Handbook of Research on Comparative Economic Development Perspectives on Europe and the MENA Region

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Chapter 21
The Role of Securitization Market in the Post-Crisis European Economic Recovery

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ABSTRACT

European national economies begin to recover, and securitization can play an important role in supporting both monetary and financial stability. In particular, securitization may allow banks to lend without over-committing of the capital and other sources of funding, and thereby to provide indirect market access to borrowers. Otherwise, such borrowers as SME's are not able to tap markets directly. At the same time securitization suffers from stigma, reflecting both its adverse reputation among investors and conservatism among regulators and standard-setters. This is the consequence of misaligned incentives in years prior to the financial crisis, when industry participants became entwined in a self-reinforcing dynamic between demand and supply of securitizations. Using data accessible within the period of 2009-2014, the chapter will input by the analysis of transformation in the securitization market within the post-crisis economic recovery of the EU.

INTRODUCTION

Concerns over the future economy of the European Union (EU) have been persistently growing since 2010 after the notorious 2008 global financial crisis. Instability of national economies and a contagious debt crisis makes European existence insecure. In the last five years, fears of a possible Eurozone collapse have been transformed into the real emergent political and economic steps of EU institutions. Therefore, securitization could be an answer to the old and new trends and can play an important role in supporting both monetary and financial stability. In other words, securitization matters as soon it creates value by minimizing the costs associated with market misbalance. In particular, securitization may allow banks to lend without over-committing capital and other sources

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of funding, thereby providing indirect market access to borrowers. Otherwise, such borrowers as Small- and Medium-sized Enterprises (SMEs) are not able to tap markets directly.

From an essentialist position, we use the following the definition of securitization by Roever and Fabozzi (2003): a form of financing in which monetary assets with predictable cash flows are pooled and sold to a specially created third party that has borrowed money to finance the purchase. These borrowed funds are raised through the sale of asset-backed securities (ABS), which can take the form of either commercial paper or bonds. The same position is articulated by academics since the beginning of the 2000s (Kothari, 2014; Davidson, 2003).

The interest in considering economic securitization and the role of securitization market is justified by its increase in the last 10 years and recent events in the Eurozone. We can see that today securitization suffers from stigma, reflecting both its adverse reputation among investors and conservatism among regulators and standard-setters. This is the consequence of misaligned incentives in years prior to the global financial crisis when industry participants became entwined in a self-reinforcing dynamic between demand and supply of securitizations.

The outstanding amount of ABS in the EU is currently about 1,500 billion Euros, or around one quarter of the US ABS market. Since its peak in 2009, the outstanding amount has decreased by a one third, or 750 billion Euros. Residential Mortgage Backed Securities (RMBS) form by far the largest securitization segment, accounting for 58%; SME ABS is second, but the account is only for 8% of the market. The largest jurisdictions in terms of outstanding ABS are the UK, Netherlands, Spain, and Italy (Barclays, 2013).

Some asset classes such as consumer finance ABS, SME Collateralized Loan Obligations (CLO), and RMBS have experienced default rates far below this average and the performance of European structured finance products has also been substantially better than US peers. The corresponding default rates for European consumer finance ABS, RMBS, and SME CLO are 0.04, 0.1, and 0.4% respectively. However, the ABS on US loans experienced default rates of 18.4% over the same period, including subprime loans (Barclays, 2013).

Using data obtained from the database of the Securities Industry and Financial Markets Association (SIFMA), the European Central Bank and the Association for Financial Markets in Europe (AFME) within the period of 2009-2014, we will try to analyze transformation in the securitization market within the post-crisis economic recovery of the EU. The econometric approach to assessing the role of securitization in mortgage lending will be implemented. It will assist with the following:

- Analysis of the impact new regulatory environment (CRD II, CRD 4, Basel III) on the European securitization market (Allen, 2011; Joint Association Reports, 2014).
- Analysis of changes in the structure of the European securitization market (Dulake, 2011).
- Influence poor credit performance analyses of some U.S. structured finance asset classes on the European securitization market.

ECONOMIC RECOVERY, SECURITIZATION, AND DEFLATION

The development of the securitization market is an important factor in the post-crisis recovery of the European economy. Smart ECB policy in relation to the securitization market as a source of liquidity for European banks will reduce deflation, which is a major obstacle to post-crisis recovery of Europe. Low inflation and deflation is dangerous for the economy of any country. Deflation eventually reduces wages at a fixed level of debt and makes it complicated to repay. Deflationary expectations cause people to delay major purchases, which results in reducing production. Such economic scenario is the worst case, because to fight deflation is more difficult than inflation. A striking example is Japan, which has suffered from deflation for almost 10 years. Reduced prices means reduces consumption of the population. People prefer to save rather than to spend, because in future prices will fall, so it means one can buy goods cheaper. Even at the psychological level overcoming this tendency is extremely difficult.

Deflation in and of itself is one of the worst phenomena for national and supranational economy. Methods of struggling with deflation differ from the same type of inflation. Moreover, in Europe the existence of a unified currency together with differentiation of national economies exaggerates the situation. In this context, one cannot devalue the currency in a country, while other measures are limited at the local level. External negative factors for member-states of the Eurozone can be named as lifting investments of China over 2013 in fixed assets with amount of US$5 trillion. This index is equal to the joint index of the United States and Europe and 20% higher than in 2012. These investments have already led or will lead in the nearest future to exceeding of production capacity, being the cause of deflation increase.

The precise analysis of the harmonized index of consumption prices, gaining from Eurostat and considering constant taxes, shows that over the past seven months, a total of 23 of 28 EU states have experienced falling prices. In accordance with this index, since July, 2013 deflation has risen in France to 1%, in the Netherlands to -2%, in Belgium and Slovenia to -4%, in Spain and Portugal to -6%, and in Greece and Cyprus to -10%.(Table 1). This is considered as the result of austerity measures.

In addition, in the Eurozone credits for business are being reduced. The most strained situation is observed among small companies in the periphery countries. In early June, 2014, ECB lowered the GDP growth forecast for the Eurozone from 1.2% to 1%, but increased the estimate for 2015 from 1.5 to 1.7%, and lowered its inflation forecast from 1 to 0.7%, while expecting to accelerate to 1.1% in 2015. Inflation in the Eurozone decelerated in May, 2014, to 0.5% opposite to 2%, it's the lowest level in the last four years. GDP growth remains sluggish – 0.2% in the first quarter, as well as in the fourth quarter of 2013. Inflation has not exceeded 1% since October, 2013 (Financial Stability Review, 2013).

As an effective method to struggle with deflation negative interest rate on short-term deposits was introduced by the Bank of Denmark almost a year ago, but the experiment was closed in April, 2014. The ECB also followed the example of Denmark and introduced a negative deposit rate at the beginning of June, 2014 (it is reduced from 0 to minus 0.1%, the base refinancing rate from 0.25 to 0.15% per annum).

Negative deposit rates mean banks will receive less from their accounts than what they placed in their accounts. This situation is a kind of fixed penalty because they keep liquidity in accounts of the Central Bank. This measure should encourage lenders to invest in the economy and not to save money. It results in the fact that deflationary risk is the main factor impeding the post-crisis recovery of the Eurozone countries.

In our opinion, the leading role in this process belongs to the securitization market instrument. The main reason of creating the asset-backed

Table 1. Harmonized index of consumption prices from 01.07.2013 to 01.03.2014

Countries	Harmonized index of consumer prices in European countries from July 2013, calculated in constant taxes
France	-1%
Netherlands	-2%
Belgium	-4%
Spain	-6%

Adopted from Eurostat News Releases: euroindicators from 01.07.2013 to 01.03.2014, http://ec.europa.eu/eurostat securitization market in Europe was the lack of alternative sources of refinancing for organizations, as well as strict requirements for bank capital. In Europe, there was initially a traditional banking model of funding organizational activities and fund rising through the financial market was not widespread, as in the United States, up to the present time. For companies, it was much easier and cheaper to obtain a loan from a bank to finance investment and other activities than to use the complex mechanism of asset securitization. However, the situation has changed with the rising costs of banking services, while alternative sources of funding, on the contrary, have become increasingly popular.

Among other reasons for the increased popularity of securitization, we can highlight the increased risk premium compared to the corporate bond market. Probably the development of securitization would continue provided the financial crisis in the United States ends. The crisis suspended and questioned the further development of the securitized assets market in the form it functioned in the pre-crisis years. Improper use of securitization mechanism led to the bankruptcy of large banks, multi-billion dollar write-offs of assets, and also widespread use of state assistance. The crisis revealed the need to revise requirements for participants of the securitization market, as well as a mechanism for transactions. Attempts to reform the market have been made in the USA and in Europe.

Resumption of operations within the asset-backed securitization market is the urgent goal for Europe and the USA, but it is also necessary to note some important observations about the roles and differences in each market. Firstly, the EU has suffered by the crisis as a major investor in securities backed by toxic assets, while the US market has suffered by the complexity and opacity of schemes during securitization transactions, and also due to the neglect of the criteria for selection of assets in pursuit of profit. Secondly, the EU scales of damage caused by the crisis are considerably fewer than in the United States due to a much smaller capacity of the European securitization market and higher quality of the cover assets. As a result of the uncontrolled use of toxic assets for securitization transactions, more ABS issues were reduced in the United States than in the EU.

Therefore, in the EU there are higher restrictions for securitized assets and thorough regulations of the transactions securitization. Thirdly, comparing with the United States the EU attracts less funding from the financial markets. About 65-70% of funding is provided through banking channels in Europe while in the United States this value is only 30-35%. Thus, in Europe the situation is follows: the dominant role in financing belongs to the banking sector; furthermore, its assets are of higher quality in comparison with the United States. Considering the details of the mechanism of securitization, we assume that securitization transactions are characterized by a certain extent of complexity, therefore, a wide range of external participants is engaged in it; namely:

1. Servicers, controlling timely payments based on the repayment scheme of pooled loans;
2. Rating agencies, which are responsible for audit and rating tranches of securities issued by the SPV;
3. Trustees, acting on behalf of investors in order to ensure payoff interests and principal of securitization securities;
4. Insurance companies, providing external credit enhancements;
5. Special purpose vehicle (SPV) as an entity established for the specific aim of refunding assets (Ber, 2007).

The form of securitization that presumes transfer of assets to the SPV (so-called true-sale securitization) represents the traditional approach of covered refinancing. True-sale transactions are considered as the irrevocable transfer of a pool of financial assets by their originator (usually a bank) to the SPV, which is funded by simultaneous sales of the newly issued securities by the SPV to investors. By such transactions, banks write-off securitized assets from their balance-sheets. These assets become legally isolated from their originators, which, in turn, enable banks to lower their capital requirements due to transferred credit and interest rate risks. Thus, the advent of innovation mechanisms, such as securitization, was a result of deteriorating profitability of traditional banking.

The crisis helped to reveal the new benefits of securitization. During the crisis, for the originators an extra motive to conduct securitization transactions has emerged (i.e., the European Central Bank repo facilities). Since access to the unsecure funding market has been hampered when low-rated ABS CB (Central Bank) could be pledged as collateral with ECB operations, this significantly alleviated the painful shut-down of the primary and secondary ABS markets in 2007 and in 2008. For example, reviewing the unprecedented scope of ECB repo operations with ABS, some smaller banks, captive banks specialized in limited banking activities, have been granted an access to a broader range of refinancing instruments. With the upward trend in the auto-ABS market and better funding conditions, non-financial corporations could benefit from the current distressed markets and even tap into ECB refinancing sources.

Since the global financial crisis, the market for ABS in the Eurozone has shrunk sharply and is still weak. The market is relatively small. In the Eurozone, it totals around 970 billion Euros compared to US$6.65 trillion in the United States. In April, 2014, the "lion's share" (roughly 650 billion Euros) is in residential mortgage backed securities (RMBS). The RMBS' share accounted for 60% in 2010, whereas the peak – equal to 72% – was reached in 2008. After the crisis, the United Kingdom and the Netherlands became the main players in this segment of the market, as legal and organizational infrastructures are better designed for the issuance of RMBS than for alternative instruments of mortgage refinancing – covered bonds. In April, 2014, the remainder is made up of ABS where the collateral is consumer loans (around 160 billion Euros) and loans to SMEs (120 billion Euros.). Therefore, there are modest outstanding amounts of commercial mortgage backed securities and collateralized debt obligations which would probably be beyond the scope of the ECB's.

The securitization market in the EU is dominated by AAA-rated ABS. The crisis has not substantially changed the structure of outstanding issues of ABS in terms of received rating. In contrast, the share of issues with the highest rating has dropped over the post-crisis period. In 2008, approximately 60% of the US-based ABS market consisted of AAA-ratings, whereas in 2011, it amounted to 25%.

Returning to the core benefits of using securitization, the high proportion of AAA-rated securities even in the post-crisis period shows that European standards of ABS deals are consistent with the principles of high quality collateral, and, in general, only fully performing loans were chosen for the asset pool. Thus, post-crisis structure of the ABS market is represented by distinct ABS classes. Such ABS classes include follows**:**

- **RMBS:** Securities, mostly issued in the Netherlands and the UK,
- **ABS in a narrow sense:** In particular, securities backed by auto-loans, by auto-leases and also by SME (small-scaled and medium-sized entrepreneurships) loans.

In the EU, the SME segment was primarily supported by the governments of Spain and Germany due to programs launched; namely:

- **Spain:** FTPYME securitization scheme[1],
- **Germany:** KfW's German PROMISE platform[2] (Teplova, 2012).

As the SME sector has a vital meaning for real economy, especially in the age of macroeconomic instability, refinancing of activities based on lending to SMEs was underpinned by European institutions, including ECB repo programs. The main problem for the ECB at the moment is that inflation in the Euro area has been falling since late 2011, and since October, 2013 it was below 1%.

Five of the 18 Eurozone member-states (Cyprus, Greece, Portugal, Slovakia, and Spain) have experienced negative rate of inflation in the last few months. Even in the countries which are not in recession such as Belgium, France, and Germany, inflation rates are significantly below the Eurozone target. More worrying is the ECB's forecast suggests that inflation will not return close to 2% in the medium-term. For governments, falling inflation rates often mean that nominal tax revenues fall, thus making the servicing or repayment of debt more difficult. That is why during its June, 2014, press conference, the ECB announced a broad package of measures in order to tackle the low inflation problem. The package aims to ease the monetary policy stance and to enhance transmission to the real economy.

We expect that the bundle of measures will have a minor effect on inflation. The ECB program should be more aggressive. Even though we welcome that the ECB began finally to act with a broad package, we consider that further measures will likely be needed such as a longer term refinancing operation (LTRO) and QE (quantitative easing) program. However, the current problem with the Eurozone is not a lack of liquidity, but rather a lack of lending to the real economy. The small cut in interest rates (including setting the ECB deposit rate in negative territory) will have minor effects, while the effectiveness of the LTRO will depend on whether banks will be ready to assume the liquidity.

We will now turn our attention to the named LTRO and QE programs. The LTRO is the crisis-proof operation of long-term refinancing of banks provided by the central bank which allows banks to obtain funds for a long-term period with low interest rates under pledge of their assets. This measure is designed to strengthen the banking system in times of crisis. Within the framework of LTRO bank lending creates new money, thus increasing the monetary base and the central bank balance sheet.

From conventional refinancing operations, the LTRO are known for their provision of liquidity. The long-term period LTRO operation is associated with high risk for the central bank itself. As soon the operation LTRO creates new money, it is considered as a positive factor for the stock market. The difference of LTRO and the policy of QE is that the allocated money gets into the banking system almost instantly. During the QE, a federal reserve system gradually buys securities (bonds) in the frame of the notice period.

In December, 2011, the ECB announced the beginning of 3-year LTRO operations. The operation was conducted on December 21, 2011. The volume of LTRO transactions were equal to 489 billion Euros of which 296 billion Euros were spent on refinancing operations of the previous loans, and new money has been created in the amount of 193 billion Euros. The cost of a three-year lending amounted to 1% per annum. Eurozone banks may request from ECB any amount of funds beginning from 1 million Euros. However, banks cannot borrow more than their assets or amount of pledge which they can provide. Moreover, banks' assets are valued on the market value rather than at their nominal.

The ECB took the pledged assets from banks at the discount to the market value from 0.5% to 46%, depending on the quality of the assets. The ECB hoped that banks will buy sovereign bonds of problematic states; it will reduce the interest rate on them and their debt burden. The ECB expected that the refinancing of banks would help them in lending to businesses and households. However, according to analysts of Standard & Poor's, an LTRO totaling 1 trillion Euros conducted by the ECB in 2011 and 2012 was ineffective (ABCP Portfolio Data, 2013). Significant differences between the conditions of funding in different parts of the Euro area still remain, and the program LTRO failed to smooth them out. Long-term refinancing operations were carried out in two stages – in December, 2011 and January, 2012. In our view, the fragmented picture of conditions in access to financing in various Eurozone countries is one of the main causes of the Eurozone economy weakness and instability.

Launching of the second LTRO program in 2012 led to rather unexpected result – the correlation between liquidity and dynamics of the European financial sector stocks suffered. Since the collapse of Lehman Brothers in September, 2008, one observed a very high correlation between the key indicators of bank liquidity-spread Euribor-OIS- and the dynamics of the European banks shares (Euro Stoxx Banks Index). In February, 2012 after fresh injection of liquidity in the form of three-year run within the second program of refinancing (LTRO) by the ECB in the amount of 500 billion Euros, this correlation was broken down, namely: liquidity in the system has increased, but bank shares continued to fall. Spread (put and call) of the Euribor-OIS is a barometer of the money market, so the wider it is the worse the situation at the money market, and vice versa.

We can conclude the existence of disintegrated transmission mechanisms in the Eurosystem. The lack of transmission monetary policy of the ECB in the real sector complicates economic situation in Europe. There are some reasons to believe that the actions of the monetary authorities in the Euro area cannot longer mitigate the negative impact from the policy side to reduce government spending. One visible example of this situation can be named as the non-liner relation between the ECB interest rate (0.75%) and interest rates, for which borrowers could take out a loan in different parts of the Euro area. This is treated as an evidence of a fragmented position, where the European Monetary Union is currently located.

According to the ECB interest rates on 1-year and 5-year loans for small and medium volume (up to 1 million Euros) for the companies in Spain increased up from 5.65% in December, 2012 to 5.97% in January, 2013. In Italy during the same period the rate for similar loans increased from 5.5% to 5.82%. Simultaneously, the difference in interest rates on loans for Spanish and Italian companies and similar loans for German companies in January, 2013 has increased significantly compared to July, 2012.

These facts indicate that the massive liquidity injection by the ECB in December, 2011 and January, 2012, using the LTRO program in the amount of 1 trillion Euros, failed in provision of a uniformed influence on financing conditions in different parts of the Eurozone. In addition, another sign of the fragmentation in the European financial system is the decline in cross-border lending (loans lenders to borrowers in a country neighboring European countries). In June, 2014, the head of the ECB – Mario Draghi – announced several rounds of LTRO under a fixed rate. The initial amount will be 400 billion Euros, but he did not clarify time period and credit terms.

In order to support bank lending, the ECB will conduct target TLTRO under fixed interest rate and in unlimited amount as long as possible. The TLTRO program purpose is to increase the volume of lending companies which is why this will impose additional requirements to the banks accounting, and the ECB will carry out inspections for purposeful use of provided funds. Maturity to all rounds is September, 2018 (i.e., loans will be provided approximately for four years, and the distribution will occur in September and December, 2014). Initially, under the Conditions of this program accepted on April 30, 2014, banks can borrow from the ECB 7% of total lending in the private sector of the Eurozone (excluding financial sector and mortgage loans to individuals). The fixed interest rate will be 10 basic points above the base, which the ECB lowered from 0.25% to 0.15%, updating of record low.

At the moment, the ECB does not consider as necessary to run a large-scale asset purchase program QE despite the low rate of inflation in the Eurozone. However, there are some doubts regarding its appropriateness, as soon the significant QE program would have strong effects on the core – the Eurozone inflation as well as periphery inflation. We continue to believe that a more aggressive quantitative easing program would significantly anchor inflation expectations.

The reason for our considerations lies in the core of the QE program as QE is an unconventional monetary policy used by central banks to stimulate economy when a standard monetary policy becomes ineffective. In the context of the policy, a quantitative easing the central bank buys or takes in pledge of financial assets for liquidity injected in the economy. However, in traditional monetary policy the Central Bank buys or sells government bonds in order to save market interest rates at a certain target level. In Europe, the nominal interest rate is close to zero; therefore, the ECB cannot lower it further. This situation is called a liquidity trap, and it occurs in circumstances of deflation or very low inflation. Therefore, the purpose of the QE policy in the Eurozone is to increase the money supply, but not for reducing interest rates, as soon they cannot be lowered.

The program simulations quantitative easing (QE) volumes 1 trillion Euros, the ECB showed that the purchase of assets by 80 billion Euros in one year may accelerate inflation by 0.8 percentage points. This situation is forecast by analysts of Finmarket (AFME, 2014). In the worst case, the program allows one to stimulate quickly the growth rate of consumer prices by 0.2 percentage points. If it occurs, the QE Program of the ECB will be very different from the program of the Federal Reserve QE both by the configuration and by the implications for the Euro and the US dollar. The reason is that financial systems of the two economic entities are very different.

The financial system in the United States is based on capital markets. In case they require funding, US-based corporations attract money on the capital market through the issuance of shares or by issuing bonds. Capital markets in the United States are highly developed. European corporations in the same case attract funding primarily through borrowing. The corporate bond market in the Eurozone is at the stagnation stage. For the Eurozone, the state of the banking system is of great importance. Therefore, the purchase of assets in the Eurozone does not have the same effect as in the United States. If the Federal Reserve buys assets, it almost automatically leads to an increase in the prices of all assets, because the process of buying assets affects interest rates. Interest rates in the Eurozone are very low, so it is impossible to affect them by asset purchases. However, it is possible to affect them by reducing the ECB basic rate, which is also very low.

Thus, in our opinion, the QE program provided by the ECB will be directed rather to the purchase of debt securities in the banking sector in order to support lending, than on the large-scale purchase of government bonds, belonging to different states in the Eurozone. The QE will not be a radical change for the ECB as soon the program will be similar to the previously adopted program of trading in the securities markets (Securities Markets Program, or SMP) and the program of government bonds redemption (Outright Monetary Transactions, or OMT). At the moment, they both are "sterilized"; that is, they have no effect on the monetary circulation. European QE is likely to be less aggressive than in the United States and Japan and very selective. The program will be organized in a way to avoid political risks and potential violation of the constitutional laws. To achieve this, we propose monthly purchases of ESM/EFSF/EIB bonds, corporate bonds and ABS to anchor inflation expectations and bring Eurozone inflation back to 2% in the medium-term. However, existing differences between the Eurozone and the United States or the United Kingdom in asset purchase will result in different forms.

Setting an appropriate size of asset purchases is not an easy task. The precise analysis considered the total amount of asset purchases by the Bank of England and the Fed and demonstrated similar magnitudes for the Euro area (20 to 25%

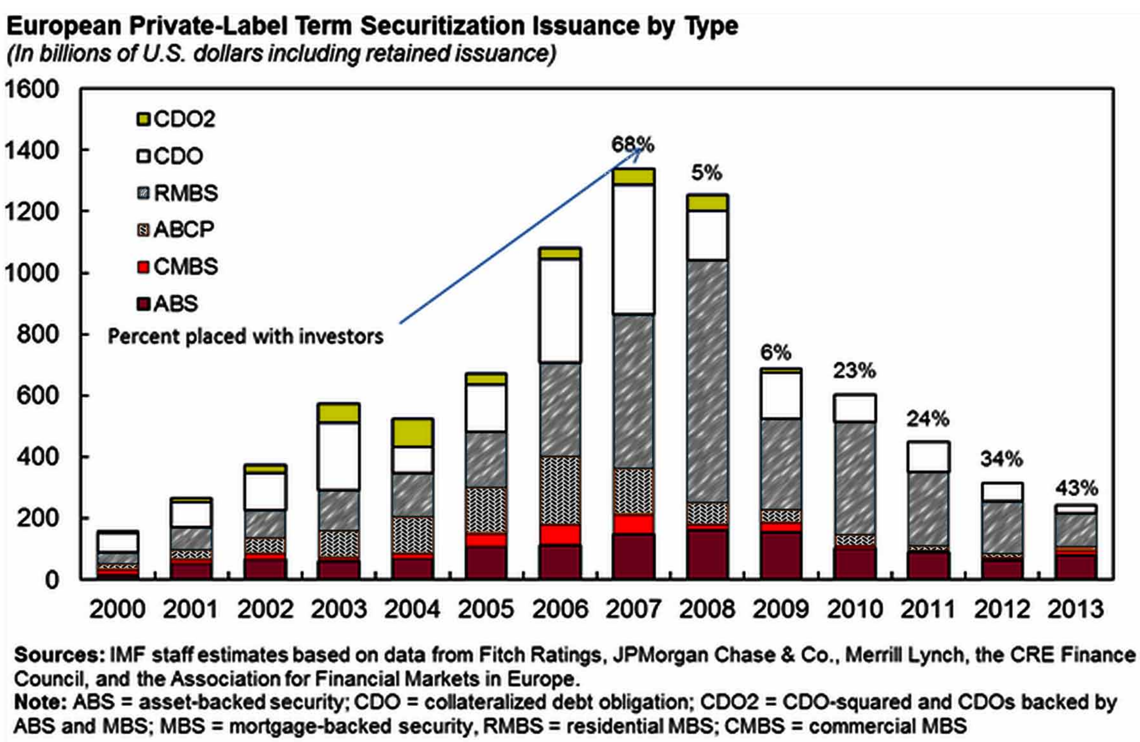
of GDP or 1.9 to 2.4 trillion Euros). The ECB should attempt to minimize the impact on the private-sector allocation process. While the QE by its definition changes relative prices, the ECB should avoid buying on small markets and distorting market pricing too much. The more the ECB becomes a player on market, the more it can be a subject for political and private-sector pressures when it wants to reverse the purchases. The ECB should buy only on secondary markets to allow the portfolio-rebalancing channel to work effectively. Purchasing on the primary market would imply the direct financing of entities which should be avoided.

The assets should only originate from the Eurozone and be denominated in Euros due to the G-7 Agreement in February, 2013. The Treaty gave a mandate to the ECB to maintain price stability – not to protect its balance sheet. Some criteria on riskiness should be adopted, but a reasonable low threshold for credit risk is recommended, such as restricting asset purchases only to the eligible collateral (without any additional eligibility criterion).

According to the ECB, at the end of 2013 total marketable assets, eligible as collateral, represented almost 14 trillion Euros which is equivalent to 146% of the total Eurozone GDP. At the end of 2013, about half of the Eurozone's eligible collateral pool consisted of government bonds, while the other half was split between uncovered bank bonds, covered bank bonds, corporate bonds, ABS, and other marketable assets which include the debts of EU rescue funds and the European Investment Bank (Figure 1).

A natural starting point for an ECB asset purchase Program would be Euro area wide government bonds, which do not exist. The closest proxy would be the bonds of the European debt, such as bonds issued by the European Financial Stability

Figure 1. Eligible assets and assets used as ECB collateral (€ bns.) (ECB data). Source: www.ecb.europa.eu



Facility (EFSF), the EU, and the European Investment Bank (EIB). Buying such pan-European assets would not affect the relative yields of Eurozone sovereign debts and would not distort the market allocation process within the private sector. However, the purchase of national government debt is more complicated for the ECB as a supranational institution without a supranational Euro area treasury as a counterpart, than it was for the Fed or the Bank of England.

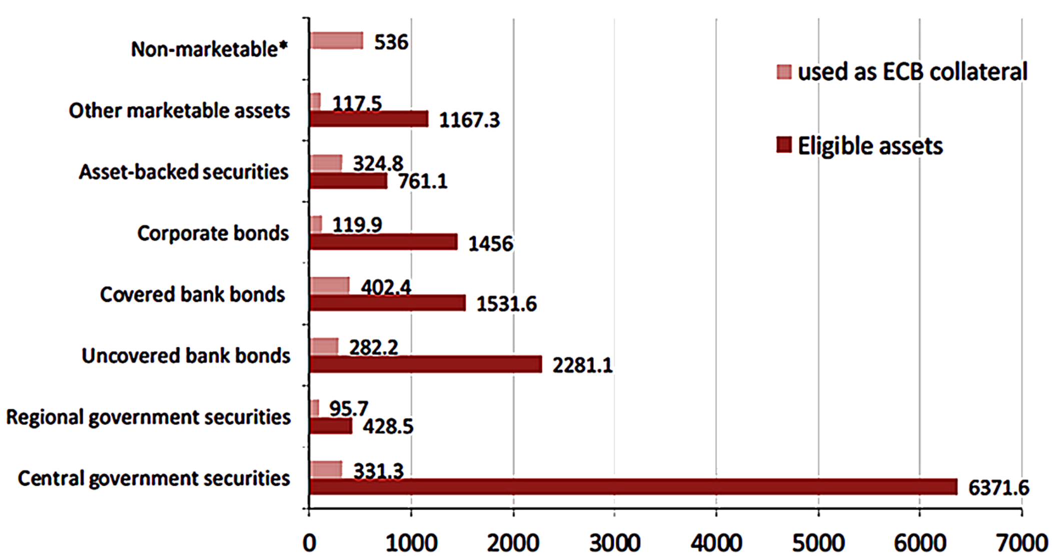
The second largest asset class is bank bonds, with 3.8 trillion Euros available in eligible covered and uncovered bonds. Among other effects, the reduction in market yields would also reduce the yields on newly issued bank bonds, thereby allowing banks to obtain non-ECB financing at a lower cost. This would improve bank profitability and could improve the willingness of banks to lend. However, bank bonds should be excluded from the ECB asset purchase program until the ECB's Comprehensive Assessment will be completed.

Until then, ECB purchases would lead to serious conflicts of interest at the ECB and would make a proper assessment by the ECB more complicated. Moreover, those banks, for which the outcome of the Assessment is unsatisfactory, should to be excluded from the ECB's asset purchases until they implement all the required restrictions to their balance sheets. This might take several months after the completion of the Comprehensive Assessment. Since 2009, the supply of corporate bonds in the Eurozone has grown significantly. The Eurozone corporate bond market is highly concentrated (Figure 2) with French companies as the main issuers of corporate bonds.

However, for work of portfolio rebalancing, the origin of corporate bonds is of less importance. The beneficial effect would come from the fact that the current owners of corporate bonds would sell their bonds and use the cash for different purposes throughout the Eurozone. The purchases would encourage new issuance of corporate bonds everywhere and lead to diversification of the funding sources. Lower funding costs for corporations should induce more corporate investment.

Another class of assets that could be bought by the ECB is ABSs, but the stumbling block in the ABS market architecture is information

Figure 2. Bonds loans – financing of EU non-financial corporations (€ bns.) (ECB). Source: www.ecb.europa.eu



asymmetry. Two issues must be highlighted in this respect. The first one is the non-transparent ABS structures which provide an opportunity to mislead investors. The second one is the concealment of information on behalf of rating agencies. To persuade investors to invest their money in the ABS, data regarding the underlying pool and deal structure are supposed to be fully disclosed, which, in turn, is treated by some originators as a huge obstacle and disadvantage of securitization as a method of refinancing.

Generally, European banks, and the German Landesbanken in particular, became the main victims of the limited and selective transparency strategy in the post-crisis period. It is worth highlighting that defaults on ABS in Europe have ranged between 0.6-1.5 percent as average, against 9.3-18.4 percent for the US securitizations since the start of the 2007-08 financial crisis (Kotkhary, 2014). Considering the total amount of European ABS, more than a half (some 612 billion Euros) is based on residential mortgages, while SME ABS constitute a smaller part (116 billion Euros). That is why we suppose that ECB should be buying also RMBS, as they represent the biggest pool of ABS and would allow the ECB to have a more significant program without buying the whole market.

The ECB should not be afraid of the potential housing bubble in Germany as the current price increase is not financed by a rise in volumes of mortgages in Germany. The ABS stock outstanding is unequally distributed across countries, with the main issuers being different from the main issuers of corporate bonds. ABS purchases would be concentrated on the Netherlands, Spain, and Italy, and could therefore be a good geographical complement to corporate bond purchases, which would be concentrated in France, Germany, and Italy. An ECB purchase could promote the development of securitization in the Eurozone. The potential for securitization is relevant, as many loans would be qualified for securitization, and in March, 2014 in the EU the outstanding amount of loans to non-financial corporations stood at 4.2 trillion Euros and to households they stood at 5.2 trillion Euros (AFME, 2014). From a monetary policy perspective, it would be very beneficial to create ABS, which is based on a portfolio of European assets. Ideally, the credit risk is pooled at the level of the private sector, thereby deepening cross-border financial integration. However, the ECB should not wait for development in the ABS market to start buying securitized products.

Thus, in our opinion, the Eurozone will escape deflation accompanying the economic recovery. However, the risks are higher than the ECB suggests. The forecast suggests that inflation will remain very low for a long period. In case of a new negative demand shock there would not be much of a buffer before economy falls into a deflationary spiral. Therefore, it is considered that a large scale QE program, based on the development of securitization market, would push down the Euro, and it would be the best way to reduce deflationary risks.

CONCLUSIVE REMARKS AND RECOMMENDATIONS

Considering the development and recovery of the European economy after 2008, we conclude that the core problem is the securitization market which is seen as a means to fight deflation. Within the securitization market, there exists a set of instruments and tools that could be used to fight deflation:

- Long Term Refinancing Operation (LTRO)
- Quantitative Easing (QE)
- covered bond program
- ABS program

The analysis has demonstrated that in the Eurozone the transmission mechanism of monetary policy provided by the ECB is the real sector of economy which does not work properly. Therefore, we contend that the only real version of the new

LTRO is to be considered the scheme "funding instead of crediting" (funding for lending), similar to the scheme that was used by the Bank of England. Note that the use of "funding for lending" scheme has been very successful for the British economy; we assume the use of this scheme for the Eurozone is possible and could appropriate.

Thus, we believe the QE program of the ECB will be likely directed to the purchase of debt securities in the banking sector to support lending, rather than the large-scale purchase of government bonds in the Eurozone. Definitely, the QE will not be a radical change for the ECB, as the program is similar to the previously adopted program trading in the SMP, and the program of redemption of government bonds OMT. They are currently both "empty", which means no effect on the circulation of money. The European QE is expected to be less aggressive than in the United States and Japan, and will be very selective. The selectiveness comes from the intention to avoid political risks and the potential violation of national constitutions.

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ENDNOTES

1. FTPYME – Asset Securitization Funds for SMEs run by the Spanish Ministry of Industry, Energy and Tourism.
2. PROMISE (Promotional Mittelstand Loan Securitisation) – the platform run by KfW for securitization of SMEs loans.