



The financial consequences of Mr Draghi?

Infrastructural power and the rise of market-based (central) banking

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Abstract

To explain when and how finance wins, political economists have studied the financial sector's instrumental power to lobby policymakers and the structural power that results from its central position in the economy. Focusing on the rise and resilience of market-based banking in the euro area, this paper develops the concept of infrastructural power as a third, complementary variant. Theoretically, the argument is based on the observation that state actors, in addition to acting on markets, also act *in* markets. Central banking is the clearest manifestation of such market-based state agency. To the extent that the central bank depends on financial markets to implement and transmit its monetary policy, financial market actors enjoy infrastructural power. The paper analyses the origins and manifestations of this infrastructural power by tracing the alliances the European Central Bank has formed with the two key pillars of market-based banking, the repo and the securitisation markets. This infrastructural entanglement between market-based banking and market-based central banking has been both an enabling condition and a key driver for the Capital Markets Union project.

Key words: Financial markets, financialization, governance, institutional change, power, regulation

JEL classification: E58 central banks and their policies, G23 non-bank financial institutions, G28 government policy and regulation

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Why did he do such a silly thing?

(J. M. Keynes, The economic consequences of Mr. Churchill, 1925 [1963])

Although we work through financial markets, our goal is to help Main Street, not Wall Street.

(J. Yellen in her first speech as Chairwoman of the Federal Reserve, 2014)

1. Introduction

Over the past four decades, the economic and political power of the financial sector have greatly expanded, transforming the political economy of capitalism. Students of this development have increasingly focused on the *marketisation* of financial intermediation as the hallmark of financialisation (Davis and Kim, 2015; Godechot, 2015).¹ At the heart of this process lies the rise of a form of banking that has variously been described as ‘securitized banking’, ‘shadow banking’ or, especially in the European context, ‘market-based banking’ (Gorton and Metrick, 2012; Hardie et al. 2013a; Mehrling et al. 2013). This business model is based on securitised, capital-market lending financed by short-term, repo-market funding. It has been a boon for banks and bankers, who benefitted from greater fee-based income, bigger balance sheets, and higher leverage ratios (Fligstein and Goldstein, 2014; Godechot, 2015). At the same time, market-based banking is widely considered the chief culprit of the financial crisis of 2008-09, which occurred when, following defaults in US subprime mortgage securitisations, the interbank money market froze (Gorton and Metrick, 2012). Crucially, however, the crisis did not spell the end of market-based banking. In fact, the contrary has been the case in Europe, where plans for a tax on repo transactions were quietly shelved while securitisation, after a brief period of stigmatisation, has become a key pillar of the European Commission’s drive for a more market-based financial system under its Capital Markets Union plan (European Commission, 2015; Gabor 2016). Both the initial rise of market-based banking and its subsequent resilience raise the question of financial sector power. How did finance get its way?

The political economy literature has emphasised two forms of political power wielded by the financial sector – *instrumental power*, which mostly takes the form of lobbying, and *structural power*, which derives from the financial sector’s pivotal position in financialized economies (Culpepper and Reinke, 2014; Woll, 2016; Pagliari and Young, 2016). These approaches have been highly successful in explaining a number of policy outcomes. However, their implicit ‘regulatory capitalism’ conception of state-economy interactions, which focuses on ‘regulation and governance through rule making and rule enforcement’ (Levi-Faur, 2005: 17), has obscured what I shall call ‘market-based state agency’. This type of economic state agency comes to the fore in particular at the centre of the monetary and financial system, where state and market actors form an ‘essentially hybrid’ public-private

¹ For further overviews on the topic of financialisation, see van der Zwan (2014) and the special issue in *Socio-Economic Review*, edited by Kornrich and Hicks (2015).



partnership (Ingham, 2004; Mehrling, 2013; Pistor, 2013). Here, state actors routinely ‘exercise statecraft through market-based channels’ (Lagna, 2016: 171), acting not just as *regulators of* but also as *participants in* financial markets (Hockett and Omarova, 2014).

This paper uses the concept of market-based state agency to shed new light on the rise and (puzzling) revival of market-based banking in the euro area. It argues that the market-based nature of central bank agency has given the European Central Bank (ECB) a strong stake in market-based banking. From this perspective, the power that ‘captured’ the ECB was neither instrumental nor structural, but *infrastructural*. Financial markets provide the infrastructure through which monetary policymakers hope to affect macroeconomic outcomes, creating a strategic alliance between market-based banking and central banking. The argument that financial markets can ‘function as vehicles of state power’ is not new (Konings, 2011: 3; c.f. Krippner, 2007; Knafo, 2013). However, the political leverage financial market actors enjoy as a result of the state’s dependence on financial infrastructures has not been systematically studied (Jacobs and King, 2016).

This paper adds an important piece to the puzzle of how finance wins by opening the black box of central banking to show how the ECB’s activities to establish and maintain monetary governability augment the infrastructural power of the protagonists of market-based banking. It explains why the ECB has gone out of its way to foster innovation and growth in the repo market and, following the financial crisis, to rescue, re-build, and champion securitisation, thus becoming the driving force behind the political resuscitation of this financial technology. In doing so, the paper also makes an original contribution to the broader debate about the puzzling post-crisis resilience of market-based banking in particular, and the resilience of financialised, neoliberal capitalism in general (Schmidt and Thatcher, 2013; Crespy and Ravinet, 2014). Relatedly, the notion of infrastructural power opens up an alternative perspective on the ‘financial dominance’ argument, according to which the constraints imposed by the structure of financial markets have replaced the constraints imposed by the government’s fiscal policy (‘fiscal dominance’) as the main threat to central bank independence (Schelkle and Mabbett, forthcoming). Whereas economists have framed the issue in terms of central banks’ new financial stability mandates dominating monetary policy (Hellwig, 2014; Smets, 2014), the present analysis highlights the threat to central bank independence from the dependence of monetary policy on financial market infrastructures. Finally, the paper presents new empirical material on the ECB’s involvement in financial markets, especially with regard to post-crisis developments in the securitisation market. This evidence is drawn from the full range of official ECB documentation, including research reports, speeches, public consultations, etc. In addition, the paper draws on 13 interviews with ECB staff and securitisation market participants, conducted between March 2013 and July 2015 in Frankfurt and London (see Appendix 1).

The paper proceeds as follows. The next section opens with a brief account of the nature and significance of market-based banking in the euro area, explains why existing concepts of financial sector power are insufficient to explain its rise, and introduces infrastructural power as a third, complementary approach. Section three describes the notion of central banking that underpins this analysis, namely a concept of central bank agency as based on market transactions rather than on administrative authority. Section four focuses on the contribution of the ECB to the marketisation of bank funding by looking at the repo market, which is at the heart of monetary policy



implementation. The securitisation of bank lending is covered in section five, which traces the ECB's efforts to re-design and revive the ABS market – an effort related to both the implementation and the transmission of monetary policy. Section five concludes with an outlook on the growing role in economic governance for market-based state agency.

2. The rise of market-based banking and the political power of finance

The period since the Maastricht Treaty of 1992 has coincided with the transformation of continental Europe's traditionally bank-based financial landscape into a system based more on arms-length market transactions. This has been true both for the capital investment chain and for the credit intermediation chain (Deeg, 2009; Hardie *et al.*, 2013a, b). Regarding the latter, European banks have traditionally engaged in relationship-based lending financed by customer deposits. Profit accrued from the interest rate margin between long-term loans on the asset side and short-term deposits on the liability side of banks' balance sheets. While banks continue to play a central role in European credit intermediation, their business model has changed, especially since the introduction of the euro in 1999. The hallmark of the new model is the marketisation of both sides of a bank's balance sheet. On the asset side, banks securitise loans into asset-backed securities that they sell to investors. On the liability side, banks complement deposit-financing by collateralised borrowing in the money market.

Political economists should care about market-based banking for three main reasons – financial stability, corporate finance, and inequality. The collapse of Lehman Brothers and the ensuing global banking crisis were triggered by a combination of losses on securitised loans on the asset side and the evaporation of short-term money-market funding on the liability side of banks' balance sheets, the so-called 'run on repo' (Brunnermeier, 2009; Gorton and Metrick, 2012). Much of this funding came from global European banks via the shadow banking system, the regulation of that system has ranked highly on the agenda of financial policymakers (Bakk-Simon *et al.*, 2011; Adrian and Ashcraft, 2012). Second, relationship-based banking has been praised for shielding borrowers from the vagaries of international capital markets, thereby providing a source of patient capital that allowed firms to pursue long-term strategies (Zysman, 1983; Hall and Soskice, 2001). This buffer function of banks is strongly diminished with market-based banking, under which borrowing conditions for firms and households depend much more directly on capital market developments (Hardie *et al.*, 2013a). Third, financialisation – defined in terms of the size or reach of the financial sector – has been identified as an important contributor to growing inequality (Kus, 2013; Flaherty, 2015). Yet finance has not only grown but also has *changed* – Olivier Godechot (2015) has singled out the marketisation-aspect of financialisation as the most important contributor to the growth in inequality in OECD countries between 1970 and 2011.

In light of this overriding importance of the phenomenon, how do political economists explain the rise of market-based banking? Those who have brought market-based banking onto the map of comparative political economy have rightly placed the business decisions of banks at the centre of their explanatory framework, emphasising 'the role of bankers themselves as an autonomous and primary driver of change' (Hardie *et al.*, 2013b: 10). However, explaining market-based banking as



emerging from the interplay between profit-seeking bankers and national regulators alone gives short shrift to the political support that is needed – especially at the EU level – to build and protect repo and securitisation markets (Gabor and Ban, 2016; Gabor, 2016a). The two dominant political economy explanations of how finance musters such political support highlight instrumental power and structural power, respectively. Conceptualising politics as ‘organised combat’ (Hacker and Pierson, 2011), the literature on *instrumental power* emphasises organised interests, lobbying, and ‘regulatory capture’ to explain how financial sector interests translate into favourable political outcomes (Baker, 2010). It shows that while the relative unity of financial sector interests means that finance often wins (Young and Pagliari, 2015; Pagliari and Young, 2016), civil society-based advocacy can sometimes carry the day (Kastner, 2016; Ziegler and Woolley, 2015). A second strand of research emphasises the dependence of the state on private investment to generate growth and employment, and the resulting *structural power* of business in general (Lindblom, 1977) and finance in particular (Bell and Hindmoor, 2014; Culpepper, 2015; Hopkin and Shaw, 2016; Woll, 2016). Although it does not require extensive organisation on the part of those who wield it, structural power can be ‘deployed deliberately, with strategic intent’, as was the case post-Lehman when banks used their structural power strategically to obtain favourable bailout conditions from governments (Culpepper and Reinke, 2014: 430; Woll, 2014).

Each of these two approaches explains important aspects of the rise of market-based banking prior to the 2008 financial crisis. Lobbying and regulatory capture shaped Basel II, which became a key driver of the securitisation boom, while governments championed financial innovation calculating that debt-fuelled housing booms would boost growth and employment. But there is a common blind spot to these approaches. They are based on the tacit assumption that state actors and market actors interact on the turf and according to the rules of *politics*. While acknowledging that it takes two to tango, they take it for granted that the dance takes place in the halls of power. From this perspective, governability is a question of *political transactions* between state actors and organised private interests, whereby lobbying, negotiation, and deliberation produce administrative or parliamentary decisions. Crucially, however, this perspective remains blind to those parts of the dance that take place on the turf and according to the rules of *markets*. This market-based form of state agency features particularly prominently at the hybrid centre of the financial system, where state actors routinely conduct *market transactions* with private-sector counterparties, buying and selling financial claims at market prices (Hockett and Omarova, 2014). Unlike market actors, state actors trade in these claims in pursuit not of private profit but of ‘public ends’ (Hockett and Omarova, 2014: 56).

Where financial statecraft is market-based, financial markets serve as the conduit for the exercise of government control over the economy. Governing through financial markets is to exert what Michael Mann has called ‘infrastructural power’, defined as the ‘capacity of the state to [...] penetrate civil society, and to implement logistically political decisions’ (Mann, 1984: 189). The expansion of infrastructural power strengthened bureaucratic-democratic states compared to their imperial and absolutist predecessors, which relied primarily on ‘despotic power’. Today, mutual interpenetration between the state and civil society is such that the organisational boundaries of the former are no longer clearly delimited (Mann, 1993: 61; cf. Konings, 2011: 5; Mayrl and Quinn, 2016). This makes infrastructural power ‘a two-way street’ that not only strengthens control *by* the state but also



allows for better control *of* the state by civil society actors (Mann, 1993: 59). Mann’s work is therefore compatible with a framework in which the flipside of infrastructural *state* power is the infrastructural power of those civil society actors that provide the conduits for state agency. In the present context, these are *financial* actors. In advanced capitalist economies, the key agents of financial statecraft tend to be treasuries – where sovereign debt management has become increasingly marketised (Hardie, 2012; Trampusch, 2015; Lagna, 2016; Livne and Yonay, 2016) – and central banks.²

3. Taking central banking seriously: Governing through financial markets

Political scientists studying the steering capacity of states in advanced capitalist economies have long emphasised the active role of the state in constructing governability (Mayntz, 1993). In neo-corporatist societies in particular, states nourished organised private associations in order to facilitate coordination and the projection of infrastructural power (Streeck and Schmitter, 1985). In the area of monetary policy, central banks such as the Bundesbank actually fostered strong trade unions (Hall and Franzese, 1998) and relationship-based banking systems (Rajan and Zingales, 2003: 38) – counterparties it could coordinate with not only through market but also through political transactions. Given this post-1970s association of the strong state with neo-corporatist arrangements it is hardly surprising that the governability literature never seriously considered market-based forms of state agency. However, doing so is crucial to understand why, departing from Bundesbank tradition, the ECB actively nourished market-based banking.

The ECB embraced market-based banking because the implementation and transmission of its monetary policy came to depend on its ability to *trade* in repo and securitisation markets. To study infrastructural power therefore means taking central *banking* seriously. This contrasts with the focus in political economy – including in the specialist literature on the ECB – on political transactions between central banks, governments, and organised interests (Hancké, 2013; Henning, 2015; Lombardi and Moschella, 2016). This literature has largely bracketed the question of *how* the central bank establishes and maintains control over the economy. Research on expectation management has been somewhat more attuned to this question (Holmes, 2014; Nelson and Katzenstein, 2014; Braun, 2015a), but its fixation on communication has rightly been criticised for ‘rendering the practices of central banking analytically invisible’ (Gabor and Jessop, 2015: 295). A small number of authors, however, have addressed the market-based nature of central banking. Samuel Knafo has traced the historical origins of this ‘new form of state power’ to the emergence of the gold standard in 19th century Britain (Knafo, 2013: 5). Crucially, the new governance technology that was central banking, although operating through financial markets, ‘contributed to an extension of state power over finance’ (Knafo, 2013: 5). Greta Krippner has reached a similar conclusion in her work on the

² Another major manifestation of market-based state agency is through the purchase of equity stakes in publicly listed companies by development banks, sovereign wealth funds, and other government agencies (Musacchio and Lazzarini, 2014; Wang 2015) Wang’s (2015: 604) observation that in ‘liberal and developed economies’ historical context and economic conditions have prevented states from becoming ‘weighty financial actors’ seems overly cautious in light of the present paper.



evolution of US monetary policy during the 1990s, which ‘involved a shift of policy implementation to markets, but *not* a retreat from the state’s role in managing the economy’ (Krippner, 2007: 478). Focusing on the euro area, Gabor and Ban (2016: 627) have shown that, compared to its national predecessors, the ECB adopted a much more market-based way of implementing monetary policy that involved mark-to-market techniques, margin calls, and haircuts.

At a fundamental level, central bank agency is market-based because central bank control over macroeconomic conditions depends on the successful implementation and transmission of monetary policy. The challenge of *implementation* arises from the fact that the operational target of monetary policy – usually the over-night interbank interest rate – is a market price.³ In order to bring or to keep this market rate in line with the policy rate, the ECB has three instruments at its disposal – reserve requirements, standing facilities and, crucially, open market operations. The challenge of *transmission* arises from the gap between this short-term interest rate and the rates of employment, growth, and inflation, which constitute the ultimate targets of monetary policy. Transmission, then, is about making policy rate signals have real effects on aggregate economic activity.

This has profound consequences for central bank agency. On the one hand, a central bank is a government body that holds and exerts administrative authority – it is the *central* bank. On the other hand, it is a central *bank* that trades in financial claims with other (commercial) banks. This essential hybridity distinguishes central banks from virtually all other branches of state power, which are based on the ‘administrative authority’ of ‘setting, interpreting and applying statutory rules’ (Hellwig, 2014: 5). By contrast – and with the important exception of minimum reserve requirements – central bank agency is based on ‘transactions on a *quid-pro-quo* basis, such as taking deposits from banks, granting loans to banks, or buying and selling assets in open markets’ (Hellwig, 2014: 5-6, original emphasis). Monetary governability, in other words, rests not so much on administrative authority, but on market transactions into which private actors enter at their own discretion. Central bank control over macroeconomic conditions therefore depends directly ‘on the structure of financial markets and on the economic characteristics of market participants’ (ECB, 2000a: 47).

In its quest to establish governable money and capital market structures, the ECB has acted as a catalyst for innovation in the two key markets that underpin market-based borrowing and market-based lending by banks. The following section shows this for the repo market, with a focus on the pre-crisis period. Section five reconstructs the ECB’s post-2008 involvement in the securitisation market.

4. The ECB and the marketisation of bank funding: The repo market

The ECB implements its monetary policy stance by injecting that amount of reserves into the interbank money market that will bring the overnight interest rate – specifically, the *Euro OverNight*

³ Even monetary economists have long neglected monetary policy implementation (Schumpeter 1954: 1078). Surveying half a century of research on the topic, Friedman and Kuttner found that ‘[o]ddly, very little of this research addresses what central banks actually *do*’ (2011: 1346, original emphasis).



Index Average (EONIA) – in line with the ECB’s main refinancing rate. The way in which the ECB ‘injects’ these reserves is by lending to banks against collateral. As the monopoly supplier of reserves and the largest market participant, the ECB wields considerable influence over the structure of the euro area money market. Hence the importance of the decision by the European Monetary Institute that the ECB would – in deviation from previous Bundesbank practice – conduct its refinancing operations in the form of (reverse) repurchase agreements (Gabor, 2016b: 10-12). A sale and repurchase agreement, or repo, consists of an exchange of cash for securities between two parties. The cash borrower (or ‘repo seller’) agrees to repurchase the securities from the cash lender (or ‘repo buyer’) at a specified date in the future. Interest is paid by the cash borrower in the form of a mark-up on the repurchase price, the repo rate. Repo thus constitutes a form of secured interbank lending, as opposed to the unsecured interbank market. Repo markets are at the heart of the global shadow banking system, where they bring together two categories of financial institutions (Financial Stability Board, 2012; Gorton and Metrick, 2012; Pozsar, 2014). Demand for securities comes mostly from non-bank institutions such as money market funds or institutional investors, who seek safe and liquid, money-like instruments. Demand for cash comes mostly from banks that use the repo market as a source of short-term funding. During the 2000s, this source became increasingly important for the European banking system, which ran a growing ‘funding gap’ as lending exceeded customer deposits (Hardie *et al.*, 2013a: 715). In 2008, there were more than EUR 6 trillion of repos outstanding in the euro area, with 64 per cent of this activity concentrated at the ten largest banks alone (Hördahl and King, 2008: 39-40; Bakk-Simon *et al.*, 2011: 17; Financial Stability Board, 2012: 35). The repo market has attracted academic and regulatory attention for two main reasons – the risk associated with the maturity-transforming nature of short-term lending against long-term collateral (Gorton and Metrick, 2012), and the bank-sovereign nexus created by the market’s reliance on government bonds as collateral (Gabor and Ban, 2016; Gabor, 2016a).

As the ECB began its operations, several high-level repo market studies identified the transnational integration of the interbank market as a crucial prerequisite for the single monetary policy. Most importantly, the Giovannini Group, which reported to the European Commission, bemoaned that Europe still had ‘essentially 15 separate repo markets’ and argued that a ‘truly unified repo market’ would facilitate central bank control over interbank rates (Giovannini, 1999: 2, 8).⁴ A study commissioned by DG Economic and Financial Affairs also emphasised that it would be ‘in the interest of the central bank to have an efficient repo market’, which would enable ‘interest rate changes [to] feed through to the real economy more quickly and more evenly’ (Stadler and Lannoo, 2000: 12). Finally, a working group of leading central banks published its own survey of the interaction of monetary policy and repo markets in the G10 countries. The report emphasised central banks’ key role ‘in the promotion and development of repo markets’ and predicted a growing European repo market as a result of its centrality in the operational framework of the nascent Eurosystem (Bank for International Settlements, 1999: 14).

⁴ On the other hand, by providing a platform where investors could pledge fixed-income securities as collateral to obtain cash, a larger repo market would make government bonds more attractive to investors, thus increasing liquidity in this market – a desirable outcome from a government perspective (Giovannini, 1999: 8). Indeed, this argument was crucial to get member states to support the project of an integrated European repo market (Gabor and Ban, 2016).



In spite of these reports, when the Eurosystem began its operations in January 1999 the market through which it intended to implement its monetary policy was a patchwork. Not only were there still 15 separate repo markets but in some countries, such as Ireland and Finland, ‘there was no money market’ at all – ‘this segment was missing, in the way we consider it today’ (CB Interview 2). In that situation, the ECB used its operational framework strategically to foster ‘unification and standardisation’ in the interbank money market (Santillan *et al.*, 2000: 7). Although all banks subject to the reserve requirement had access to the Eurosystem’s refinancing operations, only the larger ones – roughly 10 per cent, or 700 to 800 banks in mid-2000 – participated directly (ECB, 2000c: 42). The remaining 90 per cent of banks satisfied their liquidity needs in the interbank market, which acted as ‘a redistributor of central bank liquidity’ (Interview 3). The ‘home bias’ that initially characterised the German money market was quickly eliminated (Interview 4) and banks in countries with previous repo experience soon ‘acted as liquidity providers for the banks of other countries’ (Interview 2). Thus, by using the repo market as the conduit for its open market operations, the Eurosystem provoked ‘a significant increase in cross-border transactions in the euro money market’ (Santillan *et al.*, 2000: 12-13).

The Eurosystem also fostered market integration by acting as a standard setter. The two main types of repo contracts are special repos, with specific securities as collateral, and general collateral (GC) repos, in which any securities from a defined class of securities can serve as collateral.⁵ By paving the way for GC baskets consisting of euro-area government bonds, the ECB set an important standard in the repo market. Again, the ECB’s actions were motivated by considerations relating to monetary policy implementation. While the collateral framework did not discriminate between bonds issued by different national governments *de jure*, the haircuts it imposed on a mark-to-market basis depended on current market valuations (ECB, 2000b: 43). Realising that this *de-facto* discrimination stood in the way of further market integration, the ECB argued that integration ‘would benefit from the extension of a euro GC approach’ that would put all government bonds in the same collateral basket (ECB, 2002: 66, quoted in (Gabor and Ban, 2016: 626)). GC baskets for standardised repo contracts became market practice when the two leading central counterparty firms introduced them in 2005 (Eurex) and 2007 (LCH Clearnet), respectively (Gabor and Ban, 2016: 626).⁶ Since then, GC repos have seen rapid growth – between 2008 and 2013, the volume of outstanding Eurex GC repos rose from €22 billion to €165 billion (Bundesbank, 2013: 65).

What does the repo case teach us about infrastructural power and financial dominance? An important test case is provided by the financial transactions tax (FTT). It is instructive to remember that while the ‘European repo bargain’ (Gabor, 2016a: 932) was supported by both the ECB and the European Commission, the FTT, which would have covered repo transactions, was supported by the Commission but (successfully) opposed by the ECB. The Commission advocated the FTT on financial stability grounds, emphasising the potentially destabilising consequences of the excessive, pro-cyclical liquidity creation enabled by the repo market (Gabor, 2016a: 934-936). The ECB rejected

⁵ Whereas GC repos are generally cash-driven in that they satisfy the funding needs of the cash borrower, special repos are securities-driven and may, for instance, be part of short-selling strategies (Bakk-Simon *et al.*, 2011: 16).

⁶ Note that Eurex’s *GC Pooling* ® ECB Market and LCH Clearnet’s *RepoClear* €GC are designed to be compatible with the ECB’s collateral framework.



these arguments, insisting on the beneficial effects of liquidity for overall market efficiency. The ECB won and the FTT project was buried. While this outcome was certainly aided by the financial sector exercising *instrumental power* in the form of a concerted lobbying effort (Gabor, 2016a: 936-939), the reason why the interests of the ECB and of the repo lobby were aligned in the first place was *infrastructural power*, as the repo market had become the indispensable conduit for the implementation of monetary policy. Moreover, the observation that the Commission advocated a repo FTT on financial stability grounds while the ECB opposed it on the grounds of interbank market efficiency also poses a challenge to the concept of ‘financial dominance’ as defined by economists (Hellwig, 2014; Smets, 2014). If financial stability had been the ECB’s overriding concern, it should have joined the Commission in supporting the FTT. Instead, the concern for the efficiency of its governance infrastructure prevailed, turning the ECB into a staunch protector of the repo market against the FTT. As the following section will show, this pattern of central bank support for market-based banking, motivated by monetary governability considerations, is replicated in the case of securitisation.

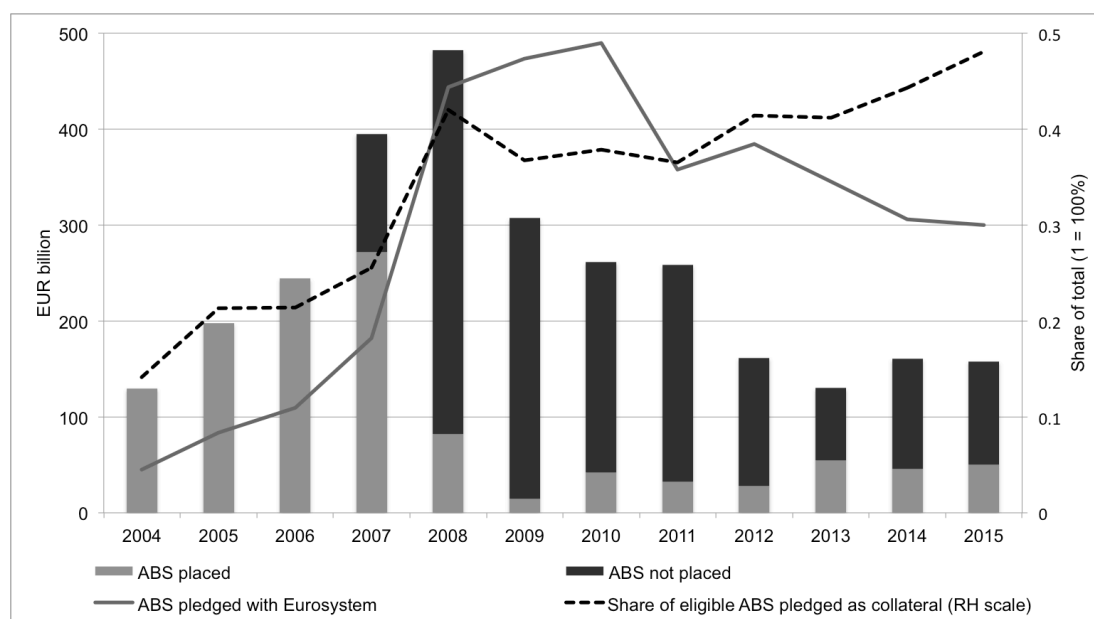
5. The ECB and the marketisation of bank lending: The securitisation market

Securitisation is the process of creating asset-backed securities (ABSs). An ABS is a security the value and interest payments of which are based on and collateralized by a pool of underlying loans – residential or commercial mortgages, as well as loans to firms and consumers. The creation of an ABS usually begins with a bank that originates loans, bundles them together, and sells them to a special purpose vehicle (SPV). The SPV is constructed as a legally separate entity, thus ensuring its bankruptcy remoteness in case of insolvency of the originating bank. The SPV finances the purchase of the loan pool by issuing and selling to investors (asset-backed) securities, sliced into tranches of different seniority (Gorton and Metrick, 2012: 430). As noted by Davis and Kim (2015: 208), securitisation ‘represents a fundamental shift in how finance is done’. There is widespread agreement that the collapse of the US market for subprime mortgage-backed securities caused the ‘run on repo’, which in turn triggered the 2008 banking crisis. Although the European securitisation industry never reached the scale of its US counterpart, it grew rapidly following the introduction of the euro, from €78.2 billion in 2000 to €453.7 billion in 2007 (Hardie *et al.*, 2013a: 712, numbers include the UK).

The Eurosystem’s collateral framework, designed to ensure that sufficient eligible collateral would be available to each national banking system, made ABSs eligible on the basis that the represented marketable debt instruments (ECB 2000b: 39). Especially when compared to other major central banks such as the Federal Reserve, which did not accept or purchase ABSs in their open market operations, the Eurosystem provided a positive impulse to the emerging securitisation market. For other things being equal, the added liquidity associated with access to central bank refinancing operations creates an ‘eligibility premium’ for financial assets, especially in periods of financial stress (Bindseil and Papadia, 2006: 20-24). However, the true foundation stone of the infrastructural alliance between the ECB and the securitisation market was laid only when, in the wake of the failure of Lehman Brothers, the ECB assumed the role of ‘dealer of last resort’ for ABSs. The remainder of this section will examine the two ECB initiatives that brought this alliance into being – the ABS loan-

level initiative, primarily related to monetary policy implementation; and the ABS purchase programme, primarily related to the transmission of monetary policy.

Figure 1. Issuance and use in Eurosystem refinancing operations of euro-denominated ABS, EUR billion.



Note: While the share of ABS not placed in 2004-07 was negligible, the exact data could not be obtained (ECB, 2013: 78).

Sources: European Securitisation Forum (data on ABS issued 2004-07); SIFMA (data on ABS issued, placed & retained, 2007-15); ECB (data on ABS eligible & ABS pledged as Eurosystem collateral); author's calculations.

5.1 Securitisation and ECB risk management: The ABS loan-level initiative

In 2007/08, banks went from placing virtually all the ABS they issued each year to retaining more than €500 billion (black columns in Figure 1). Crucially, however, these ABSs did not stay on the balance sheets of the banks. Instead, the banks used their ABSs as collateral to obtain reserves from the ECB, which at the time accepted ABSs down to a minimum credit rating of A-. As a result, the total value of ABSs pledged with the Eurosystem increased by a factor of five between 2006 and 2010 (solid line in Figure 1). When the banking crisis evolved into a sovereign debt crisis, the ECB reduced the rating threshold for certain types of ABSs in December 2011 and again in June 2012 (ECB, 2013: 74). While the total amount of ABSs pledged fell, the share of *eligible* ABSs that were used as collateral continued to increase, reaching 50 per cent in 2015 (dotted line in Figure 1). As the head of



the Risk Strategy Division of the ECB put it, '[a] vibrant market with many ABS buyers and sellers gave way to a situation in which the only absorber of new and old ABS was the ECB' (Gonzalez, 2014: 32).

The post-Lehman avalanche of ABS collateral was an 'eye opener' that alerted the ECB to the lack of transparency in European securitisation, especially regarding the quality and status of the underlying loans (Interview 5). While problematic from a regulatory perspective more generally, the immediate problem for the ECB was risk management. First, the ECB was unable to determine the value of the ABSs it had taken onto its balance sheet (Interview 5). The second concern was market liquidity – since counterparty defaults could have forced the ECB to take ownership of and subsequently to sell significant volumes of ABSs, it had a strong stake in the existence of a liquid market for these securities (Gonzalez, 2014: 32). These risk management considerations were at the bottom of the ECB's 'ABS loan-level initiative'.

The initiative was an unprecedented effort to get issuers of ABSs to provide and regularly update information on each underlying loan, and to create the IT infrastructure to make this data available to investors and, crucially, to the ECB.⁷ Notwithstanding the ECB's positive summary of the responses to its December 2009 public consultation (ECB, 2010: 1), ABS issuers strongly opposed the idea of a loan-level information requirement on the grounds of confidentiality and cost considerations (Interviews 6 & 7). However, this 'very strong pushback' (Interview 5) did not kill the initiative. Instead, the ECB put together six technical working groups, one for each ABS sector.⁸ The groups, consisting of an ECB chair and up to 15 securitisation market participants, devised templates that defined which information on the underlying loans ABS issuers would have to provide. The ECB phased in the reporting requirements for collateral-eligible ABSs between January 2013 and April 2014.⁹ At the heart of this new informational architecture stood the *European DataWarehouse* (ED). Established in 2012 as a private company in Frankfurt, the ED is owned by a shareholder consortium of 17 financial sector firms. The ECB and national central banks hold observer status on both the supervisory board and the pricing committee.¹⁰ According to the ECB's own version, it has merely acted as a 'catalyst' for the introduction of loan-by-loan reporting and the establishment of the necessary infrastructure (ECB, 2011a). However, no comparable set of standards would have emerged without the ECB taking the lead. The way in which the ECB overcame resistance from market participants was by incorporating loan-level data into its collateral eligibility criteria for ABSs. As one official put it, the ECB's position was to say 'We want to have loan-level data – if you don't

⁷ In principle, pre-crisis transparency was higher in the US securitisation market where loan-level data for non-agency mortgage-backed securities was collected and supplied by private firms (Ossa, 2012: 12). See also the example of the mortgage security CMLTI 2006-NC2, provided by the Financial Crisis Inquiry Commission (fcic.law.stanford.edu/resource/staff-data-projects/story-of-a-security).

⁸ The six sectors comprised: Residential mortgage-backed securities (RMBSs), commercial mortgage-backed securities (CMBSs), small and medium-sized enterprise (SME) loan securitisations, auto loan ABS, consumer finance ABS, and leasing ABS.

⁹ The European Securities and Markets Authority (ESMA, 2014: 180-181) embraced the ECB reporting templates as its preferred option to implement the reporting standards required by the Credit Rating Agencies Regulation (CRA III, 462/2013). The harmonisation of the regulatory use of loan-level reporting requirements has since continued to occupy regulators (ESMA *et al.*, 2015: 32).

¹⁰ Annual access fees vary across user types, ranging from zero (for institutional investors) over EUR 5,000 for international regulators (including the ECB) to EUR 100,000 for the largest rating agencies.



have the loan-level data you are out of the game’ – the game being the Eurosystem’s refinancing operations (Interview 5). This interpretation of events is confirmed by private-sector members of the ABS working groups (Interview 6), by industry reports (Ossa, 2012: 15), as well as by the data – in 2010, ABS accounted for 24% of the assets pledged in transactions with the Eurosystem, the largest share of any asset class (ECB, 2011c: 6).

The ABS loan-level initiative casts a spotlight on the importance of accounting for the market-based nature of central bank agency to understand how and why infrastructural power is a ‘two-way street’ that empowers the financial sector while also giving the state leverage over finance. Having their securities accepted as collateral in Eurosystem refinancing operations matters to issuing institutions. This put the ECB in a strong position, allowing it to implement a significant new reporting requirement against opposition from securitisation market actors. Yet the episode should not be mistaken for a defeat of the securitisation industry. This is because the loan-level initiative came on the back of a giant rescue programme for ABSs. The ECB had little choice but to put a floor under the market by allowing banks to unload their impaired ABSs holdings onto the Eurosystem balance sheet, lest it would undermine monetary policy *implementation*. To further bolster the argument that the loan-level initiative really constituted the nucleus of the infrastructural alliance between the ECB and the securitisation market, the next section will show how the latter became a solution also for the *transmission* of monetary policy.

5.2 Securitisation and monetary policy transmission: The ABS Purchase Programme

Securitisation became relevant for the transmission of monetary policy when ‘financial fragmentation’ across the euro area persisted even after Draghi’s ‘whatever it takes’ pledge had put a (tentative) end to the emergency phase of the crisis in July 2012 (Braun, 2015b: 434). The most vulnerable countries continued to experience high interest rates and weak bank lending, especially to small and medium enterprises (SMEs) (Al-Eyd and Berkmen, 2013). To the extent that this financial fragmentation hindered the transmission mechanism of monetary policy, it constituted a loss of monetary governability. In that situation, the ECB identified the securitisation market as one of the means to ‘repair monetary policy transmission’ (Draghi, 2012).

The transmission-securitisation nexus has two main angles – securitisation as a (market) refinancing and collateral-generation mechanism for banks, and ABS as a target for asset purchases by the central bank. As for market refinancing, the ECB argued that a liquid market for ABSs would offer a way for weak banks to free up their balance sheets by securitising and selling off loans to foreign investors, with beneficial effects for monetary policy transmission (Mersch, 2014). The other way in which securitisation was used for refinancing was as collateral in the refinancing operations of the Eurosystem. Securitisation could serve the purpose of transforming loans – which in principle were not eligible (ECB, 2012) – into tradable assets that could serve as Eurosystem collateral. As described above, the ECB had allowed banks to repo their already-created but impaired ABS holdings during the banking crisis of 2008. When banks in the periphery of the euro area came under pressure again in the context of the protracted sovereign debt crisis, three ECB decisions between December 2011 and July 2014 lowered the rating threshold for ABSs from AAA to BBB- (Wolff, 2014: 5).



The second aspect of the transmission-securitisation nexus emerged in June 2014 when the ECB announced its own asset purchase programme, or ‘quantitative easing’ (QE). The first part of that programme to be launched was ‘outright purchases in the ABS market to enhance the functioning of the monetary policy transmission mechanism’ (Draghi, 2014). In contrast to the US, the UK and Japan, the expansion of the Eurosystem’s balance sheet up to that point had been achieved primarily through (longer-term) refinancing operations rather than through outright asset purchases. Crucially, this was not because the ECB objected to the idea of QE, but because both public and private asset markets were, albeit for different reasons, beyond its reach. The path to large-scale purchases of sovereign debt was blocked, above all, by Germany insisting that such purchases would violate the monetary financing prohibition of Article 123 TFEU. As for private securities, the securitisation market would have been the ECB’s preferred choice. Unlike covered and corporate bonds – which were concentrated in the core countries and issued by large corporations – securitised loans would have allowed for purchases targeted to ailing sectors in the vulnerable countries. However, low issuance activity meant that the ABS market was too small for large-scale central bank purchases (Interview 3). Thus, legal and economic restrictions meant ‘the monetary transmission mechanism [was] unable to reach certain sectors (or regions) in the economy’ as a result of ‘missing asset markets’ (Brunnermeier and Sannikov, 2014: 17). Indeed, when the ECB finally launched its Asset-Backed Securities Purchase Programme (ABSPP) in November 2014, it remained fairly small relative to the other components of what would, in March 2015, become the Expanded Asset Purchase programme.¹¹ By the end of March 2016, the ECB had acquired ABSs worth EUR 19.2 billion. This ABS Purchase Programme substantiates the argument that the ABS loan-level initiative was really a blessing in disguise for the securitisation market. While the ABSPP most likely was not envisaged when the ECB first became involved in the securitisation market at the height of the 2008 banking crisis, the loan-level initiative nevertheless inadvertently paved the way for the ABSPP. This is because *without* loan-level data, the political imperative for the ECB to take a highly risk-averse approach towards asset purchases would almost certainly have prevented large-scale ABS purchases. As one ECB official closely involved in the process put it, ‘without the loan-level data information we would probably not have an ABS programme in the first place’ (Interview 5).

The expected positive effects of a deep and liquid securitisation market on the monetary transmission mechanism caused the ECB, alongside the Bank of England, to become the first EU policymaking body to embrace the idea of reviving securitisation (ECB and Bank of England, 2014). Crucially, this was a time when the European securitisation market was still dormant and suffering from post-subprime stigma – among investors, regulators and, most importantly, among policymakers in Brussels. Interviewed in late 2014, one market participant (on the issuer side) expressed his relief ‘that the ECB leads ABS out of its dodgy corner’ while ‘the regulator is still

¹¹ The ABSPP was accompanied by a third covered bond purchase programme (CBPP3) and followed by the Public Sector Purchase Programme (PSPP) in March 2015. Under the terms of this expanded asset purchase programme (APP), the Eurosystem committed to the monthly purchase of public and private securities worth EUR 60 billion, continued at least until the end of September 2016. In March 2016, the ECB expanded the APP by adding a corporate sector purchase programme (CSPP) for investment-grade bonds issued by non-bank corporations, while increasing the target for combined monthly purchases under the APP to EUR 80 billion (ECB, 2016).



convinced that it all is somehow a devilish thing' (Interview 6). At the time, securitisation was damaged by newly legislated capital charges on ABSs that were significantly higher than for comparable covered bond exposures, both for banks (via the Capital Requirements Directive, CRD IV) and for insurers (via Solvency II) (Segoviano *et al.*, 2013: 33; Hübner, 2016: 14-15). Repeating the constellation observed above for the financial (repo) transactions tax, the ECB once more sided with market actors, against the more sceptical, financial stability-oriented view of the Commission. And once more it was the ECB that won.

While the idea of 'actively purchasing and promoting a market in securitised SME loans' had been floated in European central bank circles as early as September 2011 (Posen, 2014), the ECB campaign to revive securitisation began in earnest in mid-2014. In June 2014, Mario Draghi issued an unusual appeal for a 're-visitation' by regulators of their treatment of ABSs in order to 'eliminate some of the undue discriminations towards this specific product when this product is simple, real and transparent' (Draghi, 2014). This message was re-iterated by Yves Mersch (2014) who called on both public regulators and private rating agencies to reconsider their treatment of ABSs, including 'excessive securitisation capital charges, transparency and risk retention improvements, higher credit enhancement requirements [...] which I see as overly constraining'. These remarks show that in making the case for securitisation the ECB initially found itself fighting an uphill struggle against the European Supervisory Authorities and the European Commission. However, it was not long before the ECB was heard. With the Juncker Commission, the idea to revive securitisation quickly gained momentum in Brussels. Lamenting that 'European businesses remain heavily reliant on banks for funding', the Juncker Commission's flagship project, Capital Markets Union, has placed great emphasis on building a European framework for 'simple, transparent and standardised securitisation' as a means to 'bridge banks and capital markets' – in other words, to bolster market-based banking (European Commission, 2015a: 2, 10, 2015b).

6. Conclusion

One of the central questions for political economists in recent years has been why and how finance wins. The rise of market-based banking in the euro area represents a significant win for bankers because the expansion of repo and securitisation markets allowed for greater leverage and higher profits. To explain the permissive regulatory and political environment within which market-based banking could thrive, political economists have focused on instrumental and structural forms of financial sector power. While highly relevant, this literature has limited its attention to those interactions between state and market actors that take the form of *political* transactions, overlooking forms of state action that operate through *market* transactions. Whereas most branches of government in advanced capitalist states operate on the basis of administrative authority, central bank agency is primarily market-based (Hellwig, 2014: 29; Hockett and Omarova, 2014; Jacobs and King, 2016). This point is crucial to understand why and how banking and central banking co-evolve. The dominant co-evolutionary equilibrium of the 20th century was between deposit-based banking and lender-of-last-resort central banking. In that world, central banks such as the Bundesbank regarded relationship-based banking (as well as strong social partners) as pillars of monetary governability. The introduction of the euro, by contrast, created an endogenous dynamic in which



‘increasing collateralisation in private wholesale markets’ and the ‘relatively high consumption of collateral by the Eurosystem’ reinforced each other (ECB, 2006: 76), establishing a new evolutionary equilibrium between market-based banking and *dealer*-of-last-resort central banking.

From this perspective, the power banks wielded vis-à-vis the ECB was not so much instrumental or structural, but infrastructural. The ECB engaged in market building and market making in order to establish, expand, and revive repo and securitisation markets, which served as the infrastructure for the implementation and transmission of monetary policy. The power that accrues to repo markets due to their central position for the implementation of monetary policy found its clearest manifestation in the failed attempt to impose a financial transactions tax (Gabor, 2016a). Advocated by the European Commission, the FTT was firmly opposed by the ECB, which held a strong stake in a deep and liquid repo market. The foundation stone for the infrastructural alliance between the ECB and the securitisation market was laid in 2008 when the ECB absorbed large volumes of ABSs, thus acquiring an interest in a deep and liquid market also for these securities. The QE-preventing ‘missing asset markets’ problem (Brunnermeier and Sannikov, 2014: 17) further strengthened that interest. Consistently promoting securitisation, the ECB has made a crucial contribution to the moral, political, and economic revival of an asset class that had been heavily stigmatised after the financial crisis. Today, securitisation is a key pillar of the European Commission’s flagship project of a Capital Markets Union, which aims at reorienting Europe’s financial system towards a more market-based model. Notwithstanding the ongoing conflict over the precise criteria that ABSs must meet to qualify as ‘simple, transparent and standardised securitisations’ (Association for Financial Markets in Europe, 2016), the ECB-driven reversal in the political fortunes of this financial technology stands as an impressive demonstration of infrastructural power. To be sure, this is not to say that the ECB ‘created’ market-based banking. However, by kick-starting and standardising the repo market it bolstered not only the infrastructure of monetary policy implementation but also the nerve centre of the global shadow banking system. Similarly, the ECB’s decision to backstop and re-organise securitisation represented a critical juncture for a number of path-dependent developments, from the ABS Purchase Programme to Capital Markets Union.

While elaborated on the basis of a single-case study, this notion of infrastructural power can provide a useful analytical tool to study other instances of market-based state agency. Beyond the now-familiar bond buying by central banks, a range of state actors are already purchasing a range of financial assets. The Bank of Japan’s purchases of exchange-traded fund shares, for instance, have turned it into one of the country’s largest equities investors (Bloomberg, 2016). In China, a growing number of public entities are heavily invested in domestic equities, effectively creating a ‘shareholder state’ (Wang, 2015). In Europe, the European Investment Bank and a number of national promotional banks have launched a ‘Securitisation Initiative’ that aims to increase public investment in securitised loans to small and medium enterprises (Mertens and Thiemann, 2016). Beyond asset purchases, the organisation of payment and settlement systems constitutes another promising field for future research on infrastructural power (Krarup, 2016; Quaglia, 2009). While TARGET2 was a step towards a more centralised system that encouraged payment and settlement in central bank rather than in commercial bank money, the newly introduced TARGET2-Securities (T2S) represents an unprecedented step towards financial infrastructure centralisation that will effectively nationalise the settlement of securities trades, including repo transactions. If these examples indicate



a growing role for market-based financial statecraft, the infrastructural power perspective suggests that similar causal mechanisms may be at play: Once they trade in interbank money markets, central banks are likely to develop a preference for financial deepening and more standardised and efficient market infrastructures, to the point where in-sourcing of securities settlement becomes a policy choice. Similarly, purchases of one asset class by one state agency may pave the way for purchases in other asset classes by other state agencies.

Hockett and Omarova (2014: 57) have emphasised the ‘additional good that our governments can do’ by acting in markets’, and thus the potential of market-based state agency to win back lost steering capacity and to re-establish governability. The two-way-street dynamics of infrastructural power, by contrast, point towards a more critical normative assessment. From this perspective, the flipside of a stronger reliance on market-based forms of financial state agency is the expansion of the infrastructural power of finance. Returning to the introductory quote by Janet Yellen (2014), working ‘through financial markets’ may be making it increasingly difficult for central bankers to keep the promise ‘to help Main Street, not Wall Street’.

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Appendix 1: List of Interviews

1. ECB, 11 March 2013, Frankfurt.
2. ECB, 7 May 2013, Frankfurt.
3. ECB, 1 July 2013, Frankfurt.
4. Bundesbank, 5 September 2013, Frankfurt.
5. ECB, 1 December 2014, Frankfurt.
6. Head of Transaction Management, commercial bank, 2 December 2014, Frankfurt.
7. Managing Director, rating agency, 16 February 2015, Frankfurt.
8. European DataWarehouse, 16 February 2015, Frankfurt.
9. Kreditanstalt für Wiederaufbau, 16 February 2015, Frankfurt.
10. True Sale International GmbH, 30 April 2015, Frankfurt.
11. Director, commercial bank, 6 July 2015, London.
12. European Banking Authority, 6 July 2015, London.
13. Securities firm, 7 July 2015, London.