Time has come to revive a sound and safe securitization market in Europe

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Financial regulations have made European banks more resilient. Indeed, banks have considerably strengthened their capital positions which have doubled on average, and have increased their levels of liquid assets, while reducing their risky assets, notably by scaling back market activities, an area in which they had been too frequently involved beforehand.

A deleveraging trend, with a reduction in banks' balance sheets, is normal after a debt crisis.

However, the European banks' reduced levels of profitability are making it difficult for them to find fresh capital to fulfill tightened capital requirements. The more this profitability is limited, the less it is possible for them to build up reserves and the more difficult it is to raise capital. This problem is being compounded by the increase in capital constraints. The banking sector's profitability for investors has become far lower than that of industrial companies. In this situation, compliance with the liquidity and capital adequacy ratios can only be fully achieved through a reduction in assets, including loans. In comparison, the impacts of these prudential requirements on the profitability of American banks are lower as far as they off-load a major part of their mortgage loans to entities like Fannie Mae and Freddy Mac.

Yet, resuming growth in Europe requires providing adequate sources of financing for EU enterprises and households. Besides the low margins and the high levels of indebtedness of enterprises in many EU countries, several factors are hindering credit provision.

Non-performing loans in periphery countries are high, which deters banks from lending. Furthermore, the failure of several banks has either left SMEs with no bank or finding difficulty switching to another bank. In addition, the poor sovereign ratings of these countries lead to high credit rates which strongly impact the profitability of enterprises and their capacity to borrow.

Another issue which first emerged in periphery countries but is now touching other EU states, is the increasing credit rationing of SMEs. In several countries, the proportion of bank loans facing obstacles (rejections, partial coverage or high price) has been increasing over the last months. This situation can be explained by a combination of demand and supply factors. However many observers believe that this could be the prelude to a further decrease of credit supply in these countries caused notably by rising prudential constraints being progressively imposed on banks.

To sum up, it would be too easy to say that the classical deleveraging that always follows a banking crisis is the <u>sole</u> factor behind the present slowdown of credit to the private sector: the situation has to be observed in a more granular way. Figures show that a significant number of SMEs in good standing in periphery countries have great difficulty in accessing credit.

Given the difficulty of developing market-based direct financing mechanisms for smaller companies based on bond or equity vehicles, the time needed to improve significantly the profitability of EU banks and the potential credit crunch and recession in some EU countries, revitalising SME loan securitisation is key to the solution. The ECB notably has called for the development of high quality plain vanilla products capable of being rated and priced in a simple way.

The fact of the matter is that securitization is lethargic in Europe. We should therefore take simple and rapid actions to revitalise it. I believe that three conditions are to be met in order to achieve this.

A first condition is rebuilding investors' confidence which means that the quality of underlying bank loans must be unquestionable. Using the criteria already defined by central banks for accepting SME loans as eligible collateral and the capabilities of some central banks in assessing the risks of such products would de facto contribute to the defining of high quality standards for the securitisation market. On this basis, the Eurosystem could foster the emergence in each country of the Eurozone of securitisation conduits which would purchase SME loans complying with these criteria and would therefore issue "prime" securities.

A second condition would be the provision of guarantees by European and national development banks for the securities issued by these conduits. Provided that the high quality of such securities is demonstrated and that public guarantees can be provided, numerous investors should be interested in investing as they seek investments correlated with the real economy. This should counterbalance a relative lack of return of bank loans compared with usual financial assets.

Thirdly, the ECB in conjunction with National Central Banks should be ready to purchase temporarily if needed such ABS to help the launching of this securitization market. This should be possible given the high quality of the underlying credits concerned by this proposal.

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