Securitisation: of lessons learned and things remembered

Note written for Eurofi by Ian Bell

Contemplating the monarchist émigrés who had fled France at the revolution as they came back to power after the fall of Napoleon, Talleyrand – the great political survivor of said revolution, consulate, empire and now restoration – is said to have remarked disparagingly: "they have learned nothing and forgotten nothing".

As Europe contemplates calls for a revival of the securitisation market and the regulatory changes to allow it to happen, one could be forgiven – looking back at the great financial crisis – for thinking that possibly finance also had "learned nothing and forgotten nothing". Yet this is not the case.

A renewed and expanded focus

From the call by the ECB president for a "Kantian shift" to a substantial European capital market anchored explicitly in securitisation to the recent European Commission's commitment to work towards such a market, the voices in favour of a revival of a strong securitisation market have multiplied.[1]

It is worth noting though the change in both the centrality and the context in which this project is articulated.

Calls for a revival of the securitisation market are not new. The Commission and co-legislators' work from 2014 onward resulting in the Securitisation Regulation was explicitly designed to effect such a revival. It is the legislation's failure, for whatever reasons, to achieve its aim that is leading to calls for new measures.

Back then, though, the measures were part of a suite including many other potential reforms and certainly not picked out as uniquely important. But in the recent articles, speeches and reports, the revival of securitisation is presented as both central and essential.

For a long time, securitisation reforms were primarily presented as a means to free up bank capital and allow more financing to the real economy. Today, securitisation's growth is seen in the wider context of the future of Europe in a dangerous world when our economy is seen as falling behind. To underpin Europe's future and social model, a means of channelling European savings to the European economy via the creation of a capital markets union and a strengthening of the banking sector's lending capacity appears almost existential. And for a variety of cogent reasons, securitisation is seen as uniquely able to do this[2]. The debate has moved from "nice to have" for banks to "essential to have for Europe's future."

The suspicion

This essentiality of securitisation makes it, for those who support this view, a major political priority. But this also raises legitimate concerns from those who remain to be convinced.

Are we not being presented with proposals that ask us collectively to jettison the lessons from the crisis? Are genuine concerns for Europe's future on the world stage not blinding us to the dangers we tried to shield ourselves from after the crisis?

Worse, are we not asked to encourage through regulatory incentives the return of a known danger? Is this a case where political expediency is seeking to overwhelm a prudential norm? Are we being

1. Including the ECB Governing Council Statement (March 2024), the Eurogroup Report on the CMU (March 2024), the Letta Report on the Single Market (April 2024), the Noyer Report (April 2024), the Macron-Scholtz joint op-ed in the Financial Times (May 2024) and Commissioner McGuiness speech (June 2024).
2. Refer to PCS Eurofi article in this publication, https://pcsmarket.org/wp-content/uploads/Securitisations-Europes-categorical-imperative.pdf

asked, for the sake of a "greater good" to take very real risks with financial stability?

An analysis of the key proposals demonstrates this is not the case. The core of the proposals coming from industry and many policy makers is about building on the post-crisis reforms and completing to their logical conclusions unfinished parts of those reforms or correcting obvious overshoots.

The proposals

There are, of course, a plethora of proposals to adjust the regulatory rules around securitisation and often different approaches to each specific one. However, from both the industry and policy making side five core proposals have emerged.

- An adjustment of the capital requirements for banks investing in securitisations (the CRR proposal).
- An adjustment of the rules on eligibility of securitisations for inclusion in banks' liquidity coverage ratio pools (the LCR proposal).
- An adjustment to the capital requirements for insurance companies investing in securitisation (the Solvency II proposal).
- Amendments to the mandatory disclosure requirements for securitisation issuances (the disclosure proposal).
- Amendmenents to the mandatory due diligence requirements for securitisation investors (the due diligence proposal).[3]

CRR proposal

In a nutshell, the issue around bank capital revolves around the concept of "non-neutrality". After the GFC, the Basel committee decided – not unreasonably – that securitisation could generate a greater risk than the risk the Basel rules attributed to the underlying securitised assets. These risks were called "agency risks" and the capital formulae for securitisation were tweaked by the insertion of a number (the p factor)[4].

The current proposals all centre around some form of reduction of this *p* factor.

At first glance this could seem like a request arbitrarily to reduce a prudentially calculated number to achieve a political purpose. It is the reverse.

The *p* factor was never "calculated". It was not derived from data or generated by a model. The suspiciously round 100% number was simply chosen as a rough estimate of what felt right to those around the Basel table: a "gut feeling".

What is being requested is an adjustment based on both a conceptual and data driven approach.

Conceptually, since the crisis, European legislation has banned for all securitisations the most severe causes of agency risk. It has also created a strictly defined category – STS – from which pretty much all known agency risks have deliberately been extracted.

So, what is requested is an adjustment of the p factor to reflect the actual performance data for those securitisations which would have been STS before the crisis. A data-based formula to replace the current arbitrary number.

LCR proposal

Only a very limited sub-set of STS securitisations are allowed in LCR pools. Also, those must be of the highest rating category. Should they drop even one rating notch they are instantly excluded. Also, allowed securitisation are consigned to the third and lowest strata of allowable assets with the highest haircut.

There are a number of problems with this approach. First, the EBA's conclusion that securitisations were not sufficiently liquid to be in a higher eligibility category was principally based on GFC data. But the GFC was a crisis triggered by a sub-set of US securitisations. That liquidity should vanish from an asset class during a stress period centred on that very asset class is self-evident. This is true even of the most liquid assets: during the LDI crisis in the UK in 2022, there was briefly no bid for the 30-year UK gilt. That is literally the most liquid sterling instrument in existence. Liquidity in covered bonds was shaken during the sovereign/banking crisis that followed the GFC in 2011/2012.

Since then, the STS securitisation market has demonstrated excellent and testable liquidity. This is the case both in day-to-day trading and in

3. Again, it must be stressed that this is not a complete list, nor should the fact that a proposal does not appear in this list imply that it is not valuable or worthy of examination. But these are by consensus treated as the five key proposals.

4. Basically, a *p* factor of 1 represents a 100% increase in the risk. So the capital required of a bank holding all the tranches of a securitisation is twice the capital required if the bank held all the assets in their natural form. Consequently, a *p* factor of 0,5 represents a 50% increase, etc...

stressed environment such as the LDI crisis where securitisations were the first resort of investors needing to generate liquidity.

The argument sometimes advanced that we have not had a deep liquidity crisis to test this proposition and so we should wait until such a crisis is redolent unfortunately of "generals preparing to fight the last war". Much has happened since the GFC, including in the regulation of securitisation. To ignore all that has happened and expect that next crisis to be like the last could be seen as unwise.

The approach to LCR eligibility has also resulted in a very high concentration of European banks' liquidity pools in a very small number of assets.[5] This means that, in a banking crisis, the banks will be seeking to generate liquidity by selling at the same time the same assets. This is likely to lead to greater rather than less stress on the financial system.

A better approach would be to look at both the data and the events since the GFC that demonstrate STS securitisations' liquidity which in turn would allow for more diversified and balanced LCR pools able to be used from wherever source the instability comes. This approach again is based on analysis of data and seeks to increase prudential safety rather than trade it off for policy aims.

Solvency II

EIOPA is on record as asserting that, when it comes to securitisation, Solvency II is "fit for purpose". This assertion, however, remains difficult to reconcile with certain known outcomes of the current regulation.

For example, an insurance company is required to set aside more capital to meet losses arising from holding a AAA STS prime mortgage senior securitisation tranche than it would for holding the mortgages themselves. This is notwithstanding that the securitisation is protected from losses by a junior tranche that is usually equal in around 10 to 15 times the worst losses ever suffered on mortgages. And, since these are STS securitisations, from which most, if not all, agency risks have been removed, this anomaly cannot be attributed to them.

Another example, from synthetic securitisations: if an insurance company enters as protection provider into a synthetic securitisation in guarantee form this will be on the asset side of its balance sheet. As such it will require a given amount of capital to meet potential losses as required for a "securitisation holding". But if the same insurance company enters into the exact same synthetic securitisation as an insurance contract, that risk will end up on the liability side of its balance sheet. As such it will require, for the exact same risk, a much smaller amount of capital. This is currently resulting in a regulatory arbitrage that is distorting the market for synthetic securitisations across Europe.

These two examples demonstrate that Solvency II is self-evidently *not* fit for purpose.

The request to revise the capital requirements for insurance companies holding securitisations is not a request for indulgence but a request to align the capital requirements for insurance companies to the actual risk they face and, amongst other things, prevent continued regulatory arbitrages.

Disclosure

The regulations require mandatory disclosures for all securitisations. The details of what is required are set out in secondary legislation drafted by ESMA.

Underpinning ESMA's approach would appear to be a sense of the uniquely dangerous and complex nature of securitisations derived from the worst types of transactions issued before the crisis. The result is a hugely extensive, rigid and detailed set of mandatory requirements. Impossibility to meet even the smallest portion can close the door to an originator being able to access this financing channel.

There are a number of issues here:

a) It does not take into account the overall amelioration in the safety and simplicity of European transactions brought about by the rest of the regulatory rules. This is particularly true for STS securitisations, which – in the senior tranches – far from being uniquely dangerous are uniquely safe.

b) No investor we have encountered uses the mandatory disclosure templates in their entirety – if at all – to analyse securitisations or would require, were there no such templates, equivalent disclosure.

c) The number and rigidity of the mandatory fields means that it is extremely unlikely that potential new originators (and especially smaller financial

5. See EBA report (page 88 – HQLA by Asset Class) - https://pcsmarket.org/wp-content/uploads/JC-2022-66-JC-Advice-on-the-review-of-the-securitisation-prudential-framework-Banking.pdf

institutions) have that data in full. This means that accessing securitisation will require IT expenditure that can quickly climb and make this form of financing very unattractive for mid-to-small banks.

d) This type of disclosure is not required of any other capital market instrument, including instruments whose underlying credit is based on asset performance. This results in an unjustifiable unlevel playing field generating yet further regulatory arbitrage.

The legitimacy of mandatory disclosure for securitisation is not being challenged. However, the proposals are for a disclosure regime that takes into account all the improvements around securitisations' simplicity. They should also aim at a regime based on what conservative long-time investors believe to be necessary for a reasonable analysis by a reasonably conservative investor. Finally, a levelling of the playing field with other types of capital market products could be explored via an alignment of disclosures on asset performance for asset-based financial instruments. The end result would be a fair yet conservative disclosure regime.

Due Diligence

The regulations require specific, detailed and extensive due diligence for all securitisations (and, oddly, more for STS securitisations, which are the safest products).

No-one, of course, is suggesting that investors should not perform appropriately thorough due diligence on the bonds they purchase. The question is whether, looking at investor rules holistically, it really makes sense that legislation sets out detailed, costly and mandatory rules for an STS, prime-mortgage backed, AAA rated senior tranche of a European securitisation – a product with zero losses during the GFC – and none whatsoever for corporate equity or convertible warrants or AT1 deeply subordinated convertible bonds or any other highly complex and risky capital market investment.

Once more, these rules appear grounded in a legitimate post-GFC notion that:

a) Securitisations were uniquely complex and risky.

b) Rating agencies could not be relied upon due to conflicts of interest.

c) Securitisations were uniquely opaque and thus required heightened due diligence.

However, subsequent European legislative changes have, especially for the simpler STS securitisations addressed most, if not all, those issues. Rating agency regulations have also addressed this aspect of the GFC.

But why, it could be countered, should we wish to roll-back due diligence obligations? Surely, all due diligence is a public good.

The problem is that the mandatory and detailed nature of the required due diligence imposes costs in both time and money (*e.g.*, compliance costs). When the simplicity and the safety of the product does not warrant them, those financial costs detract from the attractiveness of the product by artificially reducing post-cost returns. The cost in time also makes the market less efficient as the time taken to buy and sell even an STS, AAA prime-mortgage backed senior tranche must be counted in days or weeks compared to the minutes or even seconds it takes to sell an unrated deeply subordinated convertible bond. When compared to other, riskier markets, this lack of a level playing field becomes an incentive for investors to move to riskier products: if they have to do long and arduous due diligence anyway, why do it for the lower returns provided by the safest STS securitisations?

The heart of the proposals for reforming the current due diligence requirements is to apply a consistent and proportionate approach, bearing in mind the approaches adopted for other – often more complex – products.

Some general considerations

When these proposals, and particularly the capital requirement proposals, were put forward, some argued that there was very little if any demand from industry for such changes. This is an odd comment. It seems well established that prudential requirements should be correctly calibrated to the risk, notwithstanding the wishes of prudentially regulated entities for it to be otherwise. It is also not uncontroversial that miscalibration of prudential rules almost invariably leads to regulatory arbitrage. In turn, regulatory arbitrage almost always results in an increase in systemic risk as capital becomes allocated to the wrong part of the financial system. We believe this has become apparent in respect of high-quality, low-risk securitisations.

Conclusion

This article has set out what we consider to be the five key proposals for regulatory improvements. Other proposals exist and new ones may come later. But in all cases it is argued that the best approach is certainly not to undermine the systemic safety of European finance. What needs to be achieved is a fact-based approach that takes into account both the legislative changes already made and the actual pre-and-post GFC data. It must also be an approach that avoids the current regulatory arbitrages that result from focusing solely on the rules for securitisation rather than on the rules for capital market instruments generally, of which the former are but a sub-set. This will allow for a coherent, logical and consistent approach to the capital markets union rather than a distorted and potentially dangerous structure that would flow from manipulating prudential rules to favour some instruments over others.