FUTURE FOR SECURITIZATION IN THE EU?

1. Securitisation framework status in the EU

An official outlined that they are particularly interested by this discussion around the securitisation framework in the EU because, there was hard-fought battles around the concept of simple, transparent securitisations, notably at the Basel Committee, which were met by scepticism in the US. In the European framework securitisation is a key issue linking the Banking Union and the capital markets union. It is one of the focuses of public policy. Many public authorities, including ACPR and the Banque de France, are trying to push forward for having a more integrated capital market.

A policy-maker stated that securitisation is a very useful tool, especially after the financial crisis. It strengthens a bank's ability to lend, provides additional funding sources for companies, and increases private risk-sharing. This tends to be forgotten because of the mistakes of the past and forgotten even more in Europe because it has taken longer in Europe for securitisation to bounce back after the crisis.

Securitisation is one of the key building blocks of the capital markets union project. The framework was published at the end of 2017 after relatively long negotiations with the European Parliament and European Council and entered into application on 1 January 2019. It aims to address the key deficiencies in the past and to revive the market in three key ways: to establish a clear and consistent legal framework for all securitisation to ensure clarity and transparency, to zoom in on the Simple, Transparent and Standardised securitisation (STS), and to help the new asset class by giving it preferential prudential treatment.

The European Commission is in the midst of finalising many technical standards with the ESAs, which have taken far more time than envisaged. The implementation date has been passed and most of the standards have not been adopted, aside from one on third-party verifiers. Lots of comments had been received from the market and ESAs that the Commission wanted to carefully address. In the area of disclosure, the market was re-consulted and something more appropriate was produced. There were also inevitable bottlenecks within the European Commission.

The Commission and the ESAs are working as quickly as possible to get the rest of the Level 2 measures on stream. The notification requirement is very important and is being prioritised. Other than the disclosure templates generally the Commission does not intend to depart from what the ESAs have provided. There may be legal drafting comments but there are already some drafts that the ESAs have provided, and they can already give an indication to the market as to where these standards will end up. The Commission needs to send it to the European Council and the European Parliament, and a new European Parliament legislature will delay things further into the second half of the year. The third-party verifier act has already been sent. Others will not be reviewed due to the end of the current legislature, so the objection period will not start until the new European Parliament takes effect in July.

1.1. A persisting stigma: securitisation had almost become a bad word after the crisis

An official asked whether a definition and endorsement of STS is needed, as it could potentially be an open door for arbitrage. That had been championed at the international level. Securitisation has almost become a bad word after the financial crisis due to the role it played in that. The STS was a way to try to fight through the stigma.

A policy-maker does not know whether it is a fair assessment to say that European legislators and regulators are not in favour of securitisation. That was why the legislation was proposed. It is true that negotiations took a long time and possibly ended up more restrictive than initially planned, but the intention was to revive the market. The STS label has preferential prudential treatment. It is not clear whether liquidity ratio issues are about STS itself or the larger securitisation population.

There was an intention to revive the market and create a label that gives investors more assurance that there is quality. There were more criteria than the European Commission had started with, but the intention of those criteria was to add safety to that product. It could not be stated that the market is not picking up because of the heaviness of those criteria or the constraints of the framework; the market is not picking up because the detailed standards are not there. People do not have confidence to issue based on drafts that ESAs have sent to the Commission and do not have any certainty that those drafts and templates will be adopted by the Commission and become law.

An industry representative noted that the private securitisation market in the USA is much bigger than the European one. In Europe it is about 1 trillion, which is an outstanding amount, and before STS. In the US the public securitisation market represents more than $7 trillion. The success of securitisation in the US has been the confidence in solving the stigma issue. That confidence is given by the government sponsored entities (GSEs). Banks are trying to develop that in Europe but are limiting themselves to a very small part of the market as long as mortgage backed securisation is not adressed.

1.2. Recent securitisation frameworks impede EU financing mechanisms from benefiting from this essential tool

An industry representative agreed that STS was meant to fight that stigma. The stigma is more in the minds of the supervisors and regulators than of market participants. STS is a very burdensome process to issue. All banks need to issue securitised products, so every effort is made. In exchange for that, banks would have expected the supervisors, regulators and Commission to recognise the value of the product they have built themselves, by defining specific, positive capital charges for the main buyers of those products.

Natural buyers of those products need to be identified. In the US the natural buyers are insurance companies and banks. A lot of banks have excess liquidities but no access to a lot of corporate clients, and through securitisation they can have some corporate exposure of very good quality. If the capital treatment and the liquidity treatment is what it currently is then they will not buy it because it does not make any economic sense. Currently there is no reason for a private bank to buy a securitisation tranche. An investing bank will invest 100 and it will be recorded as only 70% high quality HQLA, but if they bought the same issuer a covered bond it is going to be 93%. These inconsistencies have to be cured.

The legal framework is extremely constraining. If a product is of high quality, then the bearers should be given all the advantages that are going along with that quality. If a bank holds a securitised product on its balance sheet, it is extremely punitive to its liquidity coverage ratio. STS is qualified as HQLA Level 2b, with a haircut of 25 to 35%. The haircut of a covered bond is only 7%, and covered bonds are qualified as HQLA Level 1 or Level 2a. Treatment of capital is extremely punitive. The capital charge for the senior tranches range from 7-15%, which is completely inconsistent as a senior tranche is very, very low risk.

Securitisation has always been of central importance for banks. To a large extent banks are disappointed by the STS regime and the way it is going, as it ultimately shows that the European authorities as a whole are not really in favour of securitisation and do not wish to develop it that much. In terms of funding, the same result can be obtained with covered bonds, and because there is a double recourse one gets even better rates and a lower cost of funding.

However, covered bonds are not bringing any advantage in terms of the balance sheet; the assets are kept on the balance sheet, which is a big burden due to taxes such as the Single Resolution Fund contribution, which is extremely heavy in Europe. There are many other systemic banking or diverse taxes, so limiting the balance sheet is important. Capital requirements are even more important. It is clear that if a bank only issues a covered bond then it does not change capital requirements, but if the loans are sold through securitisation then there is relief on the capital requirements. Private banks are extremely in favour of securitisation. The concept of STS was brilliant, but the results are extremely disappointing due to the huge number of STS qualifying criteria and detrimental treatment for regulated buyers.

1.3. Impacts of the regulatory process and legal framework on the market

An industry representative stated that in the first quarter of 2019 in the EU27 the supply of securitisation is down 87% year on year. If the UK is included along with all cross-border transactions the overall decline is 40% year on year. The first number predominantly focuses on STS securitisation; it is down 87.5%, so the market is waiting, partly due to regulatory uncertainty. That is expected, as the regulatory framework and implementation documents are extremely complex. The industry was surprised by a lack of a proper transition period, as it had always asked and argued for grandfathering and transitioning over a longer, prolonged period of time. That was not done, and the industry was not granted a more extended transition, causing the market to tank.

However, the covered bond supply is up 39% year on year. In the first three months of the year the industry has seen almost half of the entire supply of last year come to market, which is as a result of a regulatory framework which is favourable, lenient and easy to implement. The negative is that there is no proper comparison between the two products. Banks use the same collateral and achieve many of the results of funding in a similar way, in many countries with a very similar legal framework.

For private banks, regulation is the number one reason for the decline in the market and for the delay. There will inevitably be a pick-up in the market in the second quarter, because many issuers cannot wait. The result is that there is a high degree of uncertainty; private banks do not know whether the deal is STS or not because the entire framework is not in place. There are concerns about the reporting requirements and how to integrate them into due diligence, and with how to use the STS verification report. Another crucial issue is how to implement the very complex regulations, and who private banks need to turn to for advice about the interpretation. One of the regular issues on the market is that private banks are always referred to the Level 1, which is often very difficult to interpret.

A policy-maker stated that the European Commission has recently seen some STS issuance. That is surprising because the Level 2 standards are not there; some people are basing it on the drafts that the ESAs have submitted, which is encouraging. That shows that there is interest, and hopefully there will be more adoption when all the rules are in place in the second half of 2019. If this discussion was had in Q1 2020 then everyone would be better informed to make a judgement call.

An industry representative agreed. Deals have been delayed due to a lack of framework. There is a large discrepancy and no realignment of regulatory capital treatment. If an insurance company buys a 30-year mortgage pool it would receive 3% capital. If it bought a three-year mortgage backed security, it would get 3.5% capital. If it bought a leveraged loan portfolio it would get 28% capital. If it bought a AAA leveraged loan portfolio then its capital would be about 75%.

2. Existing approaches for regulation securitisation

2.1. Globally fragmented securitisation markets

An official agreed that the insurance framework is clearly not harmonised globally. On the banking side it is a treatment for securitisation provided by the Basel Committee, and normally applied by US banks. The US is against STS as they feel it is too lenient, and that Europeans are having a lax approach to the holding by banks. LCR is also a Basel standard, so securitisation in the US is thriving.

An industry representative stated that three weeks ago their company undertook a global comparison of the major jurisdictions in the world in terms of the securitisation framework. The conclusion was that there is no uniformity and that it is actually fracturing the market. The market is becoming regionalised and segmented, as opposed to unified and global. A key difference between Europe and the US is risk retention. There are many countries in the world which do not apply risk retention. That is a cost to the issuer, and in many cases, it may not be really necessary.

Liquidity treatment differs across the world. Europe has one of the better treatments, but there is a large discrepancy between the liquidity treatment of STS, RMBS and covered bonds. It is 70% versus 15%, and a 7% haircut versus a 35% haircut. There are large differences in the capital treatment of securitisation across insurance companies. In the US the treatment is exactly the same as corporate bonds. In Europe the numbers are quite dramatic; it is not possible to transfer risk from the banks to the insurance companies, especially mezzanine risk.

There is also an issue with STS and STC[1]. Europe is the only jurisdiction which has STS in a much more developed way. As of April 1, the Japanese regulation introduced a Basel-type of STC, but it does not automatically recognise European STS into Japanese TSC treatment. As a result of that there are discrepancies among the lack of mutual recognition, which consequently means the regulations are not coherent. Europe is in some of the worst positions because it will end up buying its own product and will increase the concentration within the system.

EU banks will not be able to transfer risk abroad or more towards the insurance companies. This is not atypical, because it is the same story with the covered bond market. 50% of covered bonds are bought by the banks, they use as collateral for ECB operations. The ECB holds 270 billion of covered bonds. More systemic risk for the covered bond system is created, and the restriction on the securitisation system also prevents transferring the risk out of the banking system. There are many issues that need to be tackled but putting layers and layers of requirements will not help. STS has 102 criteria, and it is doubtful that many more can be added.

2.2. Strengths and weaknesses in EU and US markets

An industry representative believed the elephant in the room is the large housing loan securitisation market. That is the only one where private banks can find depth and breadth since this is where they can build zero risk securities; the famous European risk-free bond. Such a risk-free security should be the senior tranche of a mortgage backed security sponsored by a government entity. Yet, every time that is stated to somebody from the authorities in Europe, they will say they do not want any government or public entity to be mixed with that and committed to anything. That is more evidence that Europe does not want securitisation.

A policy-maker stated that the discussion of government sponsored entities is for the next European Commission because everything being discussed is primary legislation. It cannot be changed by the ESAs in regulatory standards. It is not for these regulatory standards that are being developed, but something may need to be done in the next Commission when the securitisation regulation needs to be reviewed. The US model is an interesting idea but relies on several things, including a harmonised mortgage credit market that Europe may not have to the same extent. Guarantees by state and by budget are also unknown as to whether there is willingness in Europe to put that on the table.

2.3. Covered bonds versus securitisation

A policy-maker stated that the difference is that covered bonds are dual recourse. There is ‘full skin in the game’, which should be reflected in the prudential treatment.

An industry representative stated that by nature covered bonds have less risk than a securitised product, but the difference between the quality of a covered bond and the quality of a senior tranche of a properly securitised product should not be that big. It should be very limited; although covered bonds are less risky due to double recourse.

However an industry representative queried whether the dual recourse in covered bonds will effectively work since they have not found practical evidence on this as it has never been tested. Conversely, securitisation has been tested in rough times. Dual recourse means that the holder or investor who first claims the collateral then becomes senior unsecured pari-passu creditor of the bank. Dual recourse therefore depends on the bank foreclosure and bankruptcy regime, and what kind of recovery there will be. It is unknown how long that would take. There is no proper evidence or legal guidance of how would be handled multiple maturity covered bonds that are outstanding when a bank goes bankrupt; they may end up repaying the shorter maturities and losing money completely.

Another aspect is the existence of conditional pass-throughs, which are covered bonds which extend immediately upon insolvency of the bank. A conditional pass-through is good, because if the bank goes insolvent the bond is extended for up to 20 or 30 years as long as the maturities are there. That means that the investors would recover their money, but this same point is held against RMBS because RMBS is a pass-through security and therefore banks are being told that they cannot look into a pass-through on a weighted average basis, but on legal final maturity, which banks are still waiting for the RTSs to be able to calculate.

The covered bond market is necessary as it is a very good funding tool. It diversifies the investor base and brings longer maturity funding for the banks. However, it would make sense for all the new jurisdictions which introduce covered bonds to impose them, such as not being able to encumber more than 6-8% of assets. In this respect, one of the points that could be examined in the future is why there was a parallel existence of covered bonds and RMB in Australia and the UK.

Securitisation would allow risk transfer away from the banking system. Banks needed to transfer risk, but a covered bond does not allow that. Raising capital is also expensive. Non-banks rely on RMBS, and if there was issuance of RMBS in the UK this year most of it came from them. The two products should not be juxtaposed, but there are elements which have to be realigned. The two products should ultimately be allowed to function and support the banking system and the economy.

2.4. Ways forward

An industry representative suggested that in the short-term the technical standards be finalised in such a way that maximum flexibility is introduced, as the Level 1 framework is very rigid and demanding. The Commission needs to talk to the SSM about securitisation and the real, significant risk transfer they allow. At the moment the SSM is not completely sure that there is a significant risk transfer associated with securitisation as private banks practise it. If the significant risk transferred is not recognised to the issuers, then they have no incentive to issue at all.

An official summarised that everybody is waiting for finalisation of the standards. Level 1 needs to be examined but is a problem for the next European Commission. Most importantly, buyers need to be looked at, as they could be the regulated field of insurance.

1. Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) jointly produced a paper in December 2014 on Simple, Transparent and Comparable (STC) securitisations.