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"On good securitisation, LTF and the Capital Markets Union agendas"

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Good morning and thank you for being here.

The topic I would like to discuss today is the revival of securitisation, that is is seen as cornerstone initiative of the forthcoming Capital Markets Union and a key element to revive growth in the European Union.
I will present briefly how we look at this issue and what questions deserve a public debate in our view, in order to introduce the forthcoming panel.

Even though securitisation played a significant role in the onset of the financial crisis, I believe we all agree that securitisation is a useful financial technique that is part of the toolkit to finance the real economy.
Securitisation offers indeed many benefits: it offers access to a cheap form of funding, frees up bank regulatory capital, and enables borrowers to access a wider range of investors.
We also recognise that post-crisis securitisation is very different from its pre-crisis form.

However since securitisation includes a very wide range of structures, the key question really is what type of securitisation we want to see re-emerge.

First a number of impediments have been identified to the revival of the securitisation market.
Some of these impediments are however positive developments that do not need being addressed, such as the disappearance of leveraged money investors, or the increased share of deposits funding banks, that has reduced the need for market-based funding.

Several reasons are frequently mentioned to revive securitisation in Europe, including facilitating SME access to finance, pursuing EU financial integration, boosting European banks profitability, and increasing institutional investors' role in financing the real economy.

Yet on the first argument that securitisation will be beneficial to SME access to finance, some stakeholders argue that SME securitisation will be too complex to work due to the absence of an unified definition of what is an SME and due to the differences in bankruptcy laws between Member States.
They also argue that it would be too costly for SMEs due to the need to remunerate a number of intermediaries and to provide an attractive return to investors.
Therefore if SME securitisation is not viable economically without subsidies, one might wonder whether it is a sustainable financing alternative for SMEs.

Secondly on the argument that SME loan securitisation will address geographical fragmentation in access to finance, we might also want to be cautious.

The argument is that securitisation will offer SMEs access to a broader range of investors and thus further pursue EU financial integration, with SME ABS playing the role that Sovereign bonds used to play pre-crisis.
However harmonising SME definitions and bankruptcy laws between Member States will take years.
Until this happens, we won't be able to create pan-European pools of SME loans, and SME securitisations are likely to be based on national loan pools.
In turn, 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 SME loan ABS of say Germany, just as they did between the Sovereign debt of Greece and German Sovereign debt?

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In other words, while one the main purposes of the forthcoming Capital Markets Union is to address intra EU fragmentation, one might ask the question of whether reviving securitisation is likely to address this issue?

Lastly some wonder whether introducing a tight framework for high quality securitisation might create competitiveness concerns vis a vis the US.
We believe that the commercial success of the UCITS framework outside the European Union is a strong evidence that investors value a sound and tight framework, and that soundness and commercial success go hand in hand.
Also as it is also acknowledged that investors' negative perception of securitisation is one of the main impediments to its revival, a tight framework would help restore investors' confidence.

Now coming back to high quality securitisation, while there is a consensus on the fact that it should be part of the funding toolkit, there is no consensus yet on the type of securitisation that should be promoted.

A lot of work is currently being done to define simple standard and transparent securitisation that will benefit from a much softer prudential treatment.
A first definition was provided at the end of last year within Solvency 2 delegated act.
EBA also recently put forward another possible definition and BCBS/IOSCO are currently consulting on another definition.

While these definitions of simple securitisation have much in common and share many excellent criteria that we fully support, we believe that an additional criteria is necessary: no tranching.

As a reminder tranching is the practice of issuing against a pool of loans several types of securities with different seniorities: an equity tranche that will first absorb losses on the whole pool, then a mezzanine tranche, etc. up to senior tranches.
While this technique enables to transform BBB loans into AAA securities, it creates a number of concerns.
First tranching creates model uncertainty and manufactures complex risks that are very hard to assess.

As an example senior tranches are not risk free but are correlated catastrophe risk. 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.
However, unlike hurricane insurance where the risk can be mitigated through diversification as it is unlikely that major hurricanes will happen in several places at the same time - the risk of senior tranches is correlated, similar to an insurer faced with hurricanes happening the same month in every country where he has sold insurance policies. This is obviously a much more serious risk.

Professor Embrechts, who will be on our panel, could also describe the incredible difficulty of pricing mezzanine tranches.

It has also been shown that tranching amplifies the impact of mistakes in the assessment of underlying default risk and correlation.
Tranching also creates additional procyclicality and conflicts of interests between holders of different tranches.
Lastly, tranching attracts less informed investors who are more likely to neglect tail risks and buy assets that they do not understand.

Interestingly, a recent BIS paper found that even when securitised assets are simple, transparent and of high quality, risk assessments will be uncertain due to tranching.

For all these reasons, we therefore believe that tranching should not be part of a high quality securitisation framework.
That is not to say that it should be banned, but merely that the additional level of complexity and uncertainty that tranching creates do not justify a significant softening of its prudential treatment.

It is also important to remember that originally securitisation was "pass through", that is only transferring risk to outside investors without transforming it.

On the flipside, as tranching enables to create different risk profiles that match investors' preferences, some fear that real money investors would have no appetite for non-tranched securitisation.
This is an important and legitimate question that needs to be addressed.

We believe that:
First of all the purpose of regulation is to provide the right incentives and not necessarily feed the market's current appetite.
More importantly, 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.

A few institutional investors we talked to share this view, and it will be interesting to hear the opinion of Mr Patriniche on this topic in the forthcoming panel.

Now, once a definition of high quality securitisation is agreed upon, the question is then what to do with it: how much softer should be the prudential treatment of this securitisation?

A first key question is whether we should maintain the non-neutrality of capital charges or should we move towards full neutrality as some advocate.

Non-neutrality refers to the fact that the total capital charge for a securitisation is higher than the capital charge for the underlying assets, had they not been securitised.
Non-neutrality was originally an explicit intention of regulators to reflect the higher complexity of securitised exposures.

So the question is: should securitisations have a capital charge similar to underlying non-securitised asssets or retain a higher one?

Another question that is currently being raised is whether the prudential treatment of high quality securitisation should fully converge towards that of covered bonds.

Our view is that while we support a limited softening of the prudential treatment of high quality securitisation, we strongly believe that we should not move to full neutrality nor to a full convergence towards the prudential treatment of safer assets like Danish covered bonds.

The reason for this is that securitisation, even high quality, simple and transparent will create additional complexity, procyclicality and interconnectedness compared to simple non-transformed assets, that justifies maintaining a distinction from a macro-prudential perspective.

I will now leave the floor to our excellent panellists, who will provide the perspective of different stakeholders on these important topics.

Thank you very much.