The Return of Securitisation of Assets to the European Financial Scene...Will we get it right this time?

Catholic University of America in cooperation with Georgetown - Washington DC - April 2016

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I - Securitisation - Introductory Remarks

• In a curious twist of history and of the evolution of the financial sector we are witnessing some form of reurrection of securitisation only a few years after securitisation and structured finance have been widely deemed as one of the key causes of the global financial crisis (2007-2009).
• It is therefore interesting to critically discuss and put into perspective this “ressurection”, which is taking shape particularly in the EU.
• It is accordingly an European approach to securitisation that will be discussed, albeit in an international context.
I - Securitisation - Introductory Remarks - cont

• Actually, although for more than understandable reasons the securitisation market suffered substantially after 2008, and has largely remained in decline due to post-crisis investors’ stigma, there are distinctively European reasons which have led to brainstorming and, afterwards, institutional debate oriented towards its revival.

• This results from the fact that it has been argued – and to a large extent consistently – that the decline of securitisation has deprived the financial sector in the Eurozone of a much needed diversified funding source and of a mechanism that allowed banks to spread the risk of their investments.
I - Securitisation - Introductory Remarks - cont

- This overall view towards a rehabilitation of securitisation has been gradually voiced by various stakeholders and also ultimately at the level of the European Commission – See, as representative of such new trend - Hill J. (2014) “Capital Markets Union – Finance Serving the Economy”, European Commission Speech, Brussels 6 November 2014 (accessible at Internet).

- It has also led to a number of public consultations which been initiated by policy-makers, not only at EU but also at international level, to reprise the securitisation market without incurring the same errors that characterised pre-crisis practices – But is it possible to have the best of two worlds?
Before addressing this crucial question and potential trade-offs at stake it is important to start from an operative general notion of securitisation and asset-backed securities:

An **asset-backed security** is a bond obligation, the return on which is based on a **pool of assets (in general loans) originated by a credit institution**. This pool of assets is transferred to a special purpose vehicle (SPV), that will sell a note (the ABS) to finance the acquisition of the assets. The risk of holding the assets (the collateral) is transferred from the credit institution to the investors that will buy the ABS notes. The pool of assets will be ‘serviced’ by a servicer, whose role is to monitor and collect the credits from the borrowers, and assess the evolution of the quality of the pool through time.
Securitisation – Introductory Remarks - cont

• (notion of securitization – cont.) – (...) The assets can be transferred in a fixed amount at the beginning of the operation, or the pool can be replenished over time with newly originated credit. The quality of the pool will be assessed before being transferred to the SPV and analysed to estimate the potential deterioration (probability of default) during the life of the transaction, and the residual value of the pool in case of high default levels. The pool can be sliced and diced by type of credit (for example car loans or mortgage loans), by the characteristics of the credit (residual maturity, frequency of repayment), cost of credit, type and amount of interest (fixed or floater or prepayment risk), and by the characteristics of the borrowers (consumers and companies). These features underlie the portfolio risk profile.
I - Securitisation - Introductory Remarks - cont

• Focusing on the EU, the tentative trend to revive securitisation has led to a momentum of technical papers and position papers in this field.
• There seems to be almost a **European roadmap towards the revival of a new and transformed securitisation market in Europe**.
• Some noteworthy steps of this **roadmap** towards a “**reinvented securitisation**” include the **following 5 STEPS** *(worth of a critical reading and some pondering)*:
  • **(1)** In April 2014 the Bank of England and the European Central Bank (BoE/ECB) published a joint paper on the impact of the securitisation market in Europe -“**The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal with Them**”
I - Securitisation - Introductory Remarks - cont

- That was followed by a more detailed examination of the benefits of securitisation and the impediments that currently prevent its resurgence – (2) BoE, ECB (2014b) “The Case for a Better Functioning Securitisation Market in the European Union” - Discussion Paper, May 2014;
- This has, in turn, been followed by responses from relevant stakeholders which provided a useful insight into the conflicting interests underlying the consultation process – see (3) BoE, ECB (2014c) “The Case for a Better Functioning Securitisation Market in the European Union – Synthesis of Responses”, October 2014.
I - Securitisation - Introductory Remarks - cont

• In the wake of such developments The EU Commission started its own consultation process on a framework for what has been suggestively designated as (4) a Simple, Transparent and Standardised Securitisation - STS Securitisation (EU Commission Consultation Document (2015) “An EU Framework for Simple, Transparent and Standardised Securitisation”;

• And this Consultation led to a very recent (5) EU Commission Proposal for a Regulation on Securitization (2015) COM(2015)472 Final – of 30 September 2015;

• Other relevant and converging initiatives in this sense included the IOSCO/Basel joint task force aimed at defining criteria to identify simple, transparent and comparable securitisation (BCBS, IOSCO 2014).
I - Securitisation - Introductory Remarks - cont

- It must be emphasized that the EU initiative to revive securitisation is part of a broader design, aimed at building a single market for capital (so called capital markets union (CMU), EU Commission Green Paper 2015).

- This is anchored on a longterm policy goal to create a pan-European securities market centred on the development of disintermediated capital markets products alongside the more traditional intermediated banking ones (something that has been hard to develop in Europe). A well-functioning securitisation market, freed of the flaws that characterised the pre-crisis years, is envisaged as the key element of this project of the Capital Markets Union.
The idea of “high-quality” securitisation, endorsed by international standard-setters – primarily IOSCO and IMF – is broadly conceived as encompassing (i) simpler structures with (ii) transparent underlying assets and (iii) predictability of risks and performance. These features led to the development of the so called STS criteria (in the EU) which are believed to contribute to a more robust securitisation market that could adequately perform the allocative and intermediation functions that have been missed since 2008.

**But is this combination of features feasible? And how?**
II - STS Securitisation - How?

- The structure and development of European financial markets is traditionally compared to the US counterparts. It is commonly claimed that savings in Europe are concentrated in the banking sector, and that assets held by non-bank financial institutions in Europe are low compared to the US. This is mirrored by a lack of depth in European capital markets, where the value of equity, corporate bonds, and securitisation represent respectively 60%, 35% and 20% of the US markets – see Anderson N., M. Brooke, M. Hume, and M. Kurtosiova (2015) “A European Capital Markets Union: Implications for Growth and Stability”, Bank of England Financial Stability Paper n.33; Achieving a greater diversification of financing channels and reducing the alleged over-reliance on banks is one of the central goals of CMU – and SECURITISATION is instrumental for that.
II - STS Securitisation - How? - cont

- It has also been argued that the over-reliance on the banking sector impaired the quality of European banks’ balance sheet in the aftermath of the crisis, and that their limited lending capacity led to higher funding costs even for high-quality borrowers.
- The same did not happen in the US, where the more diversified financial system allowed alternative financing channels – capital markets-based – to meet funding demands and thus bring a quicker recovery from the crisis.
- That assessment fails to sufficiently appreciate that the European banking system had become increasingly weakened in the pre-crisis period, because the large universal banks were over-dependant on wholesale sources of finance – Furthermore EU banks have not had a federal program of support like the TARP program in the US – So comparisons unfair...
II - STS Securitisation - How? - cont

• We may try to assess reasons that can justify the stagnation of securitization in the EU. It has been widely recognised that banking regulation enacted after 2008 is one of the factors that impede the securitisation market from restarting (BoE, ECB 2014, p.2). In particular, the new regulatory capital regime in force since January 2014 brought changes to the retention rules for securitisation (Directive 2013/36/EU CRD-IV). It is contented that risk-retention requirements under Capital Requirement Directive (CRD-IV) will create costs for originators and their inconsistent application across jurisdictions may hinder the development of a pan-EU market.

• Beyond regulatory intervention, the persisting over-reliance on credit rating agencies (CRA) is also problematic...
II - STS Securitisation - How? - cont

- The overarching EU policy objective is to **restart the securitisation market** in a sustainable way that could ensure **financial stability** and **investor protection**. To this end, the **STS framework** is aimed at making risks easier to assess and analyse for investors, and at the same time transactions that comply with the STS criteria would be subject to a more risk-sensitive regulatory approach – but is this achievable?

- Supposedly these goals would be achieved by firstly, limiting the tendency to concentrate risks in systemic institutions. STS securitisation is conceived to realise an effective distribution of risks across the financial system, where asset-backed securities would be held by less leveraged institutions
II - STS Securitisation - How? - cont

• Secondly, a number of features are designed to improve the **predictability of the transaction** especially with respect to its performance. This would enhance investor confidence and demand for securitised products, because the interests of issuers and investors would be aligned and the transaction’s simplicity would allow a more controlled relationship between SPV and issuer. The idea of **simplicity in the transaction chain** is also central to control the linkages that certain types of securitisation create with the shadow banking system (SBS).

• **Again – Fine goals – sound conceptual matrix – But are these actually achievable? – Predictability and Simplicity – how to make these key conceptual goals truly operative and effective?**
II - STS Securitisation - How? - cont

• The tentative positive answer of the BoE/ECB – and also the EU Commission – relies on three main steps, namely:
  a) **standardised disclosure of information**;
  b) **transparency of credit ratings**;
  c) **design of ancillary facilities** (in fact, to mitigate a securitisation SPV’s credit risk, credit rating agencies require that institutions acting as swap counterparties and/or providing issuer accounts and liquidity/credit facilities meet certain rating requirements.

But the availability of counterparties eligible to provide such ancillary services is thus very much constrained – it would be important to find ways to consistently facilitate those ancillary services...)

II - STS Securitisation - How? - cont

Those steps towards simplicity and predictability rely in turn in a set of 6 high-level principles established by the BoE, ECB, E. Commission that cover areas related to: 1) the nature of securitised assets, which should not reference complex formulae or derivatives; 2) the performance history of underlying assets, which should be verifiable and available to investors; 3) the ultimate obligors, to which the securitisation will have recourse, with no possibility to rely on derivative-like claims; 4) the expectations of payment, whereby originators will have to demonstrate that the receivables are a homogeneous asset type and consistently originated in the course of business; 5) the receivables transferred to the securitisation, which should be current in payment and not include delinquent obligations; 6) the security – if receivables are secured over specific assets – which should be first-ranking
II - STS Securitisation - How? - cont

• In this context key features of the Commission Proposal of a Securitisation Regulation comprehend in particular a regulatory mechanism that revolves around a **private notification process** (article 14 of the Proposal) instead of a system of public certification

• According to article 14 of the Proposal R, originators, sponsors and SSPE's shall jointly notify ESMA (European Securities Market Authority) by means of a **template** specified in this article that the securitisation meets the **Requirements** of Articles 7 to 10 or Articles 11 to 13 of this Regulation ('STS notification') [requirements on **simplicity** (underlying exposures transferred from the seller to the SSPE shall meet predetermined and clearly defined eligibility criteria), **standardization** (set of key standard conditions specified in the Regulation) and **transparency** (comprehending access to data on static and dynamic historical default and loss performance)]. ESMA shall publish the STS notification on its official website
II - STS Securitisation - How? - cont

• So, Investors will still need to perform thorough due diligence before investing in STS securitisation, and this will be *merely facilitated* by the **STS notification** communicated to ESMA by the originator, and by information provided by originators, sponsors and SPVs. While it is certainly acceptable that investors will have to conduct due diligence beyond relying on the STS label, the above process is not complemented by an adequate supervisory framework, due to the limited role attributed to ESMA.

• But, accordingly, in this rather hybrid solution - compliance with the STS requirements will basically rest with originators and investors, while the role of supervisors will be limited to monitor market developments – the Regulators are not involved in the certification process.
II - STS Securitisation - How? - cont

• The Commission’s reluctance to involve a regulator (presumably ESMA or an authority set up for the purpose) in the **certification process** stems from some misplaced arguments. Much of the rationale behind it seems to flow from the failure of third parties, such as credit rating agencies (CRA) most prominently, in the years preceding 2008. The Commission argued that investors’ reliance on labels provided by third parties would generate poor due diligence and moral hazard. While this may be accurate in principle, it is difficult to associate the **ex-ante role of a public regulator**, with the above concerns related with past failures of CRA.

• So the **overall balance** between compliance resting with originators and some degree of certification by public regulators should have been different...
II - STS Securitisation - How? - cont

• The Commission has also excluded the involvement of a public authority in standardisation efforts. The Commission’s argument is that while a degree of standardisation is to be favoured because it would lead to more consistent market practices and more certainty for investors, this should be left to industry associations (EU Commission Proposal 2015, p.8).

• This approach raises concerns related to the ability of market-players to recognise the systemic effects that certain market practices can have and the level of risk they can create.
II - STS Securitisation - How? - cont

• In the years before the crisis reliance on CRAs had become indispensable in the context of these transactions because of the difficult assessment of the underlying assets’ risk, which investors could not supplement. The role of rating agencies went beyond the rating of structured securities. They provided a number of ancillary consulting services related to the products they would subsequently rate and in particular they advised on how to structure the transaction in order to receive a triple-A rating.

• BUT, the regulatory goal in the EU to limit regulatory reliance on CRAs is at odds with the persisting complexity that generates from tranching. The question that still remains unanswered is how originators and investors will supplement the function performed (admittedly quite badly) by CRAs to mitigate the information asymmetry that derives from complex transactions.
II - STS Securitisation - How? - cont

• Regulatory intervention in the EU in the area of CRAs has followed a twofold strategy after 2008. On the one hand, EU legislation has sought to increase transparency and disclosure of credit ratings through enhanced supervision of CRAs, conducted chiefly by ESMA (Regulation 513/2011, amending Regulation 1060/2009).

• On the other hand, as already highlighted, there has been a move to limit regulatory reliance on external credit ratings, to be replaced instead by either internal models or more standardised and simplified forms of disclosure to investors. The approach endorsed by the Commission in its 2015 Proposal is clearly leaning towards increased disclosure of information in a more standardised way in order to reduce reliance on third-party ratings.
II - STS Securitisation - How? - cont

• ANYHOW, CRAs will still play a relevant role in structured finance in the foreseeable future, given the necessity to have information intermediaries between originators and investors, and the relative complexity of all securitisations, even STS.

• Hence, while reduced reliance on external ratings has to be welcome given the widespread failure of CRAs before the crisis, the reliance on internal models as a way to supplement third-party ratings, proposed by the Basel Committee/E Commission, needs to be seen with caution.

• Despite introducing an improved framework and a hierarchy of approaches to assess risks in securitisations, the new approach will allow large banks to employ their internal models to establish how much capital has to be set aside against securitisation exposures.
II - STS Securitisation - How? - cont

- The concern with this policy is that it fails to address two failures that were experienced in the pre-crisis years. The first problem is that internal models rely on assumptions of market discipline which have been largely misplaced. The peril in particular would be to allow large financial institutions to devise internal risk-assessment models that enable artificially low risk measurements and as a consequence arbitrary capital relief, followed by accumulation of leverage.

- Secondly, the question of addressing systemic risk in financial markets is not adequately tackled through a system that remains largely geared to a micro-prudential approach, focusing on the risk-taking of individual banks rather than on the accumulation of risk and leverage system-wide.
II - STS Securitisation - How? - cont

• As regards supervision of STS securitisation more specifically, the Commission has clearly excluded the involvement of a public authority (presumably ESMA) in the certification process, and more importantly article 15 of the proposed Regulation allocates supervisory powers to national authorities, with ESMA playing a marginal coordination role. The notification system moreover, laid out in article 14 of proposed Regulation, places responsibility upon originators and sponsors.

• This mechanism risks leaving too much power to market actors, especially if enforcement procedures are not sound and consistent across national borders.
II - STS Securitisation - How? - cont

• The risk with this system is that it confers a private quasi-regulatory power to market-players, which may not be adequately matched by the competent authorities’ enforcement capacity.

• If too much power is left in the industry, the boundaries of the STS certification could be easily crossed and this could lead to the same undesired practices that were common before the great international financial crisis (2007-2009).
III - STS Securitisation - Conclusion

• The recent history of securitisation however, and more broadly of innovated market-based structured product, has highlighted different applications of the transaction, most notably speculation, and excessive risk-taking.

• Various policy concerns we have been highlighting – e.g. definition of STS, spill-overs into shadow banking, reliance on external ratings, regulation and supervision – suggest that without the necessary adjustments, the proposed framework could still lead to pre-crisis level of risk-taking and leverage. In particular, the above reservations can be broadly divided into two areas of regulatory concern: firstly, at a micro-level, the definition of what STS securitisation should encompass; and secondly, at a macro-level, the institutional infrastructure within which STS would operate
Ultimately, the success of the Commission’s proposal may depend on the degree of transaction standardisation that will be implemented (and accepted by market-players), even though it appears that efforts in this sense will be left to industry initiatives.

But, at the same time, the Commission has not attempted to redefine the institutional structure of debt capital markets. In spite of recent efforts to harmonise the supervision of EU capital markets with the inception of ESAs (and in particular of ESMA), the monitoring of STS securitisation will be chiefly conducted by national authorities and this could give rise to problems of inconsistent implementation and ensuing regulatory arbitrage.
III - STS Securitisation - Conclusion

• An indication of the above regulatory concern is represented by the notification system art 14 of P.Regulation). This mechanisms risks reinforcing the private ordering that has traditionally permeated this area of financial markets. Excessive reliance on the originating parties for the certification of STS criteria may not achieve the necessary degree of macro-prudential control over the transaction’s dynamics...

• **BUT – possible safety valves here?** With a particularly intense and proactive use of art 14/5 of the Proposal of Securitisation Regulation – with ESMA – in close cooperation with EBA and EIOPA – developing Draft TECHNICAL STANDARDS that would specify the Information that the originator, the sponsor and the SSPE have to provide when notifying a particular transaction.
III - STS Securitisation - Conclusion

- A particularly intense and proactive use of art 14/5 of the Proposal of Securitisation Regulation would mean very demanding parameters in terms of specification of information disclosure to benefit from the STS securitization label...

- With ESMA proposing rather constraining Draft TECHNICAL STANDARDS to be ultimately adopted by the Commission (on the basis of powers delegated to the Commission –art 14/5 Proposed Regulation)
III - STS Securitisation - Conclusion

• High level of information requirements (with proactive use of powers of art 14/5 Proposed Regulation):
  
  • (i) reinforcing predictability to all stakeholders
  
  • (ii) and ensuring the basis for prompt compensation for investors in case of failures ex post to comply with aspects stated ex ante under such demanding information obligations....
III - STS Securitisation - Conclusion

- Conversely, if a more stringent - albeit balanced - approach is not adopted, the shortcomings of the private certification mechanism may become apparent when faced with the industry’s creativity and the bounded rationality of market-players.

- Complex regulatory challenges will also stem from the persisting risks of interconnectedness and spill-overs into the shadow banking system. It is not clear how the industry, without the overseeing of a public authority, will be able to forecast and mitigate these problems.
III - STS Securitisation - Conclusion

• So, on the whole, 3 POINTS may be retained:

• 1 – The idea of fostering a new kind of securitisation is important for banks particularly in the european context with their current limitations of access to financing and capital.

• 2 – Within the same context, the idea of a Simple – Transparent – Standardised - Securitisation encapsulated in the 2015 Commission Proposal of Regulation makes sense.

• 3 – BUT – This mixed approach still lacks consistency – A new qualitative balance between industry creativity/CRAs/ and intervention of public supervisory authorities – with a more intrusive approach of these authorities – has to be found........
III - STS Securitisation - Conclusion

THANK YOU FOR YOUR ATTENTION