Yves Mersch: Securitisation revisited

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Euro Finance Week, Frankfurt am Main, 16 November 2017.

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Today I would like to come back on an issue that has found some of our attention in the recent past: securitisation.

What has happened: Is it part of CMU agenda? It is not helping banks to sanitize their balance sheets more rapidly when there is such a great need?

Simple, transparent and standardised (STS) securitisations

Let me start with some good news. The European framework for simple, transparent and standardised or 'STS' securitisations was formally adopted by the European Parliament on 26 October. The adoption by the Council is expected soon and will lead to the conclusion of a process that has taken many years of hard work. The STS Regulation is one of the cornerstones of the Capital Markets Union (CMU) project to build a single market for capital in the EU.

Some basic beliefs: At the outset I still consider the Great Financial Crisis heaving at its origin excess built-up of leverage especially short term debt. We should however not condemn wholesale all debt carrying instruments. While we must tackle the stock of legacy debt, the flow of new credit to the economy should not be hampered as it fuels the economic recovery. Therefore, a differentiated assessment of financial instruments is required.

Let me elaborate on the reasons why the ECB is interested in this particular market segment:

First, the ABS market acts as one of the transmission channels of our monetary policy, facilitating the provision of credit to the euro area real economy and, thereby, helping us to achieve our monetary policy objective.

Second, ABS are an important component of the collateral framework of the Eurosystem.

Third, securitisation, when used well, can transfer risk away from the banking sector, which may support monetary policy as it can help banks free up bank capital, allowing them to extend new credit to the real economy.

The reputation of securitisation or asset-backed securities (ABS) has been severely tarnished by the financial crisis, reflecting both the prominent role of ABS involving complex, opaque structures with poorly underwritten loans and the misuse of derivatives.

Moreover, the market was over-reliant on a highly leveraged investor base depending on short-term wholesale funding. Although these practices were more prevalent in the US, the European securitisation market was also impaired. By consequence, all ABS were demonized.

The ECB together with the Bank of England were early supporters of a better functioning securitisation market for transactions that comply with the concept of simple, transparent and standardised ABS and duly take into account the lessons learnt of the crisis.

An early intuition was that lack of transparency acted as an obstacle to the revitalisation of the securitisation market. The ECB has made a significant effort to ensure a high degree of transparency in securitisation by promoting the loan-level data initiative.

STS Regulation also requires a system of registration and supervision for ABS data repositories established in the EU. 'Securitisation repositories', as they are called, will be subject to the same

ongoing governance, technical and operational requirements as trade repositories under the EMIR framework. They will be expected to store not just loan-level data, but also all other information which the Regulation requires, such as transaction documentation. The repositories will be registered, authorised and supervised by ESMA. The ECB will wholeheartedly support ESMA in completing its tasks. So far so good. What about results?

It is duly noted, however, that the revival of the European securitisation market is still anaemic. Market-placed issuance is at historic lows. The investor base has not recovered. The EU securitisation markets are impacted by bank deleveraging, unfavourable regulatory treatment and lower relative costs of funding of alternative instruments. Admittedly, the sizeable Eurosystem covered bond purchase programme and long term loan operations have also represented viable funding alternatives for banks.

In this respect, some more patience is warranted. The STS regulation will only come into force in 2019 as various important technical standards still need to be finalised to provide further regulatory certainty which is important for securitisation market development. EBA is for example mandated to develop guidelines to ensure a common and consistent understanding of the STS criteria throughout the Union. As the ECB has argued in its opinion, this is important to ensure legal certainty and efficiency for those interpreting and applying the STS criteria.

While these initiatives are helpful in principle, they do not exist in legislative isolation. We have to be mindful of potential negative spill-over effects by other pieces of legislation. Let me highlight some areas of concern:

First, on a more technical note, under the current European Market Infrastructure Regulation (EMIR) securitisation special purpose entities (SSPEs) are classified as non-financial counterparties and accordingly, subject to certain conditions, are not required to comply with the clearing and margining obligation. However, according to the May proposal of the Commission to amend the EMIR framework, securitisation entities are reclassified as financial counterparties instead of non-financial counterparties. Therefore, these entities would potentially become subject to mandatory clearing and margining. This would mean that they have to provide collateral, with regards to their derivatives. This is surprising because securitisation derivatives already contain features to mitigate counterparty credit risk. Moreover, the nature of the securitisation derivatives makes it difficult to comply with the margining or clearing obligation. How can an SPV put down margining as it only has by definition control over its underlying portfolio? How can it post collateral? The STS Regulation exempts STS SSPEs from the clearing obligation, provided that counterparty credit risk is adequately mitigated. Further clarity on this is needed as many European securitisation transactions use derivatives for genuine hedging purposes.

Second, the revision of capital charges for STS securitisations in Solvency II is essential for the recovery of the investor base. An updated calibration should consider the difference in the risk profile and tolerance between insurance companies and banks and the capacity of the STS criteria to capture a lower risk profile in securitisations. The calibration should not incentivise insurance companies to seek investments in the underlying assets in question in an un-securitised, rather than a more liquid securitised, format.

Third, the potential benefits of securitisation are twofold: it can be used as a way to fund an asset *and* as a means of transferring risk. It can free up bank capital, allowing banks to extend new credit to the real economy. Likewise, the pricing of risks is more effective when securities are assessed by the market rather than being dormant on banks' balance sheets.

All this may support the transmission of monetary policy, where the bank lending channel may otherwise be impaired.

Finally, it may lower borrowing firms' exposure to re-financing or liquidity risk, thereby increasing

banks’ resilience and helping to contain systemic risk.

For this potential benefit of securitisation to come to fruition it is of course key that the risk transfers are genuine; in other words, it is necessary that the risk is really transferred to third parties. The experience of the crisis showed that this condition was not always met in the past. In this respect, I would like to highlight the important work done by EBA in the assessment of the current supervisory practices and the proposals made to further enhance the criteria of significant risk transfer for securitisation in its discussion paper.

Conclusion

Let me conclude.

The ECB places great importance on the health of the European securitisation market. The ABS loan-level initiative has made an important contribution in ensuring a high degree of transparency to enable investors to assess the embedded risks of securitisations.

Obviously, ABS had to become safer after the experience of the Great Financial Crisis, in particular with securitized US-subprime mortgages. Regulators and legislators have acted accordingly, and the work has not yet been completed. But we should not throw the baby out with the bath water. Instead, the potential of healthy securitizations should be exploited.

In line with the Commission goal to revive the securitisation market in Europe, in order to broaden investment opportunities for investors and boost lending to households and businesses a number of barriers need yet to be overcome. The STS Regulation could make an important contribution. Much work has already been conducted, nevertheless many important technical standards still need to be finalised and some other uncertainties still remain. In this context, we have to be mindful amid the interdependencies of different pieces of legislation.

Calibration of Solvency II is essential for insurance companies as investors in securitisation. Further clarity of securitisation special purpose entities under the EMIR framework is needed. Finalisation of Basel III may impact securitisation as a means of transferring risk. These are challenges that lie ahead of us.