The crisis did not show that banks were too risky and that we consequently need more capital markets.

It showed instead that some investment banking activities were too risky and that we need more well capitalised traditional banks with robust funding structures. **It is essential to distinguish between banks' business models** and promote those which have proven both more robust and focused on financing the real economy.

4 SMEs' lack of access to finance is mostly an issue of geographical fragmentation

... i.e. SMEs of comparable health but located in different Member States have unequal access to finance, rather than an overall shortage of credit supply. It is also not clear whether securitisation can be a sustainable financing channel for SMEs.

5 Public private partnerships have a mixed track record in terms of value for money for taxpayers and democratic accountability.

Increasing transparency and ensuring periodic reviews would help address these concerns.

6 A revival of securitisation would enable some borrowers to access a wider range of investors and increase banks' profitability and competitiveness.

However depending on the type of securitisation it might also create a number of risks, including higher interconnectedness, higher procyclicality, higher risk of joint banks default and higher reliance on external credit assessments. It would not make banks less risky and the financial system safer if it is anything other than basic securitisation. **While recent initiatives to define good securitisation go in the right direction, they should go further to comprehensively address systemic concerns.**

7 A revival of securitisation would also strengthen the central role of collateral in our financial system.

It would create new high quality liquid assets for securities financing**, whereas the risks and negative externalities of securities financing transactions have yet to be comprehensively addressed.** Securities financing transactions enable procyclical leverage creation and excess elasticity in our financial system, and they increase interconnectedness and the risk of asset fire sales. SFT being leverage creation, it also raises the question of how much leverage do we really need? More fundamentally, while collateralised funding is extremely useful at times of stress when trust disappears, it may be unhealthy to make it the new norm.

8 While significant work has been done post crisis on micro-prudential regulation

... to ensure the soundness of individual institutions, **much remains to be done on a macro prudential level** to address systemic risks.

Finance Watch

Making finance serve society

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Based on all of the above, we believe that the following recommendations are key to promote a sustainable financing of the real economy that does not create systemic risk or generate negative externalities:

1 Promote traditional banking

Agreeing with the Nobel prize-winning economist Joseph Stiglitz, we believe that *“regulations should have been designed to encourage banks to go back* to *the boring business of lending”*[1]. Yet by promoting the investment and universal banking model via a revival of securitisation and securities financing transactions, the long term financing initiative seems to be promoting instead the model that required a bail out during the crisis and whose vulnerabilities have yet to be comprehensively addressed.

Traditional banks create fewer systemic risks and negative externalities, as they are associated with short intermediation chains, lower procyclicality, no reliance on external ratings and proved more resilient during the crisis. They also have more robust funding structures, are explicitly backstopped by public safety nets and their focus is on lending to the real economy. For all these reasons we believe that well capitalised traditional banks with robust funding structures should be promoted instead of the investment banking model.

In addition, institutional investors' further involvement should only be promoted to the extent that it enables a reduction in maturity transformation, provides a countercyclical element and does not require significant asset transformation. This would be consistent with the European Commission’s objective of promoting patient capital investing in real assets.

1 Stiglitz, J., *The Price of Inequality: How Today's Divided Society Endangers Our Future*, Penguin, April 2013

2 Within securitisation, promote only basic structures with short intermediation chains

... that link borrowers and savers more directly, that include pooling but no tranching or external credit enhancements. Only these structures should see their prudential treatment revised to reflect the fact that they create lower systemic risks. As a rule, the shorter the intermediation chain and the less that the assets are transformed, the better.

3 Require credit rating agencies to rate structured finance instruments on a different scale.

In addition, replacing external ratings by banks’ internal models would require addressing the discrepancies between banks’ assessments.

4 Address the negative externalities of securities financing and incentivise more stable funding

... by introducing a minimum haircut for all securities financing transactions, capping the re-use of collateral and redesigning banks’ liquidity ratios to incentivise stable funding over liquid assets. This will curb the procyclicality of leverage creation.

5 Increase institutions’ contribution to systemic risk in prudential regulation

... through tying-in capital requirements with an institution’s contribution to systemic risk. Together with limiting the creation of pseudo safe assets, curbing procyclicality and curbing the use of securities financing, this should help to make private backstops more robust, internalise negative externalities and reduce moral hazard.

6 Improve the transparency and democratic accountability of public private partnerships

... by requiring public access to the full contracts and regular public reporting on their value for money.