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Update on the European securitisation market

André Pottas, Head of Corporate Client Operations, attended the 20th Global ABS (Securitisation) Conference in June and provides an overview of the discussions on this important, yet still largely misunderstood, market in Europe.

The IMN Global ABS Conference remains the pre-eminent annual gathering of global, and especially European, securitisation market professionals. The conference celebrated its 20th anniversary in Barcelona from 14-16 June this year, attended by some 3,500 delegates.

The conference provides a useful opportunity to take the pulse of the European securitisation industry, and digest the key topics that dominated discussions inside and outside the formal sessions.

1. The current status of the securitisation industry in Europe

Conference speakers on the whole expressed cautious optimism (pre-Brexit and pre-European Parliament new proposals – see further below) that the worst is over for the European securitisation market and that the outlook for growth is broadly positive.

History has now shown that European securitised asset pools are robust and have come through the 2008 financial crisis largely unscathed.

What is more, European regulators and central banks have now accepted that securitisation is part of the solution and not part of the problem in helping the European economy to recover from the 2008 financial crisis. There is a need to move away from the traditional (over-) reliance on bank lending in Europe, by seeking alternative solutions that disintermediate the banks and provide direct access for borrowers to institutional, non-bank lenders. Securitisation has a key role to play in this regard.

But while the regulators are now largely on board, recent evidence has shown that many politicians still need to be convinced. The stigma that was attached to securitisation post the 2008 financial crisis, stemming from the United States sub-prime mortgage securitisation debacle, has remained in the popular consciousness despite industry efforts to distance European securitisation as a funding diversification tool from the US ‘originate to distribute’ model and excessive collateralised debt obligation (CDO) leveraging that combined to lead to the 2008 crisis.

The new proposed amendments to the EU’s “Simple, Transparent and Standardised” (STS) securitisation initiative, released just days before the conference, appear to reflect a sceptical political view of securitisation as a viable funding tool.

Some of the proposed amendments, and specifically the proposed requirement for a 20% risk retention by originators, are just not practical, and will sound the death knell for securitisation in Europe if enacted in their current form.

2. Capital Markets Union (CMU)

The CMU is a medium term action plan put forward by the European Commission to create a single capital market across the EU by 2019, in an effort to mobilise capital formation by increasing and diversifying the funding sources available to European businesses, complementary to bank funding. The vision is that deeper and more integrated European capital markets will lower the cost of funding and make the financial system more resilient.

In other parts of the world the capital markets, venture capital, crowdfunding and the asset management industry all play a wider funding role than in Europe, which is more reliant on bank funding and thus more exposed to potential credit or liquidity problems in the banking sector.

The CMU proposals include 33 sub-projects; including the STS and other initiatives to restart the securitisation market in Europe; a revision of the Prospectus Directive; a revision of the Solvency II framework; and introducing a standardised insolvency regime across all EU member states.

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3. European regulatory initiative for 'Simple, Transparent and Standardised' (STS) securitisation

The STS initiative was initially presented to the European Parliament in September 2015 by the EU's financial services authority to regulate securitisations as part of the broader European CMU. The STS initiative will introduce direct regulation of the EU securitisation market, by replacing the existing portfolio of regulations relating to investor due diligence, risk retention, asset pool transparency and supervision with a single, unified regime that will apply across the continent.

The aim of the STS securitisation regulatory regime is to restore European investor confidence in securitisation, in an effort to deliver more than €150 billion of new (non-bank) lending.

Securitisation of 'high quality' assets compliant with the STS provisions would qualify for preferential regulatory capital charges for those credit institutions that originate, sponsor, or invest in securitisations.

48% of the Global ABS delegates believed that the STS initiative is a step in the right direction, but that it does not go far enough to restore investor confidence, and that a lack of clarity around certain interpretations in the regulations could hinder rather than promote further securitisation issuance.

On the plus-side, STS is creating a positive spin for securitisation in the European Press for the first time since the financial crisis. There is a growing understanding that securitisation and a functioning European securitisation market are vital to the success of the proposed European CMU.

Conference participants stressed that STS should provide a meaningful regulatory capital or ratings benefit, or else it will not be adopted by issuers. The EU regulatory capital directive is being revised in this regard, but the benefits of issuing or investing in STS compliant securitisation paper have not yet been quantified or published. Post 2008, securitisation exposures carry a punitive capital requirement in comparison to covered bonds and other capital markets instruments, and the playing field needs to be levelled for securitisation to compete.

Delegates were also insistent that the regulator needs to provide a common view on interpretation matters in STS, such as the definition of homogeneity required in the securitised asset pool. A single European capital markets regulator would go a long way to providing clarity on these interpretation questions. At the moment, originators are grappling with this and are getting different views from different country regulators, which is at odds with the intention of the CMU.

Self-certification of STS compliance will likely be required by originators/issuers, with punitive penalties for non-compliance. Post the financial crisis, it is clear that the public and politicians will require issuers and originators to be firmly on the hook for compliance. An independent third party body will probably be created and tasked with checking and signing-off on compliance.

4. Proposed amendments to the STS

On 6 June, Paul Tang MEP, the European Parliament's lead lawmaker on the STS bill, published a 'draft report' containing proposed amendments to the STS regulations. The key proposed amendments are an increase in the risk retention to 20%, a requirement that the originator, sponsor or original lender in a securitisation must be a European regulated entity, a requirement on investors to disclose holdings, a ban on re-securitisation, and the creation of a data repository for the underlying loans in securitisations.

The current 5% risk retention rate that has applied in Europe for the past several years is now entrenched and practical, and is perceived by the market and regulators as fair to both issuers and investors. The logic for the proposed four-fold increase in this retention rate to 20% is unclear, but is likely placing a stake in the ground as a starting point for further negotiations. The new proposals have been published quite early in the European Parliament's deliberation process on the STS, and will thus likely still be subject to changes.

Efforts to improve transparency and disclosure, so that investors have all the required information at their disposal to effectively assess and price for risk, are to be lauded, but imposing an essentially arbitrary and punitive risk retention figure runs the risk of disrupting the efficient pricing mechanism of the market.

Ultimately, investors are risk takers, and they decide where to invest based on the intersection of their risk and return appetite. Investors do not want all risk, and therefore all return, to be regulated out of the market, as the new round of proposals seems to be aiming to do. Investors like tranching, so that they can pick their price point based on their risk appetite. This is at the heart of how the capital markets function.

The proposed amendments appear to reflect a continued sceptical political view of securitisation as a viable funding tool, and European securitisation market participants, as well as the European regulators, will need to engage actively with the politicians to debate these new proposals.

The timing of the final introduction of STS is important and the latest round of proposed changes will hopefully not introduce significant further delays, as the longer it takes for STS to be promulgated the more European issuers and investors are leaving the securitisation market.

5. Brexit

While it would be remiss not to mention the potential impact of Brexit on the European securitisation market, this topic was somewhat bizarrely not discussed at the conference, or at least not in the formal sessions. The conference fell into the closed campaigning period one week before the vote and there was therefore a moratorium on any discussions or questions around Brexit on any of the conference panels.

The announcement of the exit vote on Thursday, 23 June, predictably blew out European bond market spreads and led to the suspension of planned issuances, effectively shutting down the market for a full week. Since then, there have been some isolated issuances, but to date for only the most vanilla asset classes and with short dated maturities.

While the full impact of Brexit still needs to be digested, it is inevitable that the exit of the UK will place significant constraint on the continued recovery of the European securitisation market, and particularly on the proposed European CMU, which it had been hoped would provide a significant incentive for European securitisation issuance and future economic growth.

In conclusion, although there are some further short-term challenges to overcome, the tide seems to be turning for the securitisation industry in Europe. Regulators and central bankers are now largely on board and recognise the value that securitisation can add to capital markets in the Eurozone. |

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