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Can European Banks Survive a Unified Currency in a Nationally Segmented Capital Market?

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### BACKGROUND

#### Iron, Steel and Cartels

The creation of the European Economic Community was an exercise in political economy. It was created on the premise that joint European political control of the raw materials for war, the production of iron and steel, could prevent a final, fatal European conflict. The result was the European Coal and Steel Community, a production cartel under joint European Control. Nearly fifty years later the continued evolution of this exercise in political economy has produced the European Economic and Monetary Union (EMU), based on the premise that common European control of the raw materials of economic war, money creation and fiscal expenditure, could prevent a final, fatal recession in which German obsession with price stability produced economic stagnation and collapse. The result is the European Central Bank, a cartel of national central banks that produces the supply of a single money, the euro, controlled by a European Council.

The Coal and Steel Community was to provide a pattern that could be applied to other critical European industries, creating large-scale European producers capable of competing with the dominant American rivals. However, this implied European consolidation, with some countries losing their national producers. This quickly led to national acrimony that the EEC was supposed to eliminate and a shift in emphasis to reduction of internal barriers to trade behind a common external tariff wall. Instead of forming producer cartels to compete with global producers, national producers were encouraged to compete with each other with the benefit of protection from foreign competitors.

#### Trade Creation, Tariff Removal and Competition

The result was an emphasis on internal trade creation within the EEC which was a great success and intra-Community trade grew rapidly, acting as an engine of demand that reinforced economic miracles in Germany, Italy and France. It also encouraged direct investments from US producers seeking production sites inside the common external tariff wall. But, after the first decade, the positive impact of trade creation on demand began to fade and new initiatives had to be sought to provide support for further integration of the EEC. The Werner commission was created to investigate the possibility of full monetary integration through the creation of a single currency. At this time there was no question of creating any formal European Monetary Union or European Monetary Fund or European Monetary Authority because of possible conflict with the already existing international commitments of the member countries under the Bretton Woods Agreements. Despite these commitments, the Rome Treaty did make ample provision for free movements of capital within the Community.<sup>1</sup>

### EUROPE AND A SINGLE CURRENCY

Despite the fact that many considered that hot money flows maneuvered by the gnomes of Zurich had been a major cause of exchange rate instability under Bretton Woods, the Werner Report reiterated the Treaty of Rome's commitment to free capital flows, while recognising that this could be achieved only through the creation of a single community currency or a formal monetary union administered by some sort of regional European IMF. The first step in this direction was the decision to reduce the fluctuation margins relative to the dollar in what came to be called the 'Snake'<sup>2</sup> within the tunnel.<sup>3</sup> However, neither the reductions in margins nor the Werner recommendations were ever implemented as the events of May and August 1971 and October 1973 produced a series of expedient serpentine monetary structures representing a joint EEC float relative to the dollar with enlarged margins (of which the European Monetary System must be considered as one), all of which bore high resemblance to the exchange rate regime of Bretton Woods and none of which envisaged free movements of capital, nor created a European IMF.

Interest in monetary union was revived under the presidency of Roy Jenkins, in the context of the sharp volatility in the US dollar in the 1970s which had created competitive distortions within the EEC because the speculative money flows tended to be concentrated in the German Mark and thus created fluctuations of the Mark relative to the other EEC currencies. The creation of the European Currency Unit (ECU) at the centre of a system of fixed but adjustable exchange rates (the ERM) in 1979 was intended as a step towards joint EEC responsibility for exchange rate policy and a step towards complete monetary integration. However, at the same time the other EEC currencies were linked more closely to the DM through a bi-lateral exchange grid so that the German Central Bank could in effect marshal the reserves of their EEC partners to prevent excessive volatility of the Mark relative to the dollar. The ECU, which was originally to have been at the centre of the system and represented a commonly formulated monetary policy was reduced to a purely representative role. The ERM was intended as a first stage, and after five years steps would be taken to produce full monetary integration and a single currency.

### **A Single Market Means a Single Money**

However, the decision to move to a common currency was only reached some ten years later as a result of the realisation that it would be necessary for the completion of the European Single Market Act (SMA), first broached in the Milan Summit in 1985 and formally initiated on January 1, 1993. The period was dominated by the belief that control of inflation, through tight control of the growth of monetary aggregates would bring about recovery in output and employment growth in Europe.<sup>4</sup> In this context the SMA was viewed as a measure that would promote economic growth without interfering with control of the money supply or increasing fiscal deficits. But, it was clear that the benefits of increased intra-EEC demand from the completion of the Single European Market could only be fairly shared among the member countries if relative price changes were determined by changes in relative productivity, rather than the increasingly variable and unpredictable exchange rates which resulted from the behaviour of the US dollar and differences in the evolution of member country macroeconomic policies. As a result, the Single Market policy to create non-inflationary demand was extended to the establishment of a full Economic *and* Monetary Union<sup>5</sup> to reinforce the price stability that was considered prelude to expanding output and employment. This meant that the ECU of the EMS would finally be transformed into a single currency as the ERM bilateral rates were irrevocably fixed.

However, since these currency provisions were not foreseen in the Treaty of Rome amendments were required that were agreed in a major revision of the Treaty at Maastricht. Since the creation of a single money required a bank of issue, the Treaty made provision for a European Central Bank which would formulate monetary policy for the entire European Union. But, a single monetary policy implied a marked degree of economic convergence across countries. It would be impossible for a central bank to operate a successful monetary policy if, say, inflation were running at 20% in one EU country and 2% in another. Thus the Treaty set out the now infamous macroeconomic convergence criteria as the minimum necessary requirements for the success of a single central bank operating a single monetary policy across the entire EU.

### **The Single Money and European Growth**

For almost all countries, meeting the convergence criteria involved substantial reductions in government spending and sustained tightening of monetary policy. Thus, somewhat paradoxically, the Single Market Act, meant to support demand without creating inflation, was transformed into a policy to reduce demand and ensure nominal convergence of a selection of macroeconomic variables. The result of the combination of the Single Market Act and the Single Currency to produce EMU was to eliminate any positive benefit on effective demand. Indeed since the negative aspects were immediate and direct, as against the long term and indirect supply effects the former dominated and the completion of the European single market failed to achieve its growth and employment aspirations.

### **MACRO CONVERGENCE VERSUS MICRO DIVERGENCE**

In addition to this contradictory impact of EMU on growth and employment in the EU, is what might be called a "design fault" or a structural contradiction, contained in the construction of the EU which seriously questions the ability of the European Central Bank to operate monetary policy and may substantially undermine the success of the Euro.

One of the reasons for the lack of progress in the EU in the 1970s was the attempt to build the EEC on the basis of common standards through harmonisation of Community regulations. On the one hand, this was based on the idea that competition in a single market required the abolition of non-tariff trade barriers in product design and local regulation. This would have implied such measures as a common method of beer production, which caused tremendous resistance in Germany as well as in the UK, each wedded to its own peculiar method of production. It proved an impossible task to reach agreement on common standards among the original members of the EEC, and the process became unmanageable with continuous community enlargement. When it risked ruin of the entire European project, harmonisation was finally abandoned in favour of a new approach of subsidiarity based on home-country regulation and national treatment. This applied what might be called the "tourist" principle to EU regulations.

An EU tourist, visiting another EU country was automatically subject to its legal system, its rules and regulations, as were any products that were acquired abroad and taken back to the tourist's home country, without any further EEC control or restriction. There seemed little reason, if products produced under foreign rules and regulations could be acquired and imported by a tourist and used without restriction in the home country, why the goods produced under foreign rules and regulations could not be directly imported and sold to the same tourist when he stayed at home. Emphasis was thus placed on mutual recognition of foreign standards. This particular principle, in the form of mutual acceptance of home country regulation, was eventually generalised in the form of "subsidiarity", which implied that regulation and control would be taken at the "lowest" (i.e. most local) level of government, preserving not only national, but local, diversity.<sup>6</sup>

The decision to abandon harmonisation gave a new boost to the Community and ensured the success of the Single Market initiative in rejuvenating the ideal of a single European currency. However, the preservation of the *micro-level diversity* of institutions and regulations that it encouraged ran directly counter to the *macro-level harmonisation* that was implied in the macroeconomic convergence criteria for the common currency contained in the Maastricht Treaty. As already noted, the uniformity of macroeconomic conditions across countries was introduced in order to allow a uniform monetary policy across the community, yet the preservation of national diversity of financial market institutions represents a substantial impediment to the benefits of convergence of macro performance for the successful operation of monetary policy by the European Central Bank. The persistence of individual differences in national money and capital markets that results from the application of home country regulation has also been supported by the failure of the EU to institute a single institution for prudential supervision of financial institutions. As pointed out previously (e.g. Kregel, 1993, 1996), bank regulation has an important impact on the efficiency of the operating procedure of the central bank because it determines the way banks respond to monetary policy actions.

### Macro Convergence and Monetary Stability versus Financial Market Unification

The concentration of the European Central Bank on the successful operation of its single monetary policy has meant a very rapid convergence of conditions in short-term money markets across the community and harmonization of short-term money markets which is far greater than that which has occurred in capital markets. This is increasingly realized by members of the ECB Council. The Vice-President of the ECB has recently noted that the greatest progress has been made in "those sectors of the financial system which are used as the primary channels for the operation and transmission of the single monetary policy. Thus, thanks to the TARGET system money markets are now close to perfect integration, given that the spreads amongst Euro area countries are extremely low and reflect different credit standings of counterparties rather than market segmentation." (Noyer, BIS, 131, p. 4). "The success of this operational framework can be demonstrated by the fact that the Eurosystem has not yet found it necessary to recourse to any fine-tuning operations. Moreover, since January, active market participants have typically and quickly eliminated cross-country interest rate differentials in the money market through arbitrage. Overall, developments in short-term money market interest rates have thus far been very stable and money market rates have, on average, been close to the interest rates at which the ECB has provided liquidity through its weekly main refinancing operations" (Noyer, BIS 133, p. 4).

The reason for the diverse rate of convergence in short-term money markets and capital markets is explained by Jurgen Stark, Deputy Governor of the Bundesbank as the result of a conflict between the efficiency of monetary policy and the unification of capital markets. He notes that it is, "the elimination of exchange rate risk that is driving this process of market integration, the major feature of which has been a far-reaching convergence of long-term interest rates. ... In the absence of exchange rate risk, spreads nowadays only reflect perceived differences in credit risk and liquidity. Increasingly, it is the latter prevailing over the former". However, the most obvious remedy for this lack of liquidity: that "national governments in the euro area should pool their debt issuing in one central agency, acting on behalf of borrowing governments ... would be a violation of Article 103 of the European Union Treaty (ex-article 104b of the Maastricht Treaty), the so-called "no-bail-out clause", which prevents governments from assuming any liability of other governments' debt." Since this "would undermine the credibility of the new currency" and thus undermine the efficacy of the ECB's monetary policy, "The upshot of this is that for the time being we will not be able to create a euro-denominated government debt market of the same liquidity and homogeneity as the market for Treasury bonds in the US, unless we were to get a fully-fledged political union with a supranational European government issuing substantial amounts of debt. I cannot see this happening in any foreseeable time span, although it could be the long-term result of a sustained evolutionary process of political integration" (Stark, p. 1-2).

### The Importance of Prudential Regulation to Macro Convergence

But this is a relatively limited view of the efficiency of monetary policy for it stops short of the impact of short-term money markets on banks and borrowers who are the decision-makers that monetary policy is meant to influence. For example, if prudential regulation is viewed as a process of hedging of risk imposed on banks by the regulatory agency (cf. Kregel, 1997) and if banks are considered as agents that intermediate risks rather than bearing risks, then

prudential regulations will determine the way banks respond to policy impulses. Differences in prudential regulation will mean that banks will respond differently to uniform monetary policy. The acceptance of national diversity has meant the acceptance of diverse national prudential regulations and these diverse regulations will have an impact on how banks and borrowers respond to changes in monetary impulses.

For example, a statistical study by Borchert notes that EU country banks divide into those that fund their marginal lending via sales of assets from their portfolios to the central bank (British, Italian, Dutch and Austrian), and those that fund via the liability side, increasing their deposits or reducing reserve requirements by inducing customers to shift deposits from higher to lower reserve ratios (German and French). This means that even if an appropriate uniform policy can be designed because of sufficient uniformity of macro conditions such as inflation and fiscal deficits apply across countries it may have a differential impact on the different national money and capital markets because of diversity of institutions and types of bank. The bottom line is that this differential response will also lead to differential impact on lending to businesses in different national markets and thus to differential impact on interest rates and levels of activity in different countries. The persistence of national differences may thus be sufficient to undermine the effectiveness of the ECB's uniform monetary policy and thus the strength of the Euro as a reserve currency to challenge the dollar.

#### **NATIONAL DIVERSITY IN TRADITIONS, PRACTICES AND REGULATIONS IMPEDE CAPITAL MARKET INTEGRATION**

The contradiction between convergence of short-term money markets to provide efficient monetary policy and the convergence of long-term capital markets noted above is not the only impediment to the creation of more efficient and liquid capital markets in the EU. "European financial markets have naturally suffered from a high degree of segmentation and a lack of cross-border competition, low trading volumes, high costs and a reluctance to introduce innovative financial instruments. This segmentation was very much a result of the currency 'barriers', but other factors also played a role. Different traditions and practices, national regulations and tax regimes have been — and still are — further obstacles to the efficient integration of the financial markets in Europe. ... It is clear that the current institutional and market arrangements in the euro area are not enough for the development of deep, integrated and liquid markets. In the new regime, many parts of the institutional frameworks, which were functioning well within individual countries, are now becoming obsolete or are inconsistent with the schemes prevailing in other countries. Hence, old rules and market architectures have to be adjusted and harmonised in order to ensure a higher degree of efficiency.... Despite the recent progress, we should not shy away from the fact that there is still much work to be done in order to remove barriers to a further market integration" (Hämäläinen, 2000, pp . 3-5). In a subsequent speech she adds after this phrase " In a world of free movement of capital and with the availability of technology which enables investors to reallocate their portfolios in real time, the remaining obstacles to the integration of European capital markets have increasingly become a major drawback and a competitive disadvantage" (2 April, 2000, p. 4).

"The integration, liquidity and efficiency of the financial markets are so essential for the success of the euro project that it is worth giving a brief overview of the current state of development of the main market segments, and thus of the opportunities available to the investors in these markets. Despite the fast integration of the money market, far less progress has been made in the segment closest to it, the repo market. There are several reasons for the lesser degree of integration in the repo market, as compared with the unsecured money market, such as the different features of the underlying bonds (i.e. their credit risk and market liquidity), a lack of harmonisation of repo agreements throughout the euro area as well as the technical difficulties related to the cross-border management and settlement of collateral.

This notwithstanding, we are witnessing promising developments in the market. The consolidation of clearing and settlement systems is underway and the repo market is benefitting from improving liquidity in the bond markets and also from indirect effects of increasing liquidity in the unsecured interbank market and the swap and futures markets. The changes experienced so far in the short term securities markets are still very limited. Previously existing markets in the euro area were generally small and very unevenly developed across the various countries. It is likely that it will take a longer period of time for these markets to take off. As to the bond markets, the changes implied by the introduction of the euro are more complex than those affecting the money market. Government bond markets are now highly integrated owing to the relative homogeneity of the issuers and to a converging trend of issuing practices towards best standards. In addition, increased competition across the borders contributes to an improvement in the functioning of the secondary markets. As a consequence, the liquidity of the government bond markets, which is reflected, inter alia, by the much larger average size of the issues, has risen. With regard to private bond issues, it is worth noting that markets for mortgage-backed securities (the so-called Pfandbriefe market), which was traditionally restricted more or less to Germany, are now developing in several other euro area countries, such as France and Spain. We have also witnessed a growth of the so-called "Jumbo" sector of the Pfandbriefe market, which contributes to an increased market liquidity for these kind of securities. In the corporate bond market, a sharp increase in the issuance volume has occurred over the last year, with a broadening of the range of institutions resorting to the bond market for funding. In particular, the increase of issues with lower credit ratings is an encouraging step towards the development of deep and liquid corporate bond markets, which will be of particular importance for small and medium sized innovative companies - the so called growth companies - to raise funds." (Hämäläinen, 2000)

Nonetheless the Euro has experienced some success in international security markets. For 1999 as a whole, net issues of international securities for 1999 were split equally, 46% and 46%, between the Euro and the US dollar. The quarter by quarter evolution shows a more favorable performance for the euro, with its share of net issues rising from 38% to 42% to 50% to 56% over the four quarters of the year, while dollar issues fell from 57% to 46% to 41% to 40% in each of the quarters of the year. More impressive for the euro, however, was the jump from 20% in the fourth quarter of 1998 before the introduction of the euro, to 38% in the first quarter of 1999 when the euro had just come into existence.

This impressive increase in issuance does not, however, mean that the euro is replacing the dollar as the currency of preference for the issue of international securities. In gross issuance the dollar has retained its dominance and issues in the Euro represent only 28% compared to 46% for the dollar. Further, the quarterly figures for the dollar are stable over the year and are little changed from 1998, although the Euro issuance rises from 27% to 28%. The dollar has not only held its share of gross issuance of fixed rate securities, it slightly improved its position, as has the Yen, while the Euro has fallen back slightly. The major gains made in Euro issuance have been in floating rate issues where there has been a shift of around 8 percentage points in favour of the Euro relative to the dollar from 60% to 52% and 21% to 29%. It is difficult to determine whether this is due to the introduction/preference for the euro or simply the reversal of the decline in long-term bond yields that accompanied the initial expectation of tightening of US monetary policy and thus a preference for Euro floating rate issues as a cheaper alternative.

The increased net issuance of the Euro can be largely attributed to European issuers. In comparison with 1998, entities resident in Europe increased their overall net issuance from \$254 billion to \$536 billion. European financial institutions led the move towards euro-denominated international securities, with commercial banks increasing their issuance in euros from \$81 billion for the predecessor currencies in 1998 to \$233 billion in 1999. By contrast, partly

due to competition to establish benchmark status among US agency issuers, almost 40% of North American issuance was by government sponsored enterprises (such as Fannie Mae). For emerging markets and international institutions the ratio of euro to dollar issues rose from  $\frac{1}{2}$  to 1.2, a shift away from the dollar that is about the same as that in European issues denominated in dollars (-\$35 billion for Europe, -\$30 billion for others). Corporate issuers were still relatively scarce although the largest issue in the 4<sup>th</sup> quarter was to Mannesmann Finance for \$2.5 billion (followed by Vodafone), to finance the takeover. This indicates that merger and acquisition activity is a major cause of new euro issues and it is thus difficult to discern whether it is the single currency that has been the cause of the increase in euro issuance, or the increase in mergers and acquisitions that has followed the completion of the Single Market Act in EMU (Cf. BIS, 2000, p. 23, all figures in this section are calculated from the statistical appendix).

Nonetheless, the early evidence thus suggests that the Euro will become a clear alternative to the dollar as currency of issue in capital markets. However, for the Euro to become a true alternative to the dollar will again be determined by return differentials as well as the strength, depth and efficiency as well as the range of instruments offered in European capital market. In particular this will depend on the creation of an interest rate and currency swaps market that is able to compete with the US. The experience in this respect is unimpressive with restricted interest rate swap activity and an extremely unbalanced dollar/Euro swap market.

The corollary of the increased Euro bond issuance is the competition between US and European investment banks in underwriting new issues. Given the dominance of Euro issuance since the beginning of the year the rise of European banks in the league tables is perhaps not surprising. However, the failure of the development of an active swaps market suggests that this will not be a permanently dominant position unless European banks are able to operate actively to use issuance as a source of activity in the swap markets.

This competition will also extend to equity markets. US equity markets, particularly the NYSE, have recently expanded their listings of international securities, primarily through ADRs. A larger, unified European securities market might bring European companies back as well as attracting more international listings, increasing the use of the Euro as an investment currency. However, the initial plans to merge the existing markets into a single market appears to have failed and Frankfurt and London appear to be discussing a merger to counter that between Paris, Belgium and the Netherlands equity markets.

#### **CAPITAL MARKET STRENGTH, DEPTH AND EFFICIENCY**

Thus, aside from market factors determining the relative return attractiveness of the EURO, the most crucial factor will be the strength, depth and efficiency of the unified European capital market and the range of financial instruments that it is able to provide to international investors. When comparing the size of financial markets between the US and the euro area Noyer notes that "the fact must be borne in mind that the structure of the financial system of the euro area differs from that in the United States. Thus, the stock market capitalisation of the euro area amounted to 63% of GDP at the end of 1998, far below the level prevailing in the United States at 155% of GDP. On the other hand, the higher level of domestic credit, 130% of GDP in the euro area, compared with 81% of GDP in the United States, indicates that bank financing is more important in the former economic area than in the latter"(cf. Noyer, BIS 131, p.2). This is also an impediment to the success of the EURO.

While the introduction of the EURO will unify the denomination of the financial assets traded in national markets, and thus eliminate currency risks associated with cross border transactions, it is not clear that it will do a great deal to break down this national segmentation in the medium term. This is basically because, as argued above, the logic of EMU has been based on an internal contradiction which attempts to combine the preservation of the institutional characteristics of national markets with convergence of macroeconomic performance. One of the characteristic practices of European financial markets is the dominance of universal banking, and thus a dominance of bank lending over capital market financing of business. Even where universal banking was not present, as in Italy, bank lending has dominated capital market financing. This has led to a non-governmental fixed income market that is only about a tenth of the size of the US market, despite the rough equivalence of government bond markets. The EU bond market is thus only about one-half the market value of the US.<sup>7</sup> Since the introduction of the EU banking directives, universal banking has become the general form of bank organisation, without bringing about radical changes in national financial market financing procedures.

The tendency for European banks to have lower returns on equity<sup>8</sup> than US banks is in part explained by this dependence on bank lending and the delays in financial innovation. Under the Basle risk-weighted capital requirements corporate lending is subject to a 100% weighting and the maximum 8% reserve requirement. The impact of capital standards on earnings has led to a process of regulatory arbitrage in the US, which has been much less pronounced in Europe. Thus the preponderance of universal banks and corporate borrowing intermediated by banks rather than through capital markets means that European universal banks will have a higher proportion of their assets subject to the full capital requirement weighting.

European banks have lagged behind US banks in increasing their fee and commission income<sup>9</sup> from intermediating between corporate borrowers and capital markets and decreasing their "on balance sheet" loan exposure without reducing their relationships to corporates as well as their regulatory capital. As European banks come under increasing pressure to reduce costs and increase returns there will be pressure to eliminate the negative influence of relationship banking on returns and an increase in regulatory arbitrage. On the side of cost reduction, continental banks have also been much slower in the process of concentration of the retail banking sector and the transformation of commercial banks into investment banks. It has generally been considered that the introduction of the Euro would accelerate this process.

As already mentioned, it is the segmented structure of national markets, produced by the preservation of national supervisory authorities that has caused most of this difficulty. For example, in the US, banks are currently reducing their capital costs and increasing their returns by means of a financing structure which allows them to increase their corporate loan origination and credit risk evaluation activities while reducing the size of their loan books and thus the size of their regulatory capital to a level that is more nearly equivalent to the economic capital associated with the economic risks of their balance sheet positions. Banks can do this by selling on as much as possible of a loan during the syndication process, or by using loan participations which leave the originating bank as the lender of record while transferring the capital requirement and interest rate risk on the loan to another bank. But this process is limited to single loan originations and depends on finding bank counterparties and is thus time consuming and costly.

An alternative method is to use credit derivatives in which the seller takes on the default risk of a loan under certain contractually specified conditions or credit events. Bank regulators are extremely hesitant to sanction derivatives for banks, and unless the hedge is written to specific loans they will not usually consider capital adequacy relief. This also makes this method costly and prevents the creation of an active, liquid market in credit risks.

The structure of the capital requirements, however, creates pressure for banks to reduce credit risks associated with their corporate lending, while it supports the extensions of lines of credit and backup credits; the Basle capital requirements on undrawn revolving credits with maturities of less than one year are zero. This means that returns on liquidity guarantees are much higher than those from bearing credit risks due to corporate loans. These liquidity guarantees are a crucial part of the process of passing credit risks to capital markets, first as guarantees for the issue of corporate commercial paper. They also serve in the process of securitisation of corporate loan books.

### **Bank Returns, Competition and Asset Securitisation**

The securitisation of their corporate loans allows banks to reduce their required regulatory capital by moving 100% weighted loans off balance sheets by selling them to capital market investors through special purpose vehicles as collateralised loan obligations (CLO). The securitisation of bank loans, long considered an impossibility, was given its original impetus in the resolution of the 1980s debt crisis when the syndicated loans to developing countries by commercial banks were turned into fixed income Brady bonds.

In a CLO a bank passes a pool of corporate loans to a special purpose vehicle that issues capital market securities against them. The bank usually contributes a guarantee in the form of a first loss reserve against a proportion of the default on the loans. The bank recovers 8% of the total less the first loss reserve which continues to carry a 100% risk weighting. The CLO provides an economic justification for regulatory arbitrage because it utilises the principle of the diversification of risk across individual loans and thus requires bank loan books of relatively large size. This means not only large banks, but also a wide dispersion of lending across geographical areas as well as across sectors of the economy. In the European context the issuance of CLOs by euro area banks would be facilitated by origination of loans across a wide range of European countries. However, the widely diverse national regulatory structures preserve the peculiarity of the loans originated by banks operating in different countries as well as the regulations applying to different banks originating CLO's under different country regulations. Full development of this market will thus depend on normalisation of loans, conditions and regulatory regimes, or else the development of the market will take place outside the EU. Although euro area banks have participated in the issue of CLOs they have usually been for their loans through foreign subsidiaries in currencies other than the euro (see box). It is interesting to note that Deutsche Bank, which is the largest European bank and one of the few European banks to use asset securitisation and the first German issuer of a CLO (the 4.2 b DM issue CORE-1) chose to issue its second leg (2.5 b E/ issue CORE-1b of corporate loans to middle market companies) only partially issued in Euro, with three of the nine tranches denominated in dollars.

Institutional differences will also affect the use of securitisation. The differences in operations already noted in the study by Borchert also will mean differential importance of securitisation for different types of banks. Clearly, CLOs offer an alternative to asset financing via the sale of assets out of bank portfolios (recall that OECD member government paper carries a zero reserve weight, as does lending of less than one year), would thus provide a larger

competitive advantage to these banks.

Thus loan securitisation will have a differential impact, not only across countries, but on the structure of banks within countries.

Finally, synthetic CLO structures currently being introduced into the market as much as funding sources as balance sheet reductions incorporate credit derivatives in place of bank first-loss provisions or other forms of credit enhancement. The bank may write the derivatives or they may be purchased by the special purpose vehicle. In order to allow EU banks to keep abreast of their global competitors, regulators will have to be very agile in adjusting their positions on these instruments. Even the German supervisory agency, which has been most receptive to facilitating securitization by moving forward with the required legislation (cf. Deutsche Bundesbank, 1997) still requires review of each structure, and appears to be overly concerned with maintaining a peculiarly German approach to the structure of the financial system. If each national regulator acts in the same way, in defence of a national model of financial structure and intermediation a unified capital market equivalent in strength, depth and efficiency to the US market will never emerge. If European banks cannot engage in the same financial engineering in euro within the EU as they can outside the EU in dollar markets the euro will never become a competing currency in capital market transactions which now dominate commercial transactions and the reserve role of currencies. Since it is the extent of financial engineering and the depth and breadth of US capital markets that has assured the dollar its international role despite the weakness of the US current account position, if the euro cannot play a similar role in European capital markets it will not rival the dollar, no matter how large its foreign surplus, or how low its deficits or how low its inflation rate.<sup>10</sup>

#### *Recent Synthetic CLO structures*

**BNP Synthetic** Olan Enterprises Plc E180m bonds E86.65m AAA +30bp 3m Euribor, 26.97m Aa2 +40bp and 38.42m Baa2 at +150bp and a 27.96m unrated first loss piece that BNP retains on bottom 11% layer of risk on E 1.635b of corporate credit exposure. Bond proceeds are invested in OATs, and Olan has engaged in a credit default swap with BNP. A second credit default swap transfers the bank's senior risk to an OECD bank. An official said that synthetic deals are trading around 5bp wider than true sale CLOs; 109 corporates with 80% publicly rated by Moody's or S&Ps which necessitated that 45% of the pool be US, Japan capped at 4%, and the rest from Canada, Australia, NZ.

**Citibank** Jul 1999 C\* Strategic Asset Redeployment Program 1999-1 Ltd E4b **Synthetic** 3 tranches of ten-year maturity (redeemed as 3 yr bullets) 100m AAA at Euribor +21bp, 28m A at + 48bp, 52m BB + 300bp backed by 172 loans to 159 borrowers pan-European corporate loans (38.5% UK, 10% Norway, 9% Finland, 8% Sweden, rest of EU excluding Greece). "Citibank placed 92% supersuperior tranche with OECD banks under a credit default swap, and used a separate swap to transfer the next 7% to the special purpose vehicle that issued the bonds. Proceeds are invested in bunds, and a premium from Citibank makes up the coupon. Citi absorbs the first \$40m of any loss. .. Citibank chose a synthetic structure, even though on pure costs terms a commercial paper transaction might have been marginally cheaper, partly to avoid the legal headache of selling assets from different jurisdictions, and partly because 57% of the pool is unfunded portions of the revolving facilities. Hedging those on balance sheet is simpler than funding them, and despite their 50% risk weighting they still absorb a lot of capital relative to their yield.

**JPM Sequils-Mincs Synthetic** Apr 1999 \$826.46 bonds conveying exposure to \$712.46m portfolio of leveraged loans: Where traditional cash flow CLOs tranche the portfolio risk into several rated tranches and an unrated equity portion, Sequils Mincs achieves the alchemy of fully funding loans rates double-B and single-B with securities rated double-A and triple-B. The Sequils vehicle issues double-A notes to the full value of the loan portfolio, gaining its rating on the strength of a 16% credit wrap from JPM, structured as a credit default swap. Separately, the Mincs vehicle issues bonds worth 16% of the pool, invests the proceeds in triple-A rated securities, and writes the matching credit protection for JPM. Key to the structure is excess spread - the risk yield on the loans is transferred from Sequils through JPM to Mincs. That extra cash contributes to raising the rating of Mincs' risk exposure to the loans to triple-B - it is used to pay, in descending order of seniority, amounts due under Mincs' credit default swap with JPM, a variable yield to Mincs investors, and the fixed fee to the portfolio manager. It has no unrated tranche.

**Deutsche Blue Stripe** June 1999-1 **Synthetic** similar to JPM Bistro of Dec 1997 laid off



the most senior \$4.25b tranche of risk on the portfolio of \$5b loans to US, UK, Canada originated by Dbs global services division to at least one OECD bank through a credit default swap, achieving a 20% risk weighting for 85% of the portfolio without having to pay a coupon. A second credit default swap shifts the junior layer of risk to Blue Stripe which issues \$750m of bonds in 10 tranches rated. Proceeds will be invested in Pfandbriefe and the final maturity will be March 15, 2005 with expected maturity in June 15 200; the deal references 330 loans to 240 companies with an internal DB rating of B+ (BBB).

**JPM Bistrot Trust Dec 1997 -Sept 1998-1-4 Synthetic** securitisation structure has been very effective at meeting the bank's needs for capital relief without the funding cost of issuing bonds, it is most appropriate for high grade credit exposures, especially off balance sheet positions taken through derivatives or unfunded commitments.

#### *Recent European Structures*

**Banco Bilbao Vizcaya Argentaria** E1.113b Feb 2000 Fondo de Titulizacion de Activos BBVA-I back by 53 loans to 49 companies with 87% of assets in Spain, the rest in Germany, Portugal, Sweden, Denmark and Czech Rep. E928.4m AAA notes 3.7 ave life paying 3m Euribor + 30bp

with AA, A, BBB and BB tranches, expires by clean up in Nov. 2006.

**BCI** E170m Nov 1999 bond backed by E4b of 179 corporate loans to rated borrowers from its New York, London and Frankfurt branches (70%US, 14%UK rest European)

**Scala I Ltd** E44m AAA notes at 3m Euribor +30bp E62mAA at 45bp and E40m A at 60bp, E24mBBB at 125bp

**Industrial Bank of Japan** Italian sub Security Portfolio of Quality Receivables Funding SPQR Ltd.(UK registered) Italian bank and local authority loans and bonds E263m; March 1999 1<sup>st</sup> Italian issuer with MPS and IMI E 214.1 m AAA +20bp, E 42.9m BBB +60-65bp

**Paribas Liberté**

**Credit Lyonnais Leaf Master Trust**

**Bayerische Hypoteken und Vereinsbank** Geldilux 99-1 Feb 1999 E2.22b backed by loans to high quality clients of the Luxembourg branch, reissue Geldilux 99-2 Sept 1999

**Société Generale** Feb 1999 Polaris Commercial Loan Master Trust 1999-1 \$1,0536 b 3 yr A1 +22 bp 3m Libor A2 5yr \$702.4m +30bp

**UBS** Oct 1998 Eisberg

**Deutsche** July 1998 CORE 1998-1 5,100 loans to German corporates DM 3.19b and \$601m of bonds.

**Dresdner Silver Tower** 125 May 13 1998 DM 2b First German combined short and long term funding, unsecured loans to 800 German corporates of 70 day ave

**Credit Suisse FB** Mar 1998 Project Funding Corp I, 41 amortizing project finance loans to independent power producers in US

#### *Other Structures*

**JPM 23 Wall Street Commercial Loan Trust** Feb 1999 - the deal will introduce a new structure to public ABS markets—the variable funding note. Banks wanting to securitise their corporate loans faced the obstacle that much of their portfolio is in the form of revolving credits which a difficult to securitise with conventional bonds. 23 Wall will issue AAA 3 yr securities under which investors will make commitments that can be drawn upon, paid back and redrawn depending on the volume of drawing on the underlying portfolio of credit facilities. In effect, each investor will extend a revolving loan to the structure,

receiving a commitment fee for the undrawn portion and a spread over libor for the drawn part. The coupon will be set in the high 30s or 40bp over Libor.

**Bank Boston** Commercial Loan Funding LLC Nov 1998-1, +28 bp 3m Libor, \$1b in six tranches

reissued as Master Trust +30bp 3m Libor another \$2.18 b.

"A great majority of public bank balance sheet CLOs backed by US corporate loans have been executed by banks with European, Japanese or Canadian parentage. Nations Bank's \$4bn transaction, still regarded as the market standard, is now two years old, and BankBoston is the only major bank to have issued a classic true sale CLO since then. Bank Boston is unusual in professing that it uses corporate loan securitisation primarily as a funding source, rather than a capital management tool: "Our commercial lending business is growing, and securitisation is a logical way for us to diversify our funding, just like other big banks do with their consumer assets," said a BB official.

## EUROPEAN MONETARY UNIFICATION AND THE EXAMPLE OF THE UNITED STATES

The monetary unification of the United States is often used as an example that has been followed by the EU. But, there are substantial differences. After the revolution the colonies faced substantial problems of impediments to free trade and the issue of a common currency. One of the biggest problems facing the young nation was the disposition of the war debts that were left over from monetary issues of the individual colonies. The US Constitution thus reserved to the Federal government the issue of money. The US did not create a central bank until the beginning of the century. Even after the signing of the Constitution individual states attempted to impose various tariffs, taxes and other impediments to the free passage of goods and services between states. The problem was eventually resolved by the Interstate Commerce Act which brought regulation of all economic activity across state borders under the control of the Federal government.

The European Council in Cologne and the European Parliament have supported both the content and urgency of the Action Plan for Financial Services. The Action Plan details the work that has to be accomplished to reap the full benefits of the Euro and to ensure the continued stability and competitiveness of EU financial markets. The Council invited the commission to report on a regular basis on the progress made and to present its first report before the end of 1999. This first report to the Council and to the European Parliament tracks progress over the first six months (until 10 October) since the adoption of the Action Plan. In view of the short period since the adoption of the Action plan this report focuses in particular on the legislative process that has been made.

### *Mechanisms & Process*

The mechanisms for implementing the Action Plan are critical to its achievement. Over the past six months, and in line with the suggestions in the Action Plan, the Commission has put in place the following structures.

*The Financial Services Policy Group (FSPG)* , comprising personal representatives of economic and finance ministers, has resumed its tasks as a forum to forge consensus between national ministries involved in financial services regulation. The FSPG has met twice since the adoption of the action plan and has assisted the Commission in monitoring progress and preparing this report. Initial informal discussions have taken place with representatives of the European Parliament with a view to finding arrangements to discuss major policy orientations with parliamentarians at an early stage.

EU representative bodies have submitted short lists of experts to help the Commission assess certain implications of technical issues raised in the Action Plan. These 'Forum Groups' of market experts, are initially considering: issues related to market manipulation; updating the Investment Services Directive; collateral, consumer information requirements for retail financial services; and differences in national legislation that hinder the cross border marketing of financial services. Further groups may be set up in the future.

Some progress has been made on implementing the Action Plan...

The challenge set by the Action Plan for all of the Union's institutions is considerable. It will demand intense and sustained activity if we are to achieve the fierce time scale demanded by the rapidly changing financial services sectors. The first months have seen welcome progress. Already the Commission has issued its Communication on Pension Funds and is actively preparing a draft directive. It has also adopted a proposal for a directive to amend the Money Laundering Directive. With regard to wholesale markets work is well under way within the Forum of European Securities Commissions (FESCO) and the Accounting Contact Committee to meet the time frame set out in the Action Plan. The Commission also recently adopted its Communication on the implementation of the Risk Capital Action Plan. The Commission will increase its efforts in the field of accounting policy and will present proposals to enhance regulatory cooperation between securities supervisors. Progress to achieve open and secure retail markets is also satisfactory. Discussions in the Council and the European Parliament on the distance selling proposal for financial services are continuing. The preparation of a legislative proposal for insurance intermediaries is on track as is the work on a number of Communications (consumer information, insurance) and a Green Paper on ECommerce and financial services. Work on prudential rules has also advanced. The proposal for a Money Directive is advancing through Council and European Parliament. The review of bank capital rules in parallel with G-10 Basel Committee on Banking Supervision, the insurance solvency requirements, and the supervision of financial conglomerates are on schedule. The adoption of a Commission Recommendation on the disclosure of financial instruments is imminent. Finally, work on wider conditions for a single market are continuing with a view to direct taxation. Council deliberations on the Commission proposal on a minimum taxation of saving income are continuing at full speed and it is hoped that a political agreement can be reached before the end of the year. The same holds, mutatis mutandis, for the work of the Council group working on the implementation of the Code of Conduct on business taxation. After the first fruitful discussions, inter alia in the Taxation Policy group, work on the taxation of supplementary pensions and financial services in general will continue as a priority in 2000. A Commission proposal for supplementary pensions is already under preparation. (E.U. 2000)

There are thus substantial differences with respect to the European EMU which grants the control of issue of the currency not to a Federal government, which does not exist, but to a monetary authority which is not only without political legitimacy, but also legally independent of any political control. Second, the principle of mutual recognition of home country regulation is diametrically opposed to the US system by which a Federal government agency is responsible for imposing common regulations on all commerce that takes place between states. These are major differences which suggest that there is little similarity between the European approach to monetary union and that experienced in the US. The EU seems finally to have recognized that reaping the full benefits of the single currency will require a fully integrated European capital market and that this will require harmonization of regulations across the EU. The European Council which met in Cologne this past year thus endorsed an Action Plan for Financial Services which seeks to introduce rapid harmonisation of financial regulations across the EU (see box) as well as to increase the market for risk capital (cf. EU, 1999). Whether these efforts to harmonise conditions in European capital markets are more successful than the attempts of the European Commission to tell Germans how to brew beer will in the end determine the fate of the Euro and with it the fate of European banks in the global market place.

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## Notes

1 In 1957 none of the member countries had yet satisfied Article IV, section 4 of the Bretton Woods treaty.

2 In fact the snake had its origin in the European Monetary Agreement which replaced the European Payments Union in 1958 and set fluctuation relative to the dollar at plus or minus 0.75%.

3 The argument in favour of reducing fluctuation bands was based on the fact that a fixed band relative to the dollar produced a band of European cross rates which was twice as large. By stabilising relative to the dollar European central banks were thus making the dollar less variable and thus more attractive to hold than their own currencies as a means of payment and in reserves. The reduction of intervention margins relative to the dollar to 0.6% was agreed in March 1971, before the declaration of dollar inconvertibility.

4 This policy was successful beyond all expectation. The average rate of inflation for the European Union in the period 1975-84 was over 10%. For the period from 1984 to 1993, when the Single Market was due to take effect, it had fallen by more than half to 4.5%. The rate of price increase for the EU is now approaching zero. However, the real rates of output growth, which averaged 3.2% during the dismal inflation decade of the 1970s, fell to an average of 2.25% for the decade of the 1980s, and in the first eight years of the current decade have collapsed to 1.8%. With stable prices Europe has grown only about half as fast as during the period of higher inflation.

The average unemployment rate for the period 1970-79 was barely over 4%; for 1980-89 it was just under 9%; while

for the current decade it has only dropped below 10% in 1998 (although it is still above 10% for those countries that have adopted the Euro). Employment, which had grown by only an annual average of 0.4% in the period 1979-89, has fallen to only 0.15% per year in the present decade to 1996. This is not really surprising, given the fall in the average rate of gdp growth in the face of high rates of productivity growth. But, even the rate of productivity growth has been declining, from an annual average rate of 5.8% in the period 1979-88 to 4.2% in 1990-1996.

5 Note that this is the correct specification of EMU, rather than the often used, but erroneous, European Monetary Union.

6 Unfortunately, this also meant that such sensible measures, such as standardised electrical outlets (introduced in the US by Herbert Hoover while Secretary of Commerce) have been impossible to achieve. While the computer industry manages to introduce common standards for data transmission protocol, it is impossible to introduce common electrical or data transmission plugs.

7 The outstanding long-term euro issues at end 1999 were 5,488.1 billion euro, 184.3 billion were non-monetary financial corporations, 206 billion by non-financial corporations, and 3097.5 billion euro by governments. US public debt at end 1999 was \$5776.1 billion, the figure held by the public was \$3715.5 billion. The Bond Market Association Research Quarterly (Feb. 2000) gives \$3000 billion as the size of the US corporate debt securities market.

8 Although the evidence here is not that clear cut. The ECB (April, 2000, Table 18) reports return on equity of 8.45% and 12.45% for the weighted euro area and weighted EU in 1995 and 2.67 and 2.95 for return on assets respectively (on a non-consolidated basis) while the equivalent figures reported by the Federal Reserve (1999, Table A.2) for the US are 14.7% for roe and 1.2 for roa for the same year for all banks. For the top ten US banks roe of 13.8 and roa of 0.9 while the next 90 banks ranked by assets show 16.8% and 1.3%. For 1998 the figures are 15.8% and 17.4% for euro area and EU roe (op.cit. Table 23) and 0.69 and 0.78 for roa. However, these figures represent a substantial increase of about 4 percentage points in roe for 1998 over 1997. For the US in 1998 the figures are 14.08% and 1.20% for all banks, 10.53% and 0.78 for the top ten and 17.42% and 1.46% for the next 90 banks. Berger, DeYoung, Genay, and Udell, review comparative international data, and estimating cross-border banking efficiency in France, Germany, Spain, the U.K., and the U.S. during the 1990s and find that on average domestic banks have higher profit efficiency than foreign banks. However, banks from the U.S. appear to operate with relatively high efficiency both at home and abroad.

9 Non-interest income as a share of assets has risen from around 0.8% and 0.92% for the euro and EU area respectively in 1995 to around 1.1 for both areas in 1998, while the ratio of net interest income to assets has fallen from 2.0% to around 1.5% for both areas (EU, Chart 4, Chart 5). For the US the figures for all banks for non-interest income 2.02% to 2.4% and a fall in net interest income from 3.72% to 3.52%. The top ten banks show a rise in non-interest income from 2.68% to 2.73% while net interest income was relatively stable at 2.16% and 2.15% for 1995 and 1998. For the next 90 banks non-interest income rose from 1.84% of assets to 2.25%, while net interest income fell slightly from 4.23% to 4.19% (Federal Reserve, Table A.2).

10 However, it should be noted that if the US surplus continues to increase as forecast, the outstanding US government securities will eventually shrink to the point that the depth and efficiency of the market is eliminated. Already the 30 year US Treasury bond is being replaced by the 10-year issue for this reason. The question then becomes whether foreign holders will be willing to hold US corporate bonds as a substitute for the risk-free Treasuries. However, should Europe succeed in producing surpluses as well, it will never build a government securities market.