# Europe pushed to go its own way on securitisation

**There are signs that policy-makers are sympathetic to industry demands for the EU to ease capital rules without waiting for an ongoing Basel review.**

*By Philip Alexander*

The EU is facing growing pressure from banks to follow through on proposals to provide regulatory support for a revival of the European securitisation market. The European Central Bank (ECB) and Bank of England published two joint papers on the topic in the first half of 2014. These were followed by a paper from the European Banking Authority (EBA) in October 2014 which made the case for establishing "simple, standardised and transparent" (SST) securitisations that might merit a more favourable regulatory treatment.

The SST concept will be included in a forthcoming European Commission green (consultation) paper on proposals to establish a capital markets union to counteract the fragmentation of European financing conditions, one of president Jean-Claude Juncker's centre-piece policies. Other elements include greater harmonisation of tax, insolvency and securities laws, all of which have been long discussed in the EU without any substantive agreement to date.

**Gonzalo Gasos**
"It is important to do something workable here and now to unshackle the securitisation market from the obstacles impeding it"

At a conference on securitisation organised by public interest advocacy group Finance Watch in February 2015, the EU finance commissioner Jonathan Hill said proposals to "build a market for high-quality securitisation" would be the first priority of the capital markets union. He assured the conference that the European Commission would remain vigilant against "unhealthy" practices such as those that led to the US subprime securitisation crisis. But he pointed out that European asset-backed securities (ABS) had performed comparatively well.

"After five busy years of trying to moor the boat in a storm, we should ask ourselves: have we always struck the right balance between reducing risk and encouraging growth? If the evidence tells us that the rules are not proportionate to the risks presented by different types of operator, then we should be ready to look at regulation again," said Mr Hill.

Staff at the International Monetary Fund (IMF) became the latest to focus on reviving a reformed version of securitisation, in a discussion note published in January 2015. Members of its capital markets department argued that "the time has never been more right to complete the task of ensuring securitisation markets are placed on a firm and sustainable footing". They called for policy-makers to focus on measures to ensure improved loan underwriting, more transparent ABS structures and better use of external credit ratings.

"Securitisation has begun to move from vilification to gentrification because of the pressure on banks to reduce their balance sheet and leverage, whereas a certain level of financing is needed for the European economy. Some policy-makers and regulators have started to ask if it is possible to build around transactions of good quality a regulatory answer that is adapted for this type of quality transaction," says Fabrice Susini, global head of securitisation at BNP Paribas.

## Urgent priority

The concept of high-quality securitisation has already been introduced into the Solvency II rules for insurers and the liquidity coverage ratio for banks (see *GRR*, November 2014, pp16-17). The banking industry is now calling for the roll-out of SST into the capital requirements directive (CRD IV). In particular, banks want lower capital requirements for SST securitisations, via the standardised approach to calculating risk weights on securitised assets in the banking book.

"The capital markets union is a worthwhile long-term project. What is important is to do something that is workable here and now to unshackle the securitisation market from the obstacles that are impeding it," says Gonzalo Gasos, a senior advisor on banking supervision at the European Banking Federation.

In his speech, Mr Hill emphasised the role of institutional investors, to "help unlock the capital around Europe that is currently frozen and put it to work in support of Europe's businesses, particularly small and medium-sized enterprises." However, Mr Gasos emphasises that this is part of the long-term perspective.

"It will take time to bring other investors into the securitisation market. The status quo in Europe is that most transactions are held by banks and their treasury departments. That is already helpful, because it distributes risks across the banking system that would otherwise be concentrated in individual banks. Creating a label for SST securitisations is a necessary step, but it is not sufficient – policy-makers need to use it to identify transactions that deserve relief on the post-crisis capital requirements," says Mr Gasos.

The green paper on capital markets union is due for publication in February 2015. Speaking to GRR on the sidelines of the Finance Watch conference, Mr Hill said this paper will be followed shortly by a European Commission consultation specifically picking up the EBA's concept of SST securitisations and going beyond definitions.

"There is certainly appetite from the ECB, the Bank of England and the member states in general to look at the potential for us to encourage the development of high-quality securitisation. We will set out a concrete framework for identifying SST securitisations, and look at a range of steps we might take that would have a positive effect in the market and contribute to funding the real economy," says Mr Hill.

## Weightings and ratings

Reopening CRD IV would potentially mean stepping away from internationally agreed capital rules on securitisations held in the banking book.The Basel Committee on Banking Supervision (BCBS) finalised a new set of rules in December 2014 that will come into force in January 2018.

Georges Duponcheele, head of banking solutions at BNP Paribas, says the new rules fundamentally disadvantage the European securitisation market in a number of ways. First is the decision to use the maturity of each tranche as a driver for risk weightings, rather than the maturity of the underlying asset pool. Tranche maturities are set based on the longest dated asset and a safety margin (typically two years) over the likely time needed for a legal process to recover assets on any defaulted loans in the underlying pool, to ensure that bondholders receive all possible cash flows even if the underlying borrower defaults. But legal processes in the EU are often longer than in the US.

"That means a deal could have a very short average life of underlying assets – such as three-month trade receivables – but a tranche maturity of at least five years in some jurisdictions to take account of the longest path of the legal system. For a given asset, the cashflow risk on a longer maturity tranche is therefore lower because there is more time to recover assets, and some ratings agencies recognise this in their criteria. But the capital charge under the current rules will be higher," says Mr Duponcheele.

A further problem highlighted by both the EBA's October 2014 paper and the IMF paper of January 2015 is the role of the external ratings-based approach (ERBA, previously known as the ratings-based standardised approach, RBA/SA) to calculating capital charges. In its December final rules, the BCBS set out a hierarchy of methods for calculating risk weights on securitisations. Banks that have supervisory approval for internal models must use these. There are then two simpler approaches: ERBA and a standardised approach based on the capital charges on the underlying asset pool and the tranche structure of the ABS. But the ERBA must take priority where possible.

The EBA identified the use of external ratings as the main source of asymmetric capital treatment for ABS – a much higher overall capital charge on securitised assets than on the same assets held directly without the credit enhancements of a securitisation. A significant factor is the role of sovereign ratings in the structured finance criteria used by some ratings agencies. As a result, capital charges on ABS range from twice those on the underlying assets for Germany to as much as seven times higher in peripheral Europe. This makes the transactions entirely uneconomic from the point of view of the banking sector.

"In the EU, as long as a deal is rated, there is the primacy of ratings over the regulatory formula. As a first step, the EU could decide that capital for SST transactions could be calculated without the ratings-based methods, while keeping the use of external ratings for non-SST deals for which there are less stringent regulatory constraints," says Mr Duponcheele.

**Georges Duponcheele**
"The new rules fundamentally disadvantage the European securitisation market"

## Waiting for Basel

The BCBS is well aware of these concerns. Under pressure from EU members, it published a paper jointly with the International Organisation of Securities Commissions (Iosco) in December 2014 that added an extra set of letters to the debate – simple, transparent and comparable (STC) securitisations. The focus on comparability fits the current Basel agenda of seeking greater conformity of capital rules between jurisdictions, but in essence the STC concept is very similar to the European SST proposal.

"Through the BCBS-Iosco working group, there is a small opening around quality in the Basel agenda, although still with an uncertain level of acceptability of the concept. The push around that concept from Europe has allowed the discussion to move beyond the technical Basel capital calculations to consider if qualifying transactions should benefit from a capital treatment that is less penalising than the current proposal," says Mr Susini.

The difficulty for the EU is that the BCBS may lack the urgency desired by European banks. The STC review could potentially continue until the new Basel securitisation rules come into force in 2018. The European Commission may not want to wait that long.

"We will seek to align the EU initiative on high-quality securitisation with other international initiatives as far as possible, but our first priority is to decide what we want to achieve here in Europe," says Mr Hill.

European regulators would have to win support from the US members of the Basel ratings and securitisation workstream if the STC initiative is to make progress. US supervisors are understandably very aware of the country's role at the epicentre of the subprime ABS collapse. The US securitisation market has also enjoyed more of a revival than that in the EU, thanks in part to a larger institutional investor base.

"The debate in the US is more around whether there should be a carve-out from risk retention rules for securitisations of residential mortgages and what can be guaranteed by the GSEs [government-sponsored entities], rather than around the prudential capital requirements for the banks. The priority is likely to be a Basel-Iosco process that makes sure there is no fracture in the market between the US and Europe, but no one knows at this stage whether the US would implement the STC proposals," says Chris Killian, head of securitisation at the US Securities Industry and Financial Markets Association.

The argument to suspend the ERBA for securitisation risk weights in the EU is strengthened by the fact that the US has already abolished the use of external ratings in its entire bank capital framework, and should therefore be sympathetic to a similar approach in Europe. However, one non-EU regulator says removing the ERBA is not a straightforward choice, especially in Europe, which does not have a consistent legal framework for loan pools underlying the ABS.

"The fundamental wish of the BCBS is to incentivise the use of internal models for banks that are planning to hold securitisations on their banking book – they should have the commitment to analyse the deals properly. But for those banks that are infrequent buyers of ABS, the point is that credit rating agencies look at the idiosyncratic legal and structural aspects of each deal, which is more risk-sensitive than a standard regulatory formula. That is why external ratings remain a focal point for pricing as well," says the regulator. GRR