Yves Mersch: Next steps for European securitisation markets

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Information Management Network (IMN) Global ABS Conference, Barcelona, 11 June 2014.

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Ladies and gentlemen,

It is a pleasure to be here with you at the 2014 Global ABS Conference.

Over the last year ABS have become a major focus of discussion within European policymaking circles. There is a growing consensus that an instrument once seen as part of the problem could in fact be part of the solution. I am therefore happy to see that the conference agenda contains many sessions touching on the key issues we are thinking about, such as regulation and economic growth. I am sure there will be several useful insights we can draw on.

In my remarks today I would like to provide you with the ECB's perspective on securitisation markets and how they fit within our overarching objectives. I also want to offer some further proposals and thoughts on how to stimulate European ABS markets, which I hope will provide some food for thought over the remainder of the conference.

The Eurosystem's interest in securitisation markets

Let me start with the ECB's perspective. As you may know, in recent months the ECB has put a great deal of public focus on reviving the European ABS market. Why are we so interested in this particular market segment?

There are three parts to the answer: price stability, financial stability, and the stability of our balance sheet.

First, and most importantly, we see ABS as a means to an end, and that end is achieving our primary objective of price stability. ABS provide a channel for the funds of liquidity-rich bank or non-bank investors to reach the real economy, in particular its more opaque segments. By stimulating further credit creation, which in turn feeds into consumer prices, this supports the transmission of monetary policy and the fulfilment of our mandate. This mechanism is useful at any stage of the cycle, but especially in an environment of low interest rates and low inflation as we see today.

It is in this context that the Governing Council decided last week to intensify preparatory work related to outright purchases in the ABS market. Under this initiative, the Eurosystem might consider purchasing simple and transparent ABS with underlying assets consisting of claims against the euro area non-financial private sector. Moreover, we see longer-term monetary policy benefits to a stronger ABS market: firms that are less reliant on bank finance in future downturns, and banks that are less constrained in their lending decisions by their capacity to hold credit risk.

The second reason for our interest in ABS is their potential financial stability role. Of course, we know that overly-complex and opaque ABS, particularly in the US, contributed to the financial instability witnessed in 2007 and 2008. But as I have long argued, alongside other policymakers, simple and transparent instruments can spread well-understood risk across different financial actors and hence play a stabilising role. As ABS can be customised, for example in terms of asset exposure, geography, and maturity, they can satisfy the needs of most non-bank investors, whether a pension fund, an insurer, or an asset manager. And sharing credit risk among the non-bank sector is important because, in a severe market disruption, the correlation between banks and non-banks' financial health is likely to be lower than the within-banking industry correlation.

Finally, the ECB takes a close interest in ABS because they are an important component of the Eurosystem's own balance sheet. As of the end of March this year, 307 billion of ABS collateral was pledged, amounting to 15% of the total pledged collateral for Eurosystem operations. If a counterparty were to default on its obligations, the Eurosystem would gain ownership of this ABS collateral and would then seek to liquidate it in secondary ABS markets without incurring a loss. Thus, we have a strong interest in ensuring that ABS is a safe and transparent asset class traded in well-functioning, liquid markets.

So these are the reasons why the ECB sees ABS as deserving specific attention. Let me add, however, that the ECB does not believe that ABS should warrant special treatment where it is not justified from a theoretical, empirical and practical perspective. The ECB is interested in ABS insofar as they can help us achieve our policy objectives in compliance with our legal obligations, while ensuring risk equivalence in our collateral framework. In other words, supporting the ABS market is not an end itself. If the ABS market benefits along the way to securing our objectives, so much the better, but we do not *a priori* favour any one type of financial instrument over another.

Still, it is no secret that, broadly speaking, European securitisation markets are not doing too well. Market-placed issuance is low, trading is thin in some segments, the size of the investor base has not recovered and various conservative regulations are under discussion. What can be done to revitalise securitisation markets in this context?

Proposals to unblock European ABS markets

Much has already been written on this topic and I will not attempt to repeat all the arguments in the limited time we have today. I would like instead to offer three proposals that I see as important to keep moving the debate forward. These relate to the regulatory treatment of ABS, transparency and standardisation requirements and the treatment of ABS by credit rating agencies. The proposals should be seen as complementary to the suggestions made elsewhere, including the recent joint discussion paper from the ECB and the Bank of England.

Regulatory treatment

My first proposal to revive EU ABS markets is to find a more holistic approach to their regulatory treatment. There has been a lot of discussion about various individual issues related to ABS: for example, excessive securitisation capital charges, transparency and risk retention improvements, higher credit enhancement requirements, as well as the current liquidity rule proposals, which I see as overly constraining. And regulators have responded by making efforts to overhaul the securitisation capital framework, categorise ABS in liquidity categories, finalise securitisation capital requirements for insurers, and reform transparency and disclosure requirements for these instruments.

In my view, however, this focus on *discrete* issues is causing us to miss their *continuous* dimension. There is still a sense that the regulatory agenda is proceeding in an uncoordinated manner.

One example concerns "high quality" treatment across regulations. The BCBS' efforts to finalise the securitisation capital framework before end-2014 will not consider "high quality" preferential treatment. In a few weeks, however, the European Commission must identify which ABS are "high quality and liquid" in the Liquidity Coverage Ratio.

Another example concerns transparency requirements across asset classes. Substantial efforts are underway to further improve the transparency and disclosure requirements of ABS in a pan-EU manner, building on the improvements to ABS transparency brought in by the ECB's ABS loan-level data templates. Yet, while so much effort is being devoted to improving transparency over an asset class where substantial progress has already been made, covered bonds continue to have no common transparency framework and indeed no common supervisory framework. Nonetheless, they benefit from preferential risk weights in the Capital Requirements Regulation – which, by the way, deviate from the Basel capital framework.

Still another example concerns capital requirements across different investors. The proposed insurer securitisation capital requirements have been set using a spread risk approach calibrated to 99.5% Value at Risk. By contrast, the bank frameworks are based on a credit risk approach calibrated to 99.9% Value at Risk. Finally, closer to home, the ECB, Bank of England, and ESMA are all involved in loan-level data reporting requirements for ABS, where there appears to be significant but not perfect overlap.

One might reasonably respond that coordinating such an approach would be challenging, that deadlines are fixed by legislation, and that it is difficult to coordinate simultaneously at the global, EU, and national levels – especially given the different mandates and scope of the various parties involved in regulation. However, I believe all of the actors are present and pieces in place to go down this route.

Indeed, the European Commission, the ECB, the Bank of England, the three European Supervisory Agencies, and the European Systemic Risk Board, cover the near totality of EU ABS considerations under discussion at the moment. They also possess many legal powers to reframe the regulatory debate in a more holistic and sequentially-sensible manner. Would it be too challenging to regularly align views at least at the EU level, and to speak with a common voice in global fora? This is already beginning, but much more could be done in my view.

Transparency and standardisation requirements

My second proposal concerns transparency and standardisation requirements for ABS products. I wholeheartedly support disclosure for ABS. This is because ABS will always have the potential to be highly complex, which implies much more room for opacity than other standard financial products.

As I mentioned, much has already been achieved or envisaged in the area of ABS transparency: the loan-level data requirements, the proposals by ESMA to have minimum common information for ABS in a single portal, and reforms mandated in the Prospectus Directive. Yet we could still streamline the reporting requirements: for example, ABS investor reports could be standardised to allow a consistent set of information to be provided across transactions and across time. These same investor reports could also be aligned, in terms of data cut-off dates, with loan-level data submissions. This would provide greater means for market participants to verify the accuracy of data provided by issuers and exert market discipline.

Another interesting area for exploration is the provision of standardised ABS prospectus templates, including common diagrams, which would allow non-specialised investors greater ability to make comparisons across products. ABS are of course highly diverse instruments and so I would not propose to shoe-horn all types into a single form. Rather, the idea is to provide a common starting template for describing ABS transactions that could then be departed from as needed.

My concern here is that prospectuses and broader transaction documentation must inform both legal and financial specialists. Some creative thinking on how to present the information in an accessible manner may help preserve legal precision while avoiding information overload. This would build on what I believe are the very helpful ESMA proposals for a transaction summary.

Looking forward, I believe that greater standardisation of ABS products is a key goal to stimulate greater market activity. SME ABS, for instance, are widely acknowledged to be extremely heterogeneous across EU countries, in part reflecting both the type of business and banking relationships that prevail in each jurisdiction. Any efforts that could be made to enhance the transparency and consistency of ABS structures could, I believe, provide greater comfort to investors reluctant to take the plunge into these instruments.

Treatment of ABS by credit rating agencies

My third proposal relates to the treatment of European ABS by credit ratings agencies. Currently many ABS in stressed economies are constrained by the rating of the corresponding sovereign. The rationale put forward by rating agencies is that there are immitigable risks that affect all issuers and assets in a particular country, above all the sovereign. As regards calibration, some quantitative and many qualitative factors are taken into account by the agencies when setting this ceiling. Yet, I question whether this ceiling is appropriate.

For example, I am not aware of any defaults on Greek RMBS or ABS transactions, despite the partial sovereign debt exchange in 2012. Or, in Italy, the vast majority of RMBSs appear to be constrained by the sovereign ceiling despite an average of 25% current credit enhancement. And, from my latest check, the ECB's Composite Index of Systemic Stress for the euro area is around the 5th percentile of the distribution since January 1999 and six times lower than the median from 2010 to 2012. This suggests that many of the systemic risks used to justify the country ceiling approach seem far off.

From all these examples, and others, I find it hard to believe that the redenomination risk that is driving so many sovereign ceilings still justifies such stringent caps. Moreover, I am not fully reassured that there is no double counting taking place in these calculations: in other words, that country credit risk is not already being captured in the credit risk assessment of the pool and third parties to an ABS transaction.

Be that as it may, I recognise that it is the rating agencies' prerogative to decide on the best methodologies to assess risks and that these methodologies will not change overnight. I do believe nonetheless that providing more transparency on how ratings are derived and, in particular, disclosing ratings absent the sovereign ceiling to investors could certainly help, as suggested in our recent paper with the Bank of England.

This proposal is underpinned by my conviction that it is investors who should decide whether to apply the sovereign cap or not when assessing a transaction. In fact, I would argue that rating agencies should publish the ratings absent any cap – whether for a sovereign, swap counterparty, account provider, or other entity – and then add on the caps in a building block approach, all for the sake of clarity. And, in my view, it behoves the rating agencies to provide more transparency on the precise methodologies for determining and applying sovereign ceilings, given the impact of these measures on the structured finance market.

This points to the important role that market participants *themselves* have to play in reviving European ABS. It is one thing for regulators to improve transparency or credit ratings agencies to provide more granular information; it is another for market participants to analyse it and trade on it.

For example, I recommend that market participants look closely at what the ECB is doing with our loan-level data initiative. We are providing much higher quality information on which they can make informed credit risk assessments of ABS, either on the basis of the individual underlying loans, or on the basis of the summary information made available in the respective data repositories.

I realise that there is no free lunch, and that there are financial and resource implications to such detailed scrutiny. But I am convinced that the more market participants "get their hands' dirty", the more the ABS market as a whole will benefit. This is because more informed market participants means greater discipline for data providers, less automatic reliance on others' opinions, and greater awareness of gaps in the transparency requirements across financial products.

Conclusion

Let me conclude.

The Eurosystem places great importance on the health of European ABS markets. ABS are an important means to achieve our policy objectives in a prudent manner, which could be achieved either by ensuring the applicable haircuts or by outright purchases in this market. Our decision to intensify the preparations could help to catalyse new securitisation activity.

But for a virtuous circle to take hold, the regulatory and market barriers that are preventing the revitalisation of European ABS markets need to come down in tandem.

Much work is already on-going to improve the environment for ABS issuance. What I have tried to outline today is several practical steps that can be taken to take this work forward. I believe that a holistic and coordinated approach among EU policy-makers, as well as greater standardisation and more methodological transparency by rating agencies, could help encourage the revival of the ABS market that we all want to see.

Thank you for your attention.