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Securitisation – its **revival** depends on a level playing field

Since April 2014 a consensus has been building in the EU policymaker circles about the need to revitalise the European securitisation market. We think that the watershed moment was the joint ECB – BoE letter published that month about the need to establish a regime for simple and transparent securitisation. Since then, a momentum has built up towards the introduction of such regime in Europe (e.g. the EBA consultation on simple standard and transparent ABS and qualifying securitisation was completed and the EBA proposal to the European Commission was published in July), and similar discussions are taking place on a global level (see, BIS-IOSCO consultation on the same topic completed in mid-February and the final proposal submitted in July).

A new consultation

The launch of a new consultation on simple, transparent and standardised securitisation by the European Commission on February 18th in conjunction with the Green Paper on Capital Markets Union in the EU propped up the momentum further. In the meantime, additional regulatory recommendations, e.g. the ones made under the Joint Committee report on securitisation (ESAs from 12 May 2015) and some proposals by ESMA, may erect additional barriers to the revival of the securitisation market in Europe. The completion and introduction of such regime, however, is not quite in sight yet: the rule making machine works slowly – the more optimistic observers suggesting 12 months at least and the more pessimistic (or maybe realistic) ones argue for a 2–3 year horizon.

Before delving into discussion of what needs to be done to fix the European securitisation market and why it must be done in coordination with other fixed income market sectors, we think it is appropriate to offer a brief refresher about what securitisation is, how it works and how it interacts with other asset-based financing instruments. We offer this refresher from the perspective of a practitioner. So:

– Securitisation is an instrument, a technique that is applied to many assets and sectors of the economy, and shares characteristics pertinent to other instruments and techniques used on the financial markets.

Its key characteristics, such as a cash-flow generating asset pool and tranching, are not unique to securitisation and can be seen in other financial instruments and techniques (e.g. Danish covered bonds, revenue bonds, infrastructure bonds or other asset-based finance for the former, and for the latter, bank capital or a lien-based instrument such as residential and commercial mortgage with first and/or second charge). 'Typical' securitisation structural features are also present in other instruments, e.g. ones that make use of SPV structure such as Italian and Dutch covered bonds or Spanish multi-cedulas. SPV structures also involve identifying the securitiseable assets and transferring them in a 'true sale' arrangement. There is no evidence to argue that such features work in these other cases but do not work in the case of securitisation – actually, the evidence points to the opposite.

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Dass sich in Europa ein gewisser Konsens ausbreitet, den Verbriefungsmarkt wieder beleben zu wollen hat der Autor sehr wohl registriert. Die strengen Regulierungsmaßnahmen im Zuge der Finanzkrise sieht er aber bei allem guten Willen noch längst nicht hinreichend beiseite geräumt und die Wiederherstellung gleicher Ausgangsbedingungen gegenüber vergleichbaren Finanzinstrumenten bei Weitem noch nicht gegeben. Zur Schaffung eines wünschenswerten Level Playing Fields reicht seiner Ansicht nach nicht der Blick auf die reinen Kapitalkosten, sondern er könnte sich beispielsweise durchaus ein einschlägiges Verbriefungsregelwerk vorstellen. (Red.)

Self-liquidating nature

Another key feature of securitisation in its most traditional sense is its self-liquidating nature – the assets backing the securitisation are repaying (amortising) the securitisation bonds as they amortise and the yield generated by the assets is used to pay interest on the securitisation notes.

Even that feature is no longer reserved for securitisation alone, e.g. conditional pass-through covered bonds also apply it, granted with a low probability of using it – they represent now low, but potentially growing, share of the covered bond market. Pass-through cash flows are also used in Danish covered bonds. Infrastructure and revenue bonds often have a similar feature, too.

Securitisation and many asset-based finance instruments (including Danish covered bonds, revenue bonds) rely on specified assets for their repayment, whereas for some kinds of covered bonds and other asset-based finance instruments the repayment may come from the issuer with an additional recourse to the assets under certain conditions, such as issuer insolvency (i.e. dual recourse instruments). For some other asset-based instruments and

for some types of covered bonds the dual recourse nature may be more tenuous.

– Securitisation market functions in conjunction with other fixed income markets and especially with other asset-based finance instruments. This interdependence is not only related to relative value within investments on the secondary market, but also in terms of eligibility, viability and usage on the primary market.

An investor, assuming all else being equal, will determine which asset-based investment to make by comparing the yields of such instruments, relative to each other (the yield of RMBS bond vs the yield of a covered bond vs the yield of a whole loan portfolio vs the yield of a bank or a corporate bond) and relative to other inputs (nominal and relative capital charge for holding such instrument, e.g. RAROC; actual market recognised and/or regulator-endorsed liquidity, e.g. actual vs LCR- or ECB- repo-eligibility-driven liquidity; cost of investing – prudentially vs prudently required due diligence and costs associated with it). Assuming that investors will be indifferent between two instruments with the same RAROC, all else being equal, we calculate the necessary yield under securitisation investments to equate their RAROC to the RAROC of the investment in the underlying exposures. The conclusion is that under both Solvency II SA and BIS 3 ERBA the securitisation tranches must carry significantly higher spreads (between 400 bps and 7,000 bps in our estimates) to make investors indifferent between the two investments on RAROC basis. In our view, this suggests that either the regulatory capital calibration is incorrect or the pricing of the underlying assets is inconsistent with its risks, or both.

Constrained by regulation

Similarly, an issuer will consider not only the headline margin of a funding instrument, but the overall costs as the sum of headline cost of funding, costs of structuring, syndication and issuance, cost of swaps, cost of servicing, monitoring and reporting, capital costs or benefits associated with it, costs and benefits of diversification of funding instruments, etc. For example, if an issuer has a portfolio of residential mortgages or commercial real estate loans, it can use them in three ways:

– to raise funding via covered bonds (no change in capital position, ALM implications, asset encumbrance implications),

– to raise funding by selling the portfolio (capital implications, non-interest income implications in case of a swap or servicing agreement, deleveraging), and

– to raise funding and/or improve capital via securitisation (capital implications, ALM implications, de-recognition and/or deconsolidation with other regulatory capital ratios implications).

These three approaches (instruments) will have different costs associated with due diligence, reporting, transparency, etc. These funding instruments will also be compared to the cost/benefit of using other funding (ECB sources, long-term unsecured debt, short-term notes, customer deposits, etc.) and their price and availability.

The principal of capital neutrality

In other words, issuers and investors constantly make choices across multitude of funding, ALM and investment instruments available to them at any given point in time. The total cost/benefit analysis of each instrument determines its use in the present moment. Funding and investment diversification, however, may be constrained by regulation, which is the case in Europe in particular, at present.

– Securitisation does not add or reduce the overall risk and associated capital of the securitised exposures, nor does any other form of asset-based finance – it simply modifies its allocation.

The principal of capital neutrality has been rejected by BIS – justifiably to some degree, but that does not diminish the need for a reference point when setting up capital for securitisation. If capital neutrality is rejected, then the sky is the limit for securitisation capital charges. We agree that additional risks may emerge as a result of securitisation (modelling risk, agency risk, informational asymmetry, etc.), but such risks are not 'reserved' for securitisation only – such risks emerge in the case of whole-loan portfolio transfers, covered bonds, bank capital, etc. The issues related to asymmetry of information, subjective assumptions about future performance of entities or assets, transparency of assets in a portfolio, etc. are issues that pertain to many financial instruments.

However, even if one rejects the principle of capital neutrality, it is inconceivable that the capital for securitisation tranches with attachment points well above the capital of the securitised asset pool can be higher than the capital of the underlying pool. This cannot be justified either in the case of sizing capital for expected and unexpected losses (banks) or of sizing capital on the basis of price volatility (insurance).

– Securitisation as a self-liquidating asset-based funding instrument must satisfy a simple economic equation – the yield of the asset portfolio must exceed the cost of funding it (all-in costs) and leave sufficient extra margin to meet expected losses and equity investor return target.

In other words, for securitisation to be economically viable, the pricing of the underlying assets (e.g. their loan margins) by the bank should be in line with the pricing investors demand in order to invest in the securitisation tranches. That is, securitisation can exist only on the basis of a realistic (pass-through) market-based pricing of the securitised exposures. On the numerical example, which we discussed above, we can conclude that the securitisation is impossible to execute, i.e. the spread required to equate RAROC of securitisation tranches and the RAROC of the underlying assets is extremely large (between 400 bps and 7,000 bps). For securitisation to exist, the lenders must re-price the underlying assets by a huge margin, which is likely to be well beyond the point of affordability of its borrowers.

Assets mispriced or costs too onerous

We consider a securitisation to be economically viable when the yield of the securitised portfolio is sufficient to meet the all-in cost of securitisation and the required return of investors throughout the capital structure of securitisation. This is the case with all managed CLO and fully placed CMBS transactions in Europe. A form of market-based pricing also exists in many Danish covered bonds (where the pricing of the mortgage to the borrower is derived from the pricing of the mortgage

bond by the market/investors) and in the arms-length sale of whole loan portfolios.

When investors determine the required return on a specific investment they factor in all their related costs: initial investment analysis and ongoing investment monitoring, capital allocated against the respective investment, liquidity needs and costs, legal and compliance costs, and so on. If such costs are materially different for similar instruments, then investors would demand different yields for those instruments to satisfy those different costs.

As a result, the high costs associated with an investment in a given securitisation (including and beyond the RAROC calculation above) may make the execution of such securitisation impossible, i.e. it may require a level of yield on the securitisation instruments, which the underlying securitised portfolio simply cannot generate. From a capital market's perspective, this means that either the assets in the securitised pool are mispriced or that the costs associated with investing in the securitisation are too onerous, or both.

Equality

Both reasons – weighed in a different way in different European countries make up the case for weak securitisation in Europe, along with the availability of alternative cheap funding for banks and low need for funding due to low levels of lending at present.

The development of regulatory treatment – capital, liquidity, operational requirements, etc. – of securitisation appears to have been done in a silo away from such treatments of other asset-based and broader set of fixed income instruments, and in disconnect from such treatment of the assets and parties forming part of a given securitisation.

Consequently, this, albeit in combination with other factors specific to Europe, has led to the demise of the European securitisation market in contrast to the quick rebound and sustained recovery of the US securitisation market in the years since the global financial crisis.

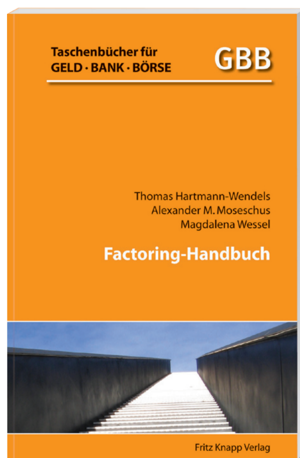
From pure economic point of view and as a result of the above, securitisation is facing a conundrum:

– on the one hand, it is costlier to issuers, so that to make it work they need to get an offsetting benefit – for example, lower capital, improved leverage or lower headline spread, or a combination thereof, and

– on the other hand, it is costlier to investors, so that to be attractive to them they need to get a higher yield.

In balance, to get the European securitisation market functioning as it should, a set of measures must be adopted, which in combination restore the level playing field across asset-based financial instruments (including securitisation, covered bonds and other asset-based finance) and other financing and investment instruments. Such measure will result in 'equalising' the cost of securitisation and other similar funding/ALM/investment instruments to issuers and investors, and in offsetting potentially relatively higher securitisation costs with some benefits from securitisation.

Fixing the European securitisation markets requires a much broader, beyond the most visible reduction of capital charges, set of measures affecting securitisation and comparable instruments. It is not about creating a privileged treatment for securitisation, but about establishing adequate prudent and prudential regime for securitisation across asset classes and realigning securitisation regulatory regime with that for other comparable instruments.



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