Finance Watch response to the European Commission consultation on an EU framework for simple, transparent and standardised securitisation

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Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Only the questions that are most relevant to Finance Watch are reproduced here.

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Question 1: A. Do the identification criteria need further refinements to reflect developments taking place at EU and international levels? If so, what adjustments need to be made? B. What criteria should apply for all qualifying securitisations ('foundation criteria')?

A. We fully support most of the proposed criteria to define simple, transparent and standardised/comparable securitisation. We welcome in particular the exclusion of synthetic securitisation from the qualifying framework.

We believe that some identification criteria need further refinement.
In particular the criterion 2(i) restricting the use of derivatives to hedging currency and interest rate risk should specify that only derivatives instruments providing genuine and effective hedging, as per IFRS 9 hedge effectiveness test, should be allowed.
Flip clauses in swaps should also be expressly forbidden, as they create legal uncertainty on their enforceability[1], risks of rating downgrades and fire sales of assets.

We also believe that **the reliance on external ratings in criterion 1 is not desirable nor consistent with the European Commission' objective to reduce the reliance on external ratings**. Embedding external ratings would once again disincentivise investors' due diligence and reduce the diversity of opinions and risk assessments. The inclusion of a hard rating threshold is also likely to create again cliff effects with the detrimental impact that we know.

We appreciate that removing the reference to external ratings might deter to some extent infrequent or non-expert buyers that do not have the resources to analyse the deals properly. This would however be a positive development as investors buying products that they do not understand are more prone to change their view and sell quickly in times of stress.

B. In addition to the proposed criteria, we believe that three other criterion should be added:
First, in order to ensure a meaningful risk transfer, limit interconnectedness and wrong way risk[2], we believe that there would be benefits in **preventing credit and liquidity puts from the originator of the credit claims to securitisations**.

Secondly**, there should be no allowance for any changes however minor to the structure without explicit noteholder consent**, irrespective of whether rating agencies are willing to issue a confirmation of rating.[3]

Thirdly and most importantly**, the definition of qualifying securitisations should not include tranching, in order for qualifying securitisation to be truly simple.**
As discussed in our recent position paper[4] (cf. pages 35, 42, 43, 59) tranching creates enormous additional complexity by manufacturing complex risks that are very hard to assess.

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[1] See Robert J. Rosenberg et al., 'The 'flip' flap: Lehman bankruptcy judge invalidates payment priority clause', Latham & Walkins LLP (13 May 2010), quoted in "*Efficient, commonsense actions to foster accurate credit ratings*" Norbert J. Gaillard and William J. Harrington, forthcoming in the Capital Markets Law Journal. OR Capital Markets Law Journal (in press).
[2] Wrong-way risk is the risk that occurs when "exposure to a counterparty is adversely correlated with the credit quality of that counterparty".
[3] See Gaillard and Harrington, pp. 7-8 with respect to the non-transparent way in which rating agencies have issued rating confirmations for amendments to securitizations that reduced investor protections.
[4] http://www.finance-watch.org/our-work/publications/998-position-paper-on-ltf

Tranching also creates model uncertainty and amplifies the impact of mistakes in the assessment of underlying asset default risk and correlation.

A recent BIS paper[5] called "Securitisations: tranching concentrates uncertainty" found that "*even when securitised assets are simple, transparent and of high quality, risk assessments will be uncertain. (..) Substantial uncertainty would remain and would concentrate in particular securitisation tranches. Despite the simplicity and transparency of the underlying assets, these tranches would not be simple*."

Tranching creates as well additional procyclicality, increases the length of credit intermediation chains, enables more risk taking in the financial system and reduces banks' ability to play a countercyclical role.[6]

Tranching also creates conflicts of interests between the holders of different tranches.
For example in the case of a delinquent mortgage, the holder of a junior tranche who will absorb the losses first will push to renegotiate with the borrower to increase the chance that he will be repaid in the end. In contrast, the holder of a senior tranche will push for foreclosure as seen during the crisis, to limit the loss and ensure that he won't be affected.

Lastly, tranching attracts less informed investors who buy assets that they do not understand, and are therefore more likely to panic and sell quickly in times of stress.
More generally, the less that assets are transformed, the lower the risk that investors suddenly doubt the quality of their assets in times of stress. This is a crucial point if we want to develop a truly sustainable securitisation market in Europe and restore investors' confidence.

For all these reasons, we believe that for qualifying securitisation to be truly simple, it should not include tranching. That is not to say that tranching itself should be banned, but merely that the additional level of complexity that it creates does not justify a softening of its prudential treatment.

Some claim that tranching enables the creation of securities that fit investors' preferences and that investors would have no appetite for non-tranched securitisation. We dispute this last point as non-tranched high quality securitisation would still be able to obtain investment grade ratings, and provided the risk-adjusted return is attractive, we believe that the market would develop a strong appetite for these securities. The current environment of very low interest rates and excess financial capital looking desperately for yield should also contribute positively to investors' appetite.

Some argue that non-tranched securitisation is not part of the legal definition and hence another product altogether. While non-tranched securitisation is not currently part of the legal definition of securitisation, it clearly is part of it economically and historically. In this respect we welcome the recognition in the green paper that securitisation is not always tranched. We should also note that future updates to sectoral directives on qualifying securitisation could easily update this definition.

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[5] BIS, Antoniades, A. and Tarashev, N., Securitisations: tranching concentrates uncertainty, BIS Quarterly Review, December 2014f, pp. 37-53

[6] For more details, see http://www.finance-watch.org/our-work/publications/998-position-paper-on-ltf

Question 2:
A. To what extent should criteria identifying simple, transparent, and standardised short-term securitisation instruments be developed? What criteria would be relevant?

While short term securitisation markets (ABCP) have a role to play, we do not support the development of a qualifying framework with differentiating criteria for ABCP, in a manner similar to that of term securitisation.

Question 3:
A. Are there elements of the current rules on risk retention that should be adjusted for qualifying instruments?

It has been recognised that the current rules on risk retention do not always provide the necessary discipline and alignment of interest, if the equity tranche can be too quickly exhausted.[7]

In order to better align interests, enforce the necessary discipline and truly restore investor confidence, we believe together with other stakeholders that risk retention requirements should be increased for both qualifying and non-qualifying instruments to a **mandatory vertical slice of 15% of the whole securitisation.**

Question 4:
A. How can proper implementation and enforcement of EU criteria for qualifying instruments be ensured?
B. How could the procedures be defined in terms of scope and process?

A. We believe that two options are possible: either self-certification by issuers with appropriate and deterring penalties in case of misleading and incorrect certifications, or certification by supervisory authorities.
We recognize however that the second option may be too resource-intensive for supervisory authorities and also agree with the ECB/BOE that "*certifications from supervisors and third parties should be avoided, as such certifications would obviate the need for both investors and the Securitising Party to retain responsibility for their role in the process*."
We would therefore **favour the approach promoted by the ECB/BOE where the securitising party is responsible for ensuring that the STS[8] criteria are met, while market regulators provide in addition appropriate supervisory oversight.**
The fact that an issuer making an incorrect certification claim would have such a detrimental impact on investors' confidence should precisely be a strong deterrent against issuers making wrong claims.

[7] *"When the probability of an unfavourable realisation of the systematic factor is high, and when the equity tranche would be exhausted if this unfavourable realisation were to occur, the originator holding the equity tranche may have less incentive to exert effort to screen borrowers than the originator holding a mezzanine tranche of equal "thickness" or a slice of the loan portfolio."* BIS 2009

[8] Simple, Transparent and Standardised

The suggestion from some stakeholders to have an industry-led entity be charged with ensuring the implementation and enforcement of the criteria should be rejected in our view, as this would be inconsistent with the European Commission's objective of reducing the reliance of investors on external assessments.

B. The scope of the self-certification by the Securitising Party should be across all the criteria relevant to achieving STS status.

Question 6: A. For qualifying securitisations, what is the right balance between investors receiving the optimal amount and quality of information (in terms of comparability, reliability, and timeliness), and streamlining disclosure obligations for issuers/originators?

Investors should have access to any information both qualitative and quantitative necessary to assess the risks adequately.

It is important to bear in mind the fact that information availability does not mean that investors will have the resources to use it. In this respect promoting only the simplest structures is at least as important as information disclosure to ensure that investors are able to perform adequate due diligence.

Question 7: A. What alternatives to credit ratings could be used, in order to mitigate the impact of the country ceilings employed in rating methodologies and to allow investors to make their own assessments of creditworthiness?

The drawbacks of relying on credit ratings are well known:
High ratings, deserved or not, are what attracted uninformed investors pre-crisis and gave them a false sense of security. The importance of credit ratings has also been shown to reduce the diversity of views in the market and magnify the impact of a few people getting it wrong. It has been demonstrated as well that the importance of credit ratings led to more market driven transactions and more procyclicality.
For all these reasons we fully support the recent emphasis on reducing the reliance on external ratings in regulation.

As an alternative we find EBA's alternative approach to credit risk criteria promising and believe that it deserves further investigation.[9]
We also believe that the simpler the structure, the higher the ability of investors to perform their due diligence and the lower the temptation to rely on external ratings.

Question 11: How should rules on capital requirements for securitisation exposures differentiate between qualifying securitisations and other securitisation instruments?

[9] https://www.eba.europa.eu/documents/10180/846157/EBA-DP-2014-02+Discussion+Paper+on+simple+standard+and+transparent+securitisations.pdf

While qualifying securitisations deserve a differentiated treatment, their prudential treatment should not be excessively softened.
The reason for this is that **securitisation, even simple, transparent and standardised, creates additional complexity, procyclicality and interconnectedness compared to simple non-transformed assets**, and this justifies maintaining a significant distinction from a macro-prudential perspective.
For the same reasons, it is also essential to maintain a significant non-neutrality of capital charges.

Question 12: Given the particular circumstances of the EU markets, could there be merit in advancing work at the EU level alongside international work?

There would be merit in advancing work at the EU level alongside international work only to the extent that it does not weaken forthcoming EU regulation.
As an example while US banks are currently securitising subprime auto-loans (a testament to human ability to forget?), it is pretty clear that we do not want to follow this kind of development in the EU.

The argument that having a tighter regulatory framework in Europe would create competitiveness concerns vis-à-vis the US is very debatable. We believe on the contrary that the commercial success of the UCITS framework is strong evidence that investors value a sound framework, and that soundness and commercial success go hand in hand.
As the lack of investor trust has been identified as one of the main impediments to the revival of securitisation in Europe, a tight EU securitisation framework would precisely help restore investors' confidence.

Interestingly, the Chinese ABS market is far more standardised and simple, with only one type of structure, static pools and only two tranches allowed, and is therefore more advanced in some respects than Europe on the path of simplicity and standardisation.

Question 15: A. How could the institutional investor base for EU securitisation be expanded?

A preliminary and more important question in our view is whether the institutional investor base for EU securitisation should be proactively expanded.
First we should note that the investor base will already expand significantly over the coming years as Members States develop third pillar pensions.
In addition, expanding the institutional investor base to small and medium investors would mean targeting those who will likely not have the resources to perform the appropriate due diligence, are likely to buy assets that they do not understand and who would have to rely on external ratings. This would not be a desirable development and we should favour instead other more sustainable financing channels where investors are able to perform themselves the necessary due diligence.

To answer the question, we believe that the current push to develop private pension funds in Europe is sufficient to expand the institutional investor base for EU securitisation.

Question 16:
A. What additional steps could be taken to specifically develop SME securitisation?
D. Would more standardisation of loan level information, collection and dissemination of comparable credit information on SMEs promote further investment in these instruments?

A. It is already acknowledged that SME loan securitisation will be too complex to work, due to the differences in national bankruptcy laws and in the definitions of what is an SME that will take many years to address.
It is also acknowledged that SME loan securitisation will be too expensive to work without subsidies, due to the need to remunerate a number of intermediaries and to offer an attractive return to investors.
This strongly questions the idea that it can be a sustainable financing alternative for SMEs.

In addition, ECB data shows that SMEs' lack of access to finance is mostly an issue of geographical fragmentation rather than an overall shortage of credit supply. As we are not able to create pan-European pools of SME loans due to the absence of a unified definition of what is an SME and due to the differences in bankruptcy laws between Member States, it raises the question of whether it is credible to expect that investors will not differentiate in times of stress between SME loan securitisations of a troubled Member State and non-troubled one, just as they did during the crisis with sovereign debt.
This issue would be best addressed by an effective banking union and by fostering robust traditional and local banks in every Member State, in line with the lessons from the crisis.

Lastly, the current debate about the need to increase the availability of credit for SMEs is framed in terms of quantity of credit, not quality.
Yet one lesson from the crisis is that access to funding is not an issue in normal times, but only in times of stress. Therefore what is needed is not just more credit in general, but more stable credit that does not withdraw quickly in times of stress.
In this respect, the global lasting relationship between a bank and an SME makes bank lending less procyclical than alternative financing channels: a bank might be more willing to support its client during difficult times as the history of the relationship gives it confidence that the SME will get through it.

D. Assessing the creditworthiness of an SME requires not only reading its financial statements, but also crucially integrating qualitative elements such as knowing the local economic context and competition and meeting its management.

These qualitative elements cannot be adequately integrated into credit scoring methodologies. Developing credit scores would also be inconsistent with the European Commission's objective of reducing investors' reliance on external credit assessments.
Consequently, we believe that more standardisation of loan level information, collection and dissemination of comparable credit information on SMEs while good in principle could be a double-edged sword: while it could promote further investment in these instruments, it could also lead to loss of information, decline in the depth of investors' due diligence, cliff effects and ultimately have an adverse impact on investors' confidence.