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EUROSYSTEM

The case for a better functioning securitisation market in the European Union

A Discussion Paper - Synthesis of responses

October 2014

The case for a better functioning securitisation market in the European Union

Synthesis of responses

General assessment

1. The overall tone of the responses was positive, welcoming the efforts of the Bank of England and the European Central Bank (ECB) to present a coherent and balanced analysis of the issues.

2. Regarding the state of securitisation, a number of respondents took the opportunity to highlight factors contributing to its decline, including: contagion from the United States, the generally small investor base in Europe in connection with a dominant role of leveraged (rather than real money) investors. Poor performance of underlying assets was not seen as a negative factor and cited only in the case of commercial real estate (CRE) lending.

3. In terms of impediments and policy options, respondents put their greatest focus on regulation. The concept of 'qualifying securitisations' was broadly supported, though some respondents emphasised the risks of reviving securitisation markets, including the transfer of risk to the shadow banking system and the distribution by banks of low risk exposures while retaining more risky exposures.

4. The following addresses each of the questions posed by the Discussion Paper in turn. The views set out in this note are those of respondents and do not necessarily reflect the opinion of the Bank of England and the ECB.

Benefits and risks

Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

5. There was general agreement with the benefits identified, with many respondents focusing on the use of securitisation as a funding tool for creditors that should ultimately support real economy lending – for example: via the flexibility to tailor securitisations to match the needs of both issuers and investors; and via allowing non-bank firms to increase their lending capacity, thereby promoting greater competition amongst creditors.

6. A number of respondents welcomed the explicit recognition of potential benefits from securitising higher risk assets, for example, to support SME and CRE lending. However, there was some scepticism as to the ability of lenders to achieve risk transfer through securitisation, including through synthetic transactions, which some viewed as necessary for supporting such higher risk lending. In particular, some respondents thought that supervisory practices, including a lack of positive attitude towards securitisation, were a limiting factor. And the interplay between risk retention and IFRS was felt to discourage risk transfer transactions carried out through cash securitisation. Respondents also emphasised other specific types of securitisation not explicitly identified in the Discussion Paper as being highly beneficial to the real economy – for example, Collateralised Loan Obligations (CLOs), attracting institutional money to the loan market; and Asset Backed Commercial Paper (ABCP), facilitating lenders in managing risks associated with providing working capital to SMEs and financing trade and consumer receivables.

Impediments

Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

7. In terms of impediments to investors, regulation generated the greatest response, highlighting the lack of consistency: across different investor types and the different regimes applicable (capital requirements, penalties regarding retention rules); across jurisdictions (within Europe and versus the United States); and across instruments (securitisation versus covered bonds and versus loans). Where regulatory initiatives have not yet been finalised, respondents expressed concern about the related regulatory uncertainty and further felt that, so far, regulatory initiatives since the crisis have been guided too heavily by the experience of the crisis, thereby failing to differentiate between securitisation technologies and asset classes underpinning securitisations. Many respondents suggested that the proposed capital charges under Basel III and Solvency II were too high in absolute terms, exacerbated by a 'cliff edge' between 'AAA'- and 'AA'-rated securities.

8. The calibration of Solvency II attracted the most attention, with a general consensus that – given insurers are buy-and-hold investors – charges should not be based on spread movements. Concerns were further raised around the degree of non-neutrality in the securitisation charges versus holding the underlying assets (e.g. a portfolio of loans).

9. Regarding the Liquidity Coverage Ratio (LCR), bank and industry trade associations felt that recognition was too limited (in terms of size and eligibility) to incentivise the use of good quality securitisations. Meanwhile, retention rules were seen by some non-bank investors and industry bodies to be

skewing investor interest towards other assets such as covered bonds, given the onus on the investor (rather than the originator) to monitor compliance. Along with due diligence requirements imposed by the Capital Requirements Regulation (CRR Article 406), this imposes obligations and costs, which respondents felt could limit the participation of small investors in particular.

10. A range of other legislative initiatives were also cited as detrimentally impacting the investor base for securitisations, including: regulations restricting money market fund investments; the Volcker rule definition of 'covered funds', preventing many financial institutions from investing in securitisations; and liquidity restrictions in the Undertakings for Collective Investment in Transferable Securities Directive (UCITS Article 19). Some investor respondents further confirmed that negative stigma emanating from the regulatory authorities was acting as a behavioural constraint upon investment in securitisations.

11. In terms of risk assessment and management, respondents rejected the notion that prepayment risk acted as a deterrent to potential investors, emphasising that it was an essential component of the transaction and should not be confused with structural complexity. Some non-bank investors were more specifically concerned with heterogeneity in bankruptcy laws across Europe.

12. In general, non-bank investor respondents were keen for more disclosure, and/or more standardised information and were supportive of existing initiatives on improving data availability provided the data were easy to use, while issuers felt there was sufficient information already available. Relatedly, a number of respondents raised concerns over the disclosure requirements associated with ESMA Article 8b of the CRA 3 Regulation – for example: that these exceeded what is necessary or feasible for ABCPs; and for some types of loan that these could cause breaches of client confidentiality.

Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

13. As with impediments to investors, there was a marked focus on regulatory considerations on behalf of issuers – for example, high capital charges applied to sponsors of ABCPs and to liquidity facilities supporting both ABCPs and Commercial Mortgage-Backed Securities (CMBS). Various issues were also raised around risk retention rules, such as the detrimental impact on 'thinly capitalised' CLO managers, and the lack of differentiation within European Banking Authority (EBA) Regulatory Technical Standards, which was felt to penalise lower risk lending.

14. Bank respondents referred to securitisation as a tool to allow for capital release for issuers (besides its use as a funding tool) and further highlighted concerns around the ability of issuers to transfer credit risk, pointing to: the interplay of risk retention and accounting rules, a lack of clarity around de-recognition in accounting standards (IAS39); and constraints on supervisors in approving capital relief, with EBA rules apparently not enforced consistently across jurisdictions.

15. Regarding credit rating agencies (CRAs), respondents were most concerned with the interaction between ratings and regulation and the continued regulatory reliance on rating agencies. For example, regulatory capital charges are based on sovereign-capped ratings, thereby creating a barrier to entry for peripheral issuers. Finally, the provision of ancillary facilities was viewed as a major risk and cost issue for securitisation, with a particular focus on the cost and availability of swaps.

Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

16. A number of respondents suggested that current low levels of market liquidity emanated primarily from a lack of primary issuance owing to cheap central bank funding, though uncertainty around regulation and the impact on banks' trading books were also cited as factors. More generally, some bank, asset manager and service provider respondents appeared to believe that market liquidity was not a prerequisite to a well-functioning securitisation market, given the inherently 'buy-and-hold' nature of the product and the investor base. Some asset managers thought there was no significant difference in market liquidity compared to other credit markets, such as corporate bonds.

Policy options

The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition?

17. The definition of 'qualifying securitisation' was broadly accepted, though there were some clear differences of interpretation. Some welcomed the fact it was not framed in terms of 'high quality', while others construed the definition as being synonymous with 'simplicity'. This was deemed to be problematic for two reasons: first, 'simplicity' had masked undesirable behaviour in the past; and second, 'simplicity' would (inappropriately) exclude more complex, however well-performing transactions, such as master trusts. A number of respondents further raised concerns around the impact on due diligence: investors would need to understand that some complexity is unavoidable and hence 'qualifying' was merely a stamp of 'analysability.'

18. Respondents also volunteered views as to whether or not 'qualifying securitisations' should be subject to risk retention rules. Many thought they should be, but others, making reference to US qualifying residential mortgages (QRM) and their exemption from US regulatory risk retention

requirements (Dodd-Frank Act), argued they should be exempt given onerous due diligence requirements and significant disclosure obligations.

What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

19. The principles were broadly interpreted as excluding two types of transaction that a number of respondents felt should somehow be considered as 'qualifying securitisation', namely: ABCPs and synthetic structures. Others thought that the principles and the way in which they were formulated could lead to the exclusion of several transactions, including asset classes such as auto ABS, SME CLOs and Dutch RMBS. Various trade bodies suggested that separate criteria for ABCP and liquidity facilities could usefully be defined. And a similar treatment was proposed for synthetic securitisations, which was supported by many respondents, for example, when structured in a simple and transparent way and facilitating risk transfer, particularly when physical transfer of assets to a securitisation vehicle is operationally complex. Some respondents, however, argued that synthetic securitisations should not be considered as 'qualifying securitisation' because they don't allow investors to take control over underlying assets in enforcement scenarios and they allow the risk of the underlying asset to be multiplied many times.

20. Specific comments on the principles in Box 3 are included as an Annex.

Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

21. Some non-bank investors thought that market liquidity would improve only if a 'qualifying securitisation' label had material consequences, primarily in terms of differential regulatory treatment. At the same time, concerns were raised around the risk of a two-tier market arising, with a reduction in the liquidity of existing (but non-qualifying) ABS that nevertheless performed well. Relatedly, it was suggested that consideration needs to be given as to how existing ABS might be 'grandfathered' into a 'qualifying' framework.

These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

22. In general, there was support for a unifying framework around 'qualifying securitisations', with some service providers highlighting a need for consistency across jurisdictions and regimes, perhaps enshrined in European Law. Many considered certification a necessity, for example, to avoid any disparity of opinion amongst both investors and regulators.

23. Opinions were mixed as to who was best placed to certify transactions. Some respondents felt that this should be undertaken by the regulatory authorities, preferably a central body to guard against manipulation. Others were concerned that a public sector body would find it difficult to maintain a single list of 'certified' transactions and to enact rulings on a timely basis, and therefore suggested a more influential role for the financial industry. One framework suggested was for certification to be carried out by so-called 'notified bodies' accredited by national securities markets supervisors or the ECB – a similar approach to existing regulation for non-financial products under European Law.

24. Irrespective of the certifying authority, respondents highlighted various consequences of a framework for 'qualifying securitisations'. For example, some asset managers were concerned over the implications for investors or for the market if securitisations lost their qualifying status. Separately, some service providers were concerned that non-qualifying securitisations could suffer a form of 'benign neglect', despite playing a positive role in funding the real economy.

Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

25. Responses regarding harmonisation focused on the Bank of England and ECB loan level data requirements. These initiatives were widely welcomed, with a number of respondents outlining potential improvements – for example, harmonising the existing templates, or even introducing a single template, widening access beyond credit institutions and improving the usefulness of difficult to interpret data. In the latter case, there were suggestions by consultants and trade associations that the central banks could provide more user-friendly interfaces and accompany the basic data with analytical tools (for example, to examine the data across different risk dimensions) and regular publications (presenting summary statistics and investigating the state of loan markets).

26. Some non-bank investor respondents also felt that harmonisation of relevant disclosure requirements and related reporting and legal frameworks across Europe could greatly benefit securitisation markets.

Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient, or are there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

27. Respondents were unanimous in their support of a single repository for key information. But there was limited appetite from issuers for any further standardisation of prospectuses or investor reports. That said, a number of potential improvements were identified, principally by non-bank investors, including: standardised definitions, such as for arrears; more clarity around the basis for calculations, particularly for less plain vanilla transactions such as CLOs and CMBS; improving conformity in reporting standards across jurisdictions; and the provision of a 'how to guide', tailored to asset class and local legislation. Other respondents proposed a European level effort to encourage CRAs to collect default data at an individual loan level and prepare standardised loan loss information.

28. Trade transparency was also highlighted as an area that might be improved with volumes and traded prices particularly welcomed.

Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

29. There was some support for credit registers from both issuers and investors on substance, particularly for SME loans. However, the development and maintenance of such a register was felt to be largely an issue for national authorities to explore, particularly given the confidentiality laws of individual countries. Those respondents that were supportive highlighted the need to ensure that the data could be used to calculate key risk factors, such as probabilities of default (PDs) and loss given default, (LGDs) and correlations.

In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

30. According to the feedback received, there was very little desire to see banks publish more macro-economic data.

Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

31. Some respondents were supportive with regard to benchmark indices, particularly of standardised pricing indices for underlying assets. More generally, however, there was a sense that this was not a priority until a well-functioning securitisation market had been established.

Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities ratings caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

32. There was general support for the idea that those CRAs which do not already provide sensitivities of securitisation ratings to sovereign ratings, ie to allow investors to see uncapped ratings, could usefully do so. That said, some respondents stressed the need to reduce reliance on CRAs, i.e. to ensure that investors properly understand the information, for example, that it should not distract from the fundamental linkage between country risk and the performance of underlying assets. Some respondents suggested the additional information would only be helpful if it had an impact either on regulatory capital treatment, which may be reliant on external ratings, or investors' 'internal systems' that may also use credit ratings to set exposure limits.

How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

33. A significant number of service providers and banks supported the idea of facilitating SPV accounts that fall outside the originator's insolvency estate, with individual respondents further noting that this would be most easily achieved through the provision of such accounts by central banks. Others suggested improvements to the private provision of ancillary facilities, for example: standardising counterparty roles and transaction structures across jurisdictions in Europe, to allow for greater comparability and ease of replacement; and clarifying treatment under the large exposures capital regime to exclude support counterparties. Swap arrangements were further highlighted as an area in which improvements might be made, including separating the treatment of related claims under insolvency.

Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

34. In terms of alternative policy options, the overriding concern of respondents regarded regulatory treatment, which is perceived as being overly harsh. In the view of many respondents, capital requirements needed to be lower, and should be made more consistent across regimes and across assets. Many thought the treatment of securitisations under the LCR

should be modified and should be made more consistent with covered bonds. Risk retention requirements, in turn, should be more principles-based and the onus should be on the issuers rather than the investors.

Annex: Specific comments on Box 3: Principles of a 'qualifying securitisation'

Nature of assets: Some respondents were concerned that this principle would exclude transactions that should be included, for example: guaranteed mortgages; mortgages with variable rates that are specific to the loans; mortgages that allow borrowers to switch interest rates over a predetermined horizon; interest-only loans; and zero-interest loans, such as automobile loans.

Underlying asset performance history: A number of respondents were concerned over the length of the requirements noting, for example, that changes in banks' scorecards and underwriting standards made it difficult to produce a 'substantially similar' history, particularly for longer-lived assets such as mortgages. There was also some concern that new entrant banks would be unfairly excluded.

Primary obligors: As above, ABCP and synthetic securitisations were heavily cited in this case.

Expectation of payment: Respondents broadly agreed with this principle, while suggesting further restrictions, such as concentration limits. Others pointed to unnecessary exclusions, for example, multi-originator securitisations and CMBS, where CRE lending is inherently 'lumpy'.

Current and self-liquidating: An overriding concern regarding this principle is that it may rule out various transactions standard to the market, which may include delinquencies – for example, credit card master trust structures and ABS backed by interest-only loans.

Security: A number of respondents argued that it was inconsistent to include securitisations backed by unsecured assets while excluding second lien loans.

Perfection of interest: There was some concern over the practicality of this principle, with a number of respondents raising the issue that legal regimes vary across jurisdictions and interest is not always perfected at closing. It was argued, instead, that the true sale criterion should accept the practice of 'equitable assignment'.

Initial data: There was broad agreement with this principle, though there were some concerns over the reliance of investors on models provided by issuers. Some respondents put forward additional proposals for disclosure, for example: that reporting templates be given to investors at the point of marketing, so shortfalls can be addressed; and that originators should disclose the level of internal capital held against the pool prior to securitisation.

Ongoing data and information: This principle attracted broad agreement, with the caveat that the reporting requirements be in line with, and not more burdensome than, existing regulations. Suggestions for improvement included: that standardised reporting templates be provided for transactions containing similar assets and located in the same country; that trigger metrics are clearly reported; that certain terminology and calculations are defined, such as providing a clear and consistent view of delinquencies; and that reports are provided in a user-friendly way.

External parties: A number of respondents disagreed with this principle on the basis that it acted against a general policy objective of reducing reliance on CRAs.