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The “Securitisation Regulation”: Missing the Target?

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Executive Summary

> With its proposal for an EU regulation on securitisation, the European Commission tries to strike a balance between the funding opportunities that this financial practice could bring and the specific risks that it entails.

> The proposed regulation would introduce a differentiated, advantageous, prudential treatment for securitisations that are “simple, transparent and standardised”. In this way, it tries to deal with some of the most pressing issues identified with securitisation during the Global Financial Crisis in 2008.

> However, the proposed regulation still presents shortcomings and uncertainties, leaving doubts as to its capacity to boost investments and avoid risky practices.

> While aiming at re-orienting financing towards SMEs, employment and growth, the proposed framework is unlikely to actually bring significantly higher funding to firms, and could fuel real-estate bubbles.

Securitisation, a financial practice that appeared in the 1960s and peaked in the run up to the global financial crisis of 2008, is nowadays presented by policymakers as a promising tool to revive a sluggish European economy by channelling funding from capital markets to firms, notably Small- and Medium-Sized Enterprises (SMEs). It entails pooling contractual debt, such as mortgages, auto loans or credit card loans, and selling the related cash flow to investors in the form of securities. The European Commission has made a proposal for a new regulatory framework for securitisation (the Securitisation regulation), as a first building block of its Capital Markets Union (CMU), trying to balance two objectives: creating growth and jobs and ensuring financial stability. However, some of the proposed criteria to identify “Simple, Transparent and Standard (STS) Securitisations” are raising doubts, as is the proposed mechanism for supervision. Finally, there seems to be no guarantee that the proposal will channel funds mostly to innovative SMEs, but rather again to residential loans. This Policy Brief reviews the rationale for regulating the practice, and some of the main questions arising from the Commission’s legislative proposal.

From the shadows to the spotlight: the case for regulating securitisation

Securitisation, a financial practice that was mostly unknown beyond the relatively limited circles of finance until 2008, had its 15 minutes of fame when it allegedly triggered the biggest financial crisis the United States and the world had known since the Great Depression.

What is securitisation? It is a funding technique for banks, which consists in converting exposures such as loans to households and SMEs into tradable securities that they can sell to investors on capital markets. Concretely, the loans are sold to an *ad hoc* structure – a Special Purpose Entity (SPE) – that finances their purchase through the emission of tradable securities on capital markets. The SPE then collects payments of interests and principal on the loans, or receivables, and distributes this cash flow to the investors. For banks, securitisation aims both at raising capital on the market in order to meet their regulatory capital requirements (the amount of highly liquid assets they must hold in order to face liabilities in periods of stress), and to reduce those very same requirements by shifting some of the risky assets off their balance sheet. Indeed, when loans are securitised, the investors, not the bank, bear the risk of non-repayment (the ‘credit risk’). The cash that the bank kept as provision is thus freed and can be used to extend new loans. For investors, this technique creates new financial instruments into which they can invest their money.

Presented in this way, securitisation may look like a good idea for all parties involved. However, as Verena Ross, Executive Director of the European Securities Market Authority (ESMA) sums it up in a recent hearing in the European Parliament (2016): "As a funding tool, it (securitisation) can contribute to a well-diversified funding base. As a risk transfer tool, it can also act to improve capital efficiency and allocate risk to match demand (…) on the other hand, it is also recognized that when not properly used, securitisation can become a significant destabilising factor." In the run up to the financial crisis of 2008, in the US but also in Europe, poor standards governing the selection of underlying assets led mortgage lenders to issue loans to ever riskier borrowers and to households ever more unlikely to repay – the infamous 'subprime' mortgages. This 'credit risk' was assumed to be mitigated, since all loans were backed by the borrowers' houses. However, banks and investors, on the basis of inadequate models, wrongly assumed that prices on the housing market would keep rising so that even in case of non-repayment of the loans, the losses could still be absorbed by seizing and selling the houses. Even if the houses were to lose value, securitisation was supposed to pass on the losses to investors. However, when the subprime crisis hit, the complexity of contractual arrangements in the securitisation process and in derivatives markets, strongly interconnecting all the major banks and investment funds in the US and Europe, made it impossible to clearly assess the respective losses of each individual financial institution. Thus, by September 2008, an accumulation of inappropriate standards and practices used in the securitisation process led to a dramatic loss of confidence on global financial markets which brought them to a complete standstill.

"Simple, Transparent and Standard Securitisation": a step in the right direction, but doubts persist

Against this backdrop, the regulatory puzzle faced by policymakers is how to revive this activity while correcting the pre-crisis malpractices and inadequate standards. The proposal put forward by the European Commission "laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation" (2015: 1) aims to create a label identifying safe securitisations and promoting it as a way to channel funding from capital markets to SMEs.

The regulation under discussion includes a list of 55 criteria that a securitisation should comply with in order to qualify for the STS securitisation label. As the Commission stated in the introduction to its proposal: "The "STS standard" does not mean that the securitisation concerned is free of risks, but means that the product respects a number of criteria and that a prudent and diligent investor will be able to analyse the risk involved" (2015: 15). The criteria therefore aim at mitigating the risks arising from the process of securitisation itself such as modelling risk, agency risk and legal risk, allowing the investors to focus their assessment on the credit risk of the underlying assets. The purpose of this distinction between 'good' and 'bad' securitisation is to introduce a sort of premium for engaging in STS securitisation, in the form of lower prudential capital requirements. In the discussion, however, some points of contention have emerged on these criteria. They are detailed below.

Tranching

The inclusion of tranching in the STS-compliant securitisation process has been criticised by civil society organisations, such as Finance Watch, and economists. They argue that tranching introduces extra complexity in the securitisation process and makes the risk assessment difficult for investors. Tranching refers to the creation of different classes of securities in the capital structure of the SPE, with different levels of seniority, the most senior tranches being less exposed to the underlying credit risk than the junior tranches. It allows the securities of the most senior tranches to get a better rating, higher than traditional unsecured debt securities and higher than the original pool of underlying assets, thus enlarging the pool of very safe assets in which institutional investors who are very risk-averse can place their funds. Yet, as Antoniades and Tarashev (2014: 37-38) have shown, tranching creates uncertainty for tranches in the middle of the structure: "mezzanine tranches would be subject to considerable uncertainty because of the so-called cliff effect: a small estimation error could mean that the risk of such a tranche is as low as that of a senior tranche or as high as that of a junior tranche." If tranching is to be allowed, then additional safeguards are necessary in order to reduce the uncertainty or mitigate the potential risks attached specifically to mezzanine tranches.

Synthetic securitisation

In contrast to 'true sale' securitisations, the classic type of securitisation described above, in synthetic securitisation, the underlying assets – the loans – are not transferred from the bank's balance sheet to the SPE's balance sheet, only the credit risk is transferred. This is done through a guarantee or a derivative contract – e.g. a credit default swap (CDS) – sold by the SPE to the bank. Concretely, the SPE and the bank agree that if the credit risk materializes – borrowers do not repay their loans – the SPE will pay a certain amount to the bank as a compensation for the loss. In exchange, the bank pays a regular premium to the SPE, which issues debt securities backed by this cash flow that it places to investors on capital markets to raise the money it needs to pay the bank in case of defaults on the loans.

A transfer of assets can be a complicated operation on the legal side, and in some cases it can be impossible, notably for some loans to SMEs. Synthetic securitisations allow the risk transfer without requiring an actual transfer of assets. There are however two main issues with synthetic securitisation. First, instead of just taking the credit risk off the bank's balance sheet, it replaces it with a new counterparty risk (the risk that the SPE does not have the funds to pay in case the CDS is activated). Second, the derivative contracts linking the parties can vary greatly in their conditions, introducing greater complexity in the operation. The European Commission had originally proposed to exclude – at least temporarily – synthetic securitisations from the STS standard, following the European Banking Authority (EBA)'s advice that there are currently no established criteria to assess the quality of these securitisations. However, in his draft report on the Commission's proposal, the rapporteur for the European Parliament, Paul Tang, tabled amendments allowing their inclusion on the grounds that this technique allows the banks to manage their on-balance sheet risk more efficiently, thus freeing capital for other loans to the economy.

Risk-retention: keeping incentives aligned

The poor quality of the underlying assets has been one of the major sources of risk in pre-crisis securitisation. This securitisation of bad loans – the famous 'subprime' mortgages – has been related to what is called the 'originate-to-distribute' model: issuing loans meant to be securitised with lower quality standards than the ones to be kept on the originator's balance sheet. This model resulted in 'cherry-picking', with banks keeping the 'safe' loans on their books, and securitising the riskier ones. In that model, the incentives of the originator and those of the investors went in opposite directions: while investors were looking for safe investment opportunities, the banks were offering risky loans in bulk. The poor quality of these loans was hidden behind their sheer number and credit enhancement techniques.

A partial solution has already been integrated in the Capital Requirements Regulation (CRR) of 2014 in the form of a requirement for the bank originator of a securitisation to retain on its book the riskier 5% of the securitisation, thus keeping some 'skin in the game' and absorbing the first losses on the pool of securitised assets. The Securitisation regulation introduces as part of the STS criteria the requirement that securitised loans should be underwritten following the same standards for risk assessment as those kept on the balance sheet.

While these requirements are likely to promote higher underwriting standards for the loans banks issue and limit the credit risk related to underlying assets, some argue that the risk-retention rate should be higher than 5% for the banks' incentives to be fully aligned with those of the investors. Finance Watch, as well as a group of 83 economists, thus advocate for a retention rate of 20%. The EBA, however, argues that there is no evidence that higher rates of retention provide better results, and that a rate of 5% allows STS securitisations to qualify for the prudential treatment for significant risk transfers.

EU-level supervision: the unanswered question

Regulation, however well-conceived, is rather useless without a proper enforcement mechanism. For securitisation, the proposed regulation leaves it to the national supervisors to monitor the respect of its provisions, including the 55 criteria for STS securitisations, and to sanction non-compliance. Uniform interpretation of the provisions and coordination of their implementation – which are paramount for the desired cross-border European securitisation market – is supposed to be provided by the ESMA.

Necessary cross-sectorial supervision

It is worth noting that not one, but three of the European Supervisory Authorities have been working on securitisation – the European Securities Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the EBA – reflecting the fact that securitisation closely links one of the core activities of commercial banking – issuing loans – to capital markets and institutional investors, among them insurance companies.

In its proposal, the European Commission suggests that the three authorities work together on securitisation in the framework of their joint committee, a solution also used for the supervision of financial conglomerates. As a matter of fact, cross-sectorial work on this issue makes sense. Each of the three authorities covers more specifically a part of the process and a set of actors. Excluding one of them would probably lead to sub-optimal supervision structures.

However, dividing the tasks between the three authorities might be difficult in practice: monitoring developments along the securitisation chain requires keeping a larger view of the system and monitoring all actors' behaviour, which will require extensive communication and coordination.

Beyond coordination, the need for a single EU-level supervisor

Véron and Wolff (2016: 133) consider that “the EU should enhance its system-wide surveillance (…) the surveillance of a more complex financial system in which the role of banks could gradually become less dominant implies new challenges, which call for an adequate infrastructure”. While it sought to reduce the role of bank intermediation in the European economy and give more space to capital markets funding, it is surprising that the plan for a CMU does not foresee any specific arrangement to strengthen supervision in this sector.

It has been said that the institutional implications of the project for a CMU – a European securities market supervisor – had been kept for after the UK referendum on EU membership, out of fear that they would reinforce the pro-Leave campaign. We could thus expect this question to come back on the agenda soon enough if the UK does indeed make use of Article 50 TEU and leaves the EU. However, this still seems highly unlikely: creating a new institution with strong competences would be a bold step that most governments would not advocate as long as there is no major crisis to resolve in relation to capital markets. And since the current narrative is that European securitisations, in contrast to US securitisations, performed well during the crisis the probability of a crisis is perceived as low and the existing infrastructure deemed adequate.

However, if the ultimate goal really is the development of an EU-wide market for securitisation, then more than mere coordination will probably be required. The current framework can design common templates, but what about assessing the quality of a securitisation that would aggregate loans issued in different countries? The development of such cross-border securitisation may require a far more uniform implementation than the current system allows. Even though it may not be the most pressing issue at this point, policymakers should keep the door open to further institutional upgrades in the medium term, transforming the ESMA into a fully-fledged European securities markets supervisor.

A better allocation of capital in the European economy?

If the legislator does manage to adopt a regulatory framework that is sufficiently clear for both issuers and investors to engage in the securitisation market, fully aware of and informed about the structural risks involved in the products and of the underlying credit risk, and if that supervision is efficiently coordinated so that there is no major discrepancy in supervisors’ interpretation of the rules, it could be argued that on a micro-economic level, all is well: only reliable borrowers obtain loans; banks securitise these loans in a simple manner, and include all the relevant information on the underlying exposures; investors place their money in assets that correspond to their own appetite or aversion for risk and make a financial gain through the interests on repayment.

Yet even in that best-case scenario, there is absolutely no guarantee that the funding thus raised on capital markets will support sustainable output growth in the real economy. Indeed, the two main classes of securitised assets are residential mortgages (Residential Mortgage-Backed Securities, RMBSs) that constituted 59% of all new issuances at the end of 2013, according to the EBA report on securitization) and, far behind, loans to SMEs (8%). The reason behind the preference for RMBSs is clear: residential mortgages are generally more homogenous, and information is much easier to collect and process than for loans to SMEs, making the credit-risk assessment easier.

Where the securitisation market for SMEs has been strong in recent years (i.e. Italy and Spain), banks have retained most of the securities thus created on their balance sheets and used them as eligible collateral for the ECB’s refinancing operations, in large part because of the low demand from investors for these products. Clearer and more transparent information on SME credit could help steer investors’ demand for securitised SME loans. However, considering that, by nature, loans to SMEs are diverse, difficult to standardise and costly to document, this funding channel would only make a difference for a limited number of larger SMEs.

Bertay, Gong and Wagner (2015) have shown that this relatively easier securitisation process for loans to households results in a distortion of banks’ lending behaviour: banks prefer lending to households for housing and consumption rather than to firms for investment because they know they will be able to easily shift the loans off their balance sheet. And since there is only a finite quantity of capital to be allocated, more loans to households means less to SMEs. They conclude that the development of the securitisation market so far (their study covers the period from 1995 to 2012) has not increased funding for investment and capital formation by SMEs but to the contrary constrained the supply side of the economy in countries where securitisation has developed the most.

If one recalls that in the run-up to the global financial crisis in the US, but also in some European countries such as Ireland and Spain, investors' demand for RMBS flooded money into the housing market, creating a credit and a real estate bubble, it may be argued that this path to economic growth has already proved unsustainable. While it injects capital on the demand side to boost economic output in the short run, the crisis has shown that it also leads to a lack of productive investments, which resulted in a loss of competitiveness in the peripheral members of the Eurozone.

Securitisation probably is not the main factor explaining this lacklustre investment in the Eurozone periphery before the crisis, but it appears to be a contributing factor. There is thus no reason to expect securitisation to naturally allocate capital to firms, let alone SMEs. If the goal of the Securitisation regulation really is to allow a better allocation of capital to support innovative SMEs and a sustainable path to economic growth, then the class of underlying assets that are to be securitised should be a major concern: if capital does not naturally flow towards SMEs, it should be directed towards them.

Beyond financial stability, focus on economic growth in the EU

Any attempt to divert capital away from securitised loans to households and into securitised loans to SMEs would entail interfering with the way banks conduct their business, in the pursuit of a clearly oriented policy goal, beyond setting a mere 'level-playing field' between financial activities.

In the current context of political turmoil and social unrest across Europe, the EU cannot afford another decade of sluggish economic growth and mass unemployment, nor another unsustainable credit bubble followed by a financial crisis. This conundrum should lead EU policymakers to search for a middle way: regulation should allow the revival of securitisation, since it currently appears to be one of the ways to channel funds from capital markets to the real economy, but only as long as it does fuel an innovation- and jobs-rich economic growth, not unsustainable asset bubbles. To ensure this, what is needed is a robust and clear legal framework eradicating the risks arising from the securitisation process itself. At the same time, it is necessary to establish a strong supervision of securities markets at EU-level, and entrust it with the necessary powers to make sure the funds go to the economic sectors which are actually in need of funding

Without this broader outlook on the needs of the real economy, restoring the securitisation market may well miss the target and end up doing nothing more than helping banks restore their profitability – through the fees collected on issuance and servicing – without any significant advantage for society at large.

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