

THE IMPAIRED EU SECURITISATION MARKET: CAUSES, ROADBLOCKS AND HOW TO DEAL WITH THEM

Introduction

The securitisation market in the EU continues to be impaired. Public issuance of Asset Backed Securities (ABS) remains very limited and mostly concentrated in a few jurisdictions. The market is shrinking. This is a concern because securitisation, if appropriately structured and regulated, can complement other long-term wholesale funding sources for the real economy, including for small and medium-sized enterprises (SMEs). Furthermore, if a sufficient share of the overall ABS issuance were publicly placed, this could translate into a diversified funding source for banks and potentially transfer credit risk to non-bank financial institutions, thereby providing capital relief that could be used to generate new lending to the real economy. This note assesses the current EU securitisation market, including from a forward looking perspective. A particular focus is the promotion of simple structures and well identified and transparent underlying asset pools with predictable performance (so-called ‘high-quality’ securitisation), while still impeding the resurgence of the more complex and opaque structures that contributed to the financial crisis. This short paper was prepared for the G20/IMF Spring meetings. A longer, more substantive joint discussion paper will be issued in May.

1. Aims and benefits of securitisation

A market for prudently designed ABS has the potential to improve the efficiency of resource allocation in the economy and to allow for better risk sharing. It does so by transforming relatively illiquid assets into more liquid securities. These can then be sold to investors thereby allowing originators to obtain funding and, potentially, transfer part of the underlying risk, while investors in such securities can diversify their portfolios in terms of risk and return. This can lead to lower costs of capital, higher economic growth and a broader distribution of risk.

A more diversified bank liability structure further tends to reduce the dependency of banks’ lending decisions on business cycle conditions and to lower the exposure of debtors to re-financing or liquidity risk, which increases banks’ resilience and helps contain systemic risk. Securitisation is also uniquely shaped to provide targeted funding to a variety of economic activities, including by allowing lenders to match the profile of their funding liabilities with those of the loans they have originated, and to address specific investor preferences regarding the distribution of risk exposures. And high-quality/simple and transparent senior ABS can in principle help meet the increasing demand for high-quality collateral, providing a complement to government debt.

From the perspective of central banks, securitisation can play an important role in supporting both monetary and financial stability. In the current fragile macroeconomic environment, for example, high-quality ABS can support the transmission of accommodative monetary policy in conditions where the bank lending channel may otherwise be impaired. In particular, securitisation may allow banks to lend without committing too much capital and other sources of funding, and thereby provide indirect market access to groups of borrowers that are otherwise not able to tap markets directly, such as SMEs.

Despite its long-term social value, securitisation today suffers from stigma, reflecting both its adverse reputation among investors and conservatism among regulators and standard-setters. This is the consequence of misaligned incentives in the years prior to the financial crisis, with many industry participants becoming entwined in a self-reinforcing dynamic between demand and supply of securitisations.

The potential for securitisation markets to damage financial stability was evidenced clearly during the crisis. The Financial Stability Board (FSB) has adopted a two-pronged strategy towards ensuring a more resilient shadow banking system, of which securitisation markets are a key building block. First, the FSB has developed a monitoring framework to enhance national authorities' ability to track developments in the shadow banking system with a view to identifying the build-up of systemic risks and enabling corrective actions where necessary. Second, the FSB has coordinated the development of policies in five areas where oversight and regulation need to be strengthened to reduce systemic risks, including policies improving transparency and aligning incentives in securitisation.¹ Official authorities ought to lend their full support to a successful implementation of this strategy to ensure the benefits of securitisation are fully realised and that the market recovers in a form that adheres to standards conducive to financial stability.

2. The current situation of the EU securitisation market

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

In 2006, all primary issuances were placed with end-investors and other banks; by 2009, almost all deals were retained by the originating banks and many were placed as collateral with central banks (see Chart 2). Despite some small improvements since, public issuance volumes remain very low in the EU and continue to be mostly originated in a small set of countries such as Germany, Netherlands and the UK. The deals that have emerged from the more stressed economies either involve short maturities, high yielding assets or SME transactions with specific support from the European Investment Bank

¹ See FSB document entitled "Strengthening Oversight and Regulation of Shadow Banking - An Overview of Policy Recommendations" and dated 29 August 2013

(EIB)/European Investment Fund (EIF) (e.g. via purchases of senior or mezzanine tranches and/or via guarantees).

Chart 1. European ABS outstanding (EUR billion)

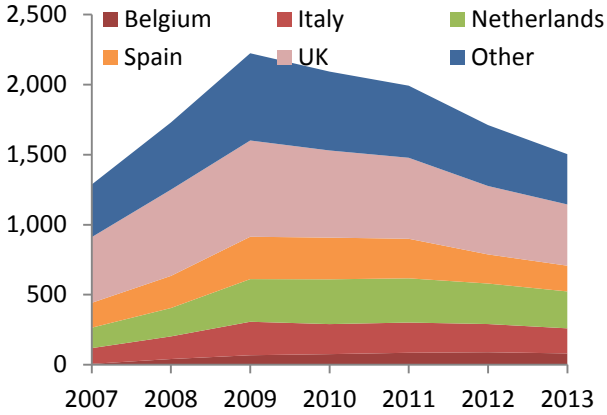
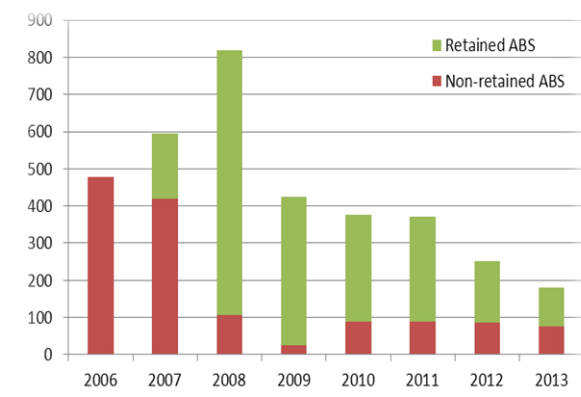


Chart 2. European ABS issuance (EUR billion)



Source: Association for Financial Markets in Europe (AFME). End observation: 2013 Q4.

Despite the low issuance and the modest take-up by investors, most European structured finance products performed well throughout the financial crisis, with low default rates. According to an analysis by Standard & Poor’s, the cumulative default rate on European structured finance assets from the beginning of the financial downturn, July 2007, until Q3 2013 has been 1.5%. Some asset classes such as consumer finance ABS, SME Collateralised Loan Obligations (CLO) and RMBS have experienced default rates well below this average and the performance of European structured finance products has also been substantially better than US peers.² By way of comparison, ABS on US loans experienced default rates of 18.4% over the same period, including subprime loans.

3. What measures and initiatives were proposed and implemented so far to address earlier misalignments?

To address earlier flaws in the securitisation market, several financial regulations and other initiatives have already been implemented in the EU. These are focused on removing misalignments of interests and information asymmetries between issuers and investors, including creating greater transparency to support accurate pricing of credit risk. The new regulations include, amongst others, the following:

- Risk Retention Rule (originators to maintain some “skin-in-the-game”), introduced in 2011;
- measures that address information asymmetry with the securitisation process by increasing transparency of the securitisation structures (the due diligence requirement);
- EU Credit Rating Agency legislation in 2013, making rating agencies more transparent and accountable.

² The corresponding default rates for European consumer finance ABS, RMBS and SME CLO are 0.04, 0.1 and 0.4% respectively.

There have also been a number of public sector initiatives to improve the functioning of the EU securitisation market.³ For example, significant steps have been taken to introduce consistently-recorded loan-level data in all major ABS asset-classes throughout Europe via the Eurosystem's and the Bank of England's loan-level data initiatives.⁴ Market participants now have access to comprehensive asset level data, which helps prevent originators, seeking to clean up their balance sheets, from off-loading through securitisation their lowest quality assets. More broadly there are initiatives to ensure that information on asset performance, transaction documents and cash flows associated with deal structures is publicly available. This high level of transparency is an important first step towards restoring investor confidence in European ABS.

In 2013 the EIB and EIF launched a European-wide scheme to increase their involvement in securitisation. The "EIB Group ABS initiative for SMEs" provides credit enhancement for senior and mezzanine tranches of securitisations backed by SME loans, including guarantees, and facilitates their execution.⁵

Finally, there have also been pan-European and national initiatives from the private sector to enhance transparency and standardisation in securitisation markets.

4. What are the remaining roadblocks?

The new regulations to protect investors, as well as policy makers' and authorities' efforts to reduce the perceived regulatory stigma of ABS and to clarify their support for simple and more transparent securitisations have so far failed to kick-start the EU securitisation market. In large part, this may reflect current conditions, including: the availability of cheap funding from other sources, deterring issuance of ABS; ongoing macroeconomic weakness in several European countries, aggravating investors' concerns about future asset quality deterioration of the ABS collateral pools; and low demand for loans, making it difficult to build collateral pools providing sufficient income to support the coupons and credit protection investors demand. On this latter point, often referred to as deal economics, a sustainable recovery in stressed euro area jurisdictions will only be possible as credit risk gradually recedes on the back of structural reforms, strengthening economic fundamentals and unlocking profitable investment opportunities. Still, while these shorter-term factors decrease, there are a number of remaining structural roadblocks that may prevent investors and issuers from returning to the market. By addressing these issues now, the authorities can help to catalyse the return of asset backed securitisation to support monetary and financial stability and economic recovery.

a. Regulatory treatment

³ The loan-level information also facilitates central banks' risk assessment of ABS that counterparties use as collateral in central bank credit operations. In fact, due to the increased level of transparency and standardisation in structured finance markets, the Eurosystem decreased its haircuts on ABS in July 2013, from 16% to 10% in the permanent framework.

⁴ For the Eurosystem, this began in January 2013 for RMBS, SME ABS and CMBS. In January 2014, the reporting requirements began for the other asset classes - auto, leasing and consumer ABS transactions – and in March 2014 for credit card ABS. For the Bank of England, reporting requirements were introduced in December 2011.

⁵ See "SME Loan Securitisation 2.0 – Market Assessment and Policy Options", Working Paper 2013/19, EIF Research.

Regulatory initiatives have been designed to address the shortcomings highlighted during the crisis. However, the proposed changes arguably treat ABS in ways that might be perceived as unduly conservative, both relative to their performance in the European context and more particularly relative to other forms of long-term wholesale funding such as covered bonds. One reason is that the proposed changes do not appear to distinguish sufficiently between the actual performance of simple and prudently structured ABS – for example, including some of those predominantly issued in Europe – and of more complex, opaque structures. In addition, there appear to be inconsistencies *across* different regulatory initiatives in a number of different fields such as capital charges and liquidity requirements.

The proposed changes in the regulatory treatment and the current uncertainty about their final outcome affect investors' willingness to participate in the market. The December 2013 consultation papers from the Basel Committee on Banking Supervision (BCBS) on proposed revisions to the securitisation framework affecting banks and from EIOPA affecting insurance companies (Solvency II), although including a less adverse treatment than previously discussed, still propose capital charges that may be perceived as high for high-quality ABS, particularly when compared with similar asset types. Similarly, a key issue would be the relative treatment of securitisation and covered bonds in the forthcoming EU implementation of the Liquidity Coverage Ratio (LCR). Banks, insurers and pension funds that are affected by these regulations are the major players in the securitisation market, and their ongoing participation is vital to its ongoing functioning.

For the market to recover in a meaningful way, further measures may be needed. One way of achieving this would be to take into account the simplicity, structural robustness and transparency features of ABS which have meant that low risk and well-structured ABS issued in some markets have displayed strong performance and minimal losses through a period of severe financial stress. In this respect the latest EIOPA proposal for Solvency II as of December 2013 to introduce a distinction between Type A and Type B securitisation⁶ as well as the communication on 27th March 2014 from the European Commission to the European Parliament and Council⁷ are welcome first steps.

b. Reliance on credit rating agencies

Credit rating agencies influence the ABS market via three important channels. First, as a result of weak economic conditions, rating agencies now require far greater levels of credit enhancement to achieve a given rating, which consequently makes it more costly to issue structured finance assets (supply side effects). Second, rating actions taken on sovereigns indirectly lead to ABS downgrades. In some EU countries, rating agencies currently also apply maximum rating caps to ABS that are not related to the underlying collateral quality itself, but to sovereign rating levels. In those EU countries affected, a triple-A rating - the benchmark in ABS markets - is no longer achievable without a guarantee from a supranational institution like the EIF, regardless of their credit support. Third, ratings on ABS

⁶ Under the latest proposal, EIOPA has introduced two types of risk factor, based on structural, collateral and transparency standards of each investment. Type A securitisation needs to meet tighter criteria compared with Type B securitisation.

⁷ The Commission will work on the differentiation of “high” quality securitisation products with a view to ensuring coherence across financial sectors and exploring a possible preferential regulatory treatment compatible with prudential principles.

transactions drive regulatory capital charges incurred by many ABS investors. The reliance on ratings by credit rating agencies may thus lead to unwarranted pro-cyclicality effects.

c. Transparency and harmonisation

Whilst significant effort has been expended to create standards for quality, transparency and simplicity and therefore help to boost investor trust, market participants continue to cite the lack of transparency and standardisation of ABS and related data on underlying assets as a key constraint. The central banks' loan-level data reporting templates and market-led initiatives are encouraging steps towards more transparency and harmonisation of reporting standards. Over the long run, the Single Supervisory Mechanism might also influence transparency and underlying underwriting standards. Nevertheless, further improved and standardised data availability may be needed to enable investors to assess the credit risk inherent in securitised assets and to help restore investor confidence in the securitisation market.

5. Concluding remarks and way forward

This analysis suggests that revitalising publicly-distributed ABS issuance on any meaningful scale would require concerted policy action in various fields, involving a range of official entities.

Standard-setters and legislators being responsible for the regulatory treatment can change incentives to participate in the ABS market. It would be important that the authorities seek to ensure that new regulations at global and EU levels do not act to the detriment of the securitisation market.

To this end, the plans of EU and international regulators such as the BCBS and IOSCO to review developments in securitisation markets and promote the concept of so-called 'high-quality' securitisations should be helpful. These efforts should be reinforced and accelerated without delay to reduce the current regulatory uncertainty that is impeding the reactivation of the market. A key question is the actual criteria to distinguish high-quality transactions relative to the wider ABS universe. In this regard, central bank eligibility criteria aiming at ABS with simple structures and well-identified and transparent underlying asset pools with predictable performance could form a useful guide. These criteria have already been demonstrated to filter undesirable ABSs (proven by default performance), are set in a manner free from conflicts of interest, and are widely accepted by market participants. As regards the next question—actual treatment—high-quality securitisations should receive treatment commensurate with these reduced risks, in contrast to the currently-proposed 'catch all' regulatory treatment for all ABSs.

The 'high-quality' segment of the securitisation market should aim to be more resistant to market stress, thereby providing banks with a resilient form of funding. But it is also important to support more junior tranches of safe and robust securitisation markets. In this regard, authorities should continue to help improve the availability of data and analytics and seek to ensure that these are delivered as efficiently as possible. This will help improve general standards applied to even the riskiest securitisation transactions and should facilitate investment in all ABS across a broader base of investors, also implying greater degree of credit risk transfer between the bank and non-bank sectors.