

STS SECURITISATION Q&A

What are the positives and what to watch out for?

→ IS EU SECURITISATION UNFAIRLY PENALISED BY REGULATION?

While the credit losses of EU securitisations were indeed very low, the marked-to-market losses were very high in some cases, up to 80%¹. This means that the value of securitisations sometimes declined by up to 80%.

Asset managers are in most cases not allowed by their investment mandate to keep positions with such high potential losses, and are therefore required to close them and take the loss, rather than holding to maturity. You therefore have to look at both types of losses. Talking only about credit losses is misleading.

A tougher regulatory environment for EU securitisations is therefore not unfair.

→ WILL SECURITISATION HELP EUROPEAN INNOVATIVE START-UPS AND SMES TO GET MORE FUNDING?

Innovative start-up companies need equity funding. Venture capital provides it.

Due to their lack of tangible assets and sometimes unusual business model, start-ups often struggle to get loans. This is why they need access to equity funding. The promotion of venture capital funds will therefore help them.

Securitisation on the other hand repackages and sells loans to investors. Since start-ups don't get loans, **securitisation is not the answer for start-ups, as there are no loans to securitise.**

Regarding SMEs, ECB surveys show that **European SMEs' biggest concern today is "finding customers" whereas "access to finance" is their lowest concern.**

SME loan securitisation is too complex to work due to the differences in the definition of what is an SME between different member states, and the divergences in national bankruptcy laws.

It is **also too expensive to work without subsidies**, due to the need to remunerate a number of intermediaries and offer an attractive return to investors. This will lead to more expensive loans for SMEs.

This probably explains why SME securitisation hardly exists in the US.

"SME loan securitisation practically does not exist in the United States, yet US SME financing has become more available since late 2009, most likely due to the early clean-up of the banks and effective policies to foster economic growth" (Bruegel, Darvas, Z., Paper for European Parliament, Banking system soundness is the key to more SME, 2013).

¹ Moody's Investor Services Sept 2014: Default & Loss Rates of Structured Finance Securities: 1993-2013

Reviving securitisation is not a sustainable funding alternative for SMEs, only a way to boost the profitability of TBTF banks.

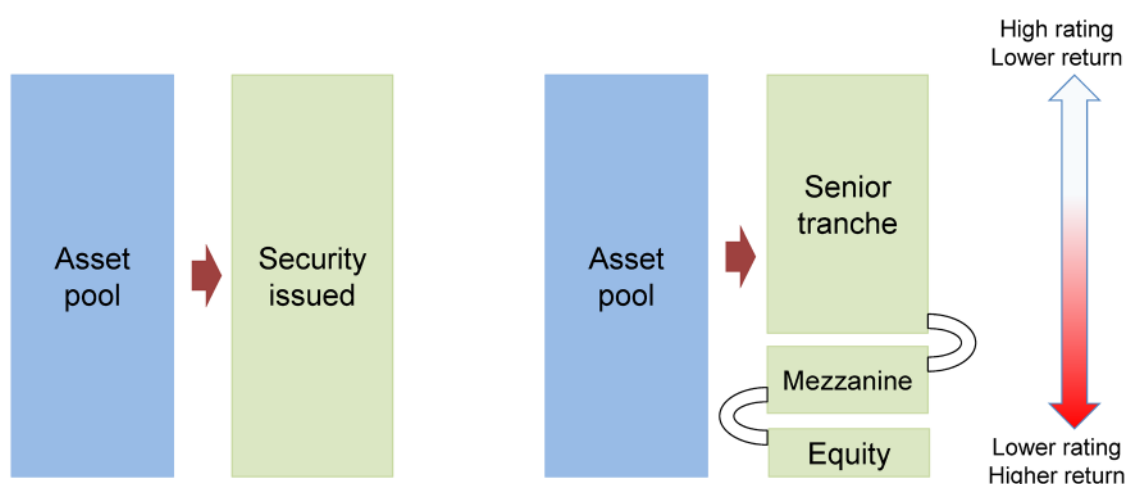
The biggest beneficiaries of the revival of securitisation will be large too-big-to-fail banks, since they are the ones manufacturing the securitisations and collecting the fees.

It is also important to remember that while securitisation will enable them to transfer risk and get capital relief, this will not automatically translate into more loans, since banks choose to allocate their capital to the most profitable activities and SME lending is not one of them. As we do not have a bank structure reform that would have refocused banks on lending to businesses and households, more lending capacity does not equal more lending.

→ DOES STS SECURITISATION INTEGRATE THE LESSONS FROM THE CRISIS?

The proposed Simple transparent securitisation is not truly simple as it allows for tranching.

Tranching is the practice of issuing against a pool of loans not one type of security but several types of securities with different seniorities: an equity tranche that will first absorb losses on the whole pool, then a mezzanine tranche, up to senior tranches that are protected from losses by the more junior tranches and offer a lower return.



It is recognised that tranching creates enormous additional complexity by manufacturing risks that are very hard to assess. As an example senior AAA tranches are not risk free but are catastrophe risk. Catastrophe risk is a risk that materialises very rarely but when it happens the losses are big. Buying them is equivalent to selling insurance against hurricanes, where you earn a little premium all the time, but are exposed infrequently to very high losses. This is one of the most complex types of risk to assess for an investor.

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 that will be first affected by the non-repayment will push for renegotiation with the borrower to increase the chance that he will be repaid in the end, just as a bank would.

On the contrary, the holder of a senior tranche will push for foreclosure to limit the loss and ensure that he won't be affected. So tranching creates conflicts of interests between investors in different tranches.

Lastly, as seen during the crisis, since tranching is the mechanism that enables BBB loans to be transformed into AAA securities, tranching tends to attract less informed investors buying assets that they do not understand, as they rely on the good ratings instead of performing their own due diligence.

The risk retention requirement of 5% aimed at addressing conflicts of interest does not work. It should be raised to 15% and only achieved through retaining a vertical slice of all tranches

One of the main lessons from the crisis is that in many cases banks did not care to whom they lent because they knew they would sell the loans on to investors, and investors did not care as they only looked at the ratings. Ultimately the taxpayers paid the bill as no one was accountable and there were conflicts of interests between the banks granting the loans and the investors.

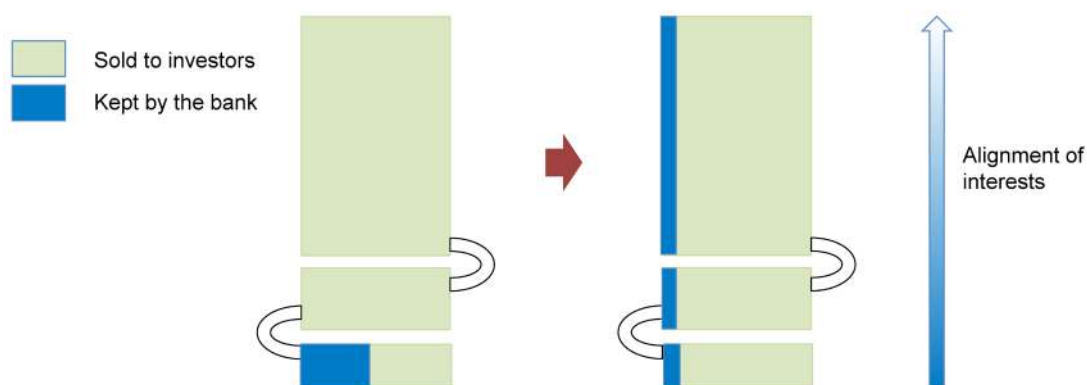
To address that, prudential regulation required banks to keep 5% of the securitisations they manufactured. It is however documented that 5% is too low to provide a meaningful disciplining effect to for banks. Once losses reach 5%, the bank has no longer any incentive to care about investors. We therefore recommend increasing the risk retention requirement to 15%.

The forthcoming proposal also foresees an exemption from the 5% requirement in case the securitisation is guaranteed by a financial institution whose risk weight is equal or below 50% under CRD IV. While in theory it sounds alright as the guarantee protects investors, in reality this is a problem because it creates counterparty risk in case the guarantor cannot deliver on its commitments: as we saw during the crisis institutions considered safe proved unable to honour their commitments, such as AIG FP, despite their very high rating.

If the guarantor is another bank that also engages in securitisation, the chances are that it will also be in difficulty precisely when it is called on to honour its commitment. For all these reasons this exemption should be rejected.

Another concern is the fact that banks are currently being given the choice between retaining either a vertical slice of each tranche, or only the equity tranche or other options.

It has however been documented that when banks keep only the first loss or equity tranche, it fails to exert adequate discipline² because this tranche is often already assumed to be worth nothing. We therefore recommend removing the choice of options and require that the retention requirement can only be satisfied by retaining a vertical slice of each tranche, to ensure an alignment of interest ALL THE WAY between the bank originator and the investor.



² BIS 2009

The door should be firmly closed to a future inclusion of synthetic securitisation.

Whereas originally the framework proposed by the EC excluded synthetic securitisations, it now opens the door to a future inclusion under pressure from lobbyists.

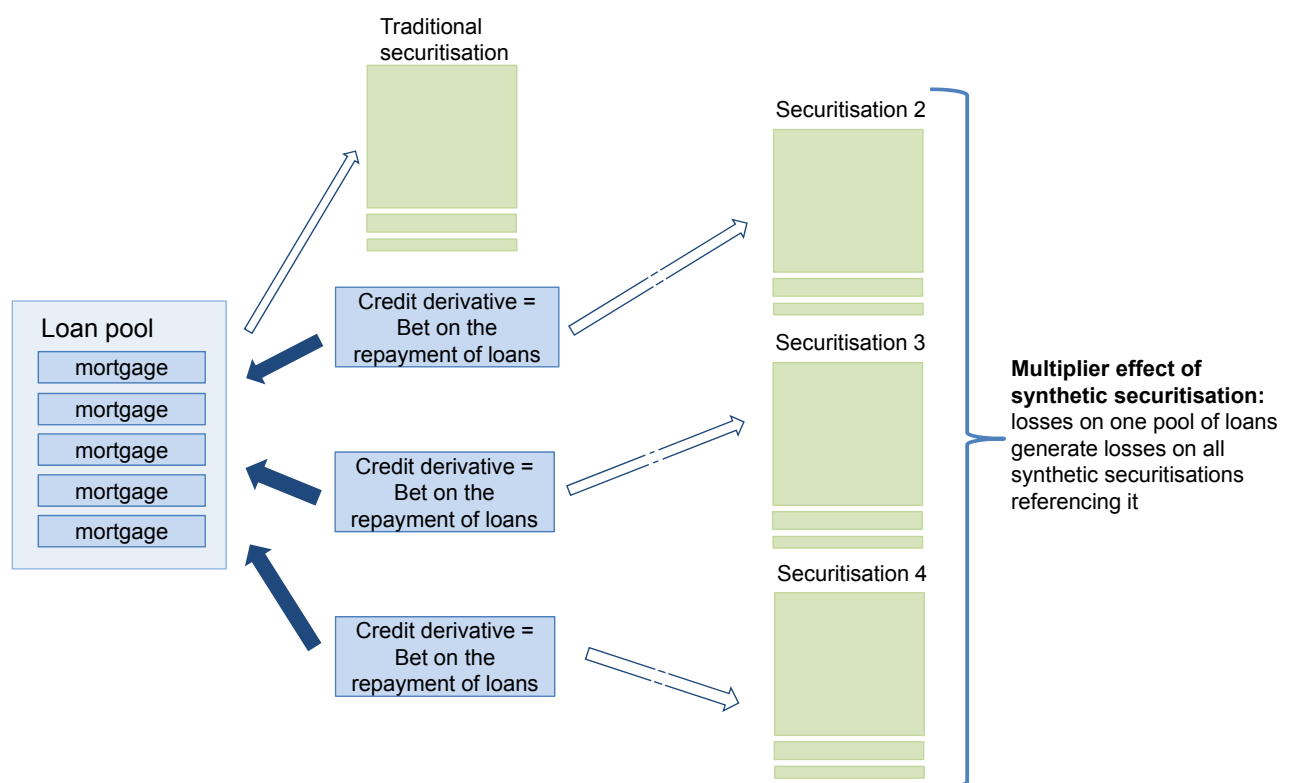
As a reminder, in synthetic securitisation the underlying assets are not loans but derivative contracts called credit default swaps, which are in effect financial bets.

The bets are like insurance contracts against the non-repayment of a loan: the buyer of the bet pays a premium, and in case the reference loan is not repaid in time, he will receive an agreed sum as compensation.

In effect instead of selling loans to investors, the originating bank is buying insurance contracts on the loans from investors. Therefore one key difference is that **synthetic securitisation does not finance anything**.

More importantly, synthetic securitisation enables financial institutions to **create an unlimited number of bets and securitisations** referencing specific loans, thereby **amplifying greatly the impact of loan losses**.

Synthetic securitisations are equivalent to letting all your neighbours buy a fire insurance policy on your house. Not only might it give the wrong incentives, but it also dramatically amplifies the financial impact of your house burning, just as synthetic securitisations enabled the creation of many more subprime loan securities than there were subprime loans.



For all these reasons, it is essential to maintain the exclusion of synthetics and promote only the securitisations that DO finance the real economy and not those that are simply derivative bets amplifying market cycles.

Excessive maturity transformation should not be allowed in ABCP

ABCP are short term securitisations whose maturity is on average 30 days. Whereas the original European Commission proposal allowed underlying assets to have a maximum residual maturity of 3 years, some are pushing to extend the maximum maturity for some assets to 6 years.

Arguably underlying assets with such a long maturity should be securitised through a normal term securitisation, not an ABCP. Allowing that would once again allow for excessive maturity transformation where 6 years assets are financed over 30 days with related risks of not being able to renew your funding. Contrary to some claims, forthcoming bank liquidity ratios will not comprehensively address this risk.

One of the clear lessons from the crisis is that we should firmly prevent this type of excessive maturity transformation and forbid assets with maturities over 3 years in ABCP.

Failure to address these four concerns would be promoting once again a securitisation that is not simple and does not integrate the lessons from the crisis with the risks that we know. STS securitisation without these additional criteria should be rejected.

→ HOW CAN WE MAKE STS SECURITISATION A SUCCESS AND INCREASE THE COMPETITIVENESS OF THE EU'S FINANCIAL SECTOR?

There is no trade-off between having a tight robust framework and commercial success and competitiveness.

The commercial success of the UCITS framework is strong evidence to the contrary, namely that investors value a sound and tight framework, and that soundness and commercial success go hand in hand.

As the lack of investor trust is one of the main impediments to the revival of securitisation in Europe, a tight framework would precisely help restore investors' confidence.

About Finance Watch

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