Market Insight

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Draghi's ABS purchase programme – will it be enough?

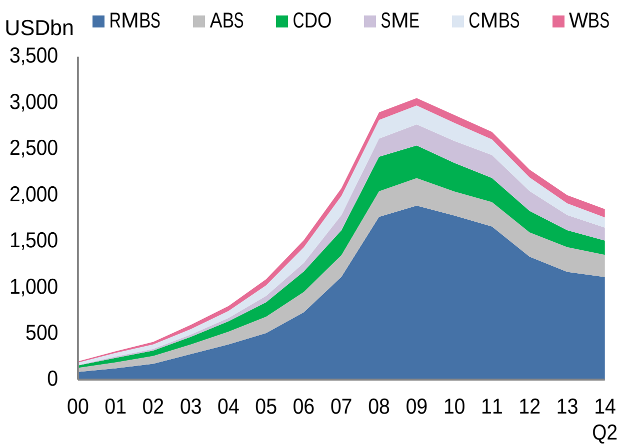
London 26 September 2014, by Amir Khan and Mike Nawas

Is the asset-backed securitisation ("ABS") purchase programme, proposed by the European Central Bank ("ECB"), aimed at preventing economic deflation or at building confidence in a stuttering securitisation market? Or is it the European way to recapitalise banks? Or, is it a mechanism to prompt banks to intensify lending to SMEs and other parts of the "real economy"? Some would argue that it is meant to achieve all of these; some would be more optimistic than others. Mario Draghi, in his European Parliament address on September 22nd 2014, has provided important insights into what the programme will constitute when it is formally announced on October 2nd. Our Market Insight establishes whether it is likely to be enough to achieve the aim of having securitisation contribute to real economic growth in Europe.

Recent themes in the European securitisation industry

The European securitisation industry, in terms of volumes outstanding (including tranches retained by issuers themselves, often used for repo's with the central bank), stood at around US$ 2.0 trillion at the end of 2013 (the similar figure in the US was around US$ 9 trillion). The annual volume of issuances placed with investors has reduced to almost one-fifth from its 2007 levels.

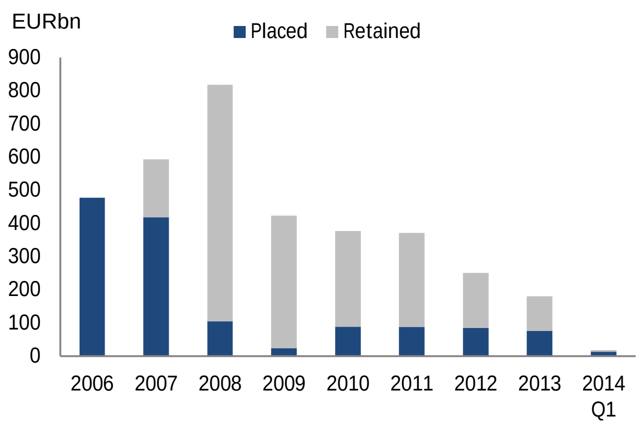
Figure 1: European Securitisations Outstanding



Source: Data Snapshot, AFME Securitisation: Q1 2014

While the securitisation market in terms of placed deals has recovered somewhat since the low point of 2009, the total issuance volume remains well short of the pre-crisis levels.

Figure 2: European Securitisations Issuance



Source: SIFMA

The reasons behind this decline are well known:

- General suspicion towards securitisation as a fallout from the US sub-prime mortgage crisis
- Penal capital treatment under new regulations
- Use of alternate funding instruments, such as covered bonds
- Disappearance of a number of large investors

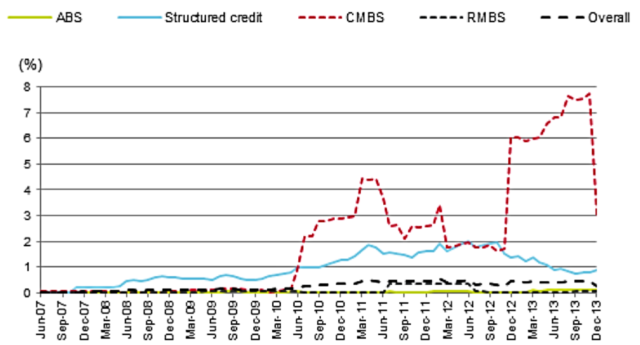
More specifically, the decline can be related to important changes to the typical characteristics of securitisations that (in the past more so than now) have made them useful funding tools for issuers:

Table1: Characteristics of European securitisations

Pre-crisis	Post-crisis
Regulations allowed issuers to use securitisation to reduce risk weighted assets and regulatory capital, freeing up credit lines to allow for new lending	Tighter regulation with respect to regulatory capital relief via securitisation. Consequently, issuers begun to see securitisation predominantly as funding tool, rather than a funding plus capital management tool
Deep market: large number of senior investors and an active market for mezzanine and equity buyers, allowing issuers to place the entire capital structure thereby derecognising assets and achieving risk transfer	Many investors exited the securitisation industry. Senior investors have returned but are still being held back by current regulatory treatment. Mezzanine and equity investors almost disappeared, although some are returning
Not counted towards asset encumbrance levels	Increasingly counted towards asset encumbrance, in line with for covered bonds (if only senior tranches are placed)
Positive spread between margins on underlying loan portfolios and cost of funding in the securitisation market forms the basis of a powerful disintermediation tool	The sharp rise in margins on securitisation tranches has undone the positive spread if all tranches are placed and diminished the spread if only senior tranches are placed. Even though margins have declined again significantly, they are still too high

The credit statistics of European securitisations show a marked difference between the well-performing ABS and RMBS segments, and the poorer credit quality of other segments such as structured credit and CMBS. The ABS and RMBS segments, i.e. the areas that are gaining support from Mr Draghi, have shown an exceptionally modest credit default history. Low losses are mainly based on the typically high granularity, diversification and seasoning of the assets that are used in these transactions.

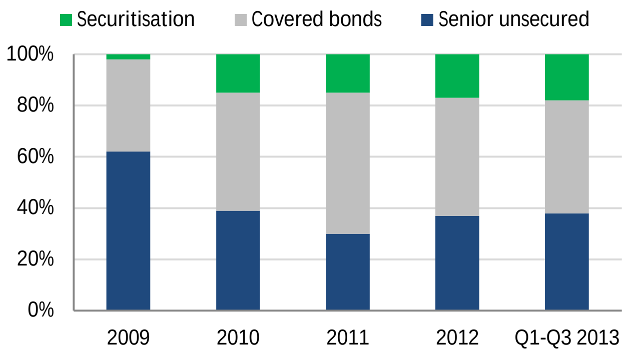
Figure 3: 12-month European securitisation rolling default rates



Source: Standard & Poor's 2014

As investors have begun to accept the durability of this strong performance, the spreads on securitisation tranches have reduced materially since the peak of the financial crisis. We see this as a first positive step and one that signifies greater acceptability of and liquidity for these products, as evidenced by the re-emergence of securitisation as a core part of the wholesale funding mix for banks:

Figure 4: Europeanbanks' new term wholesale funding issuance

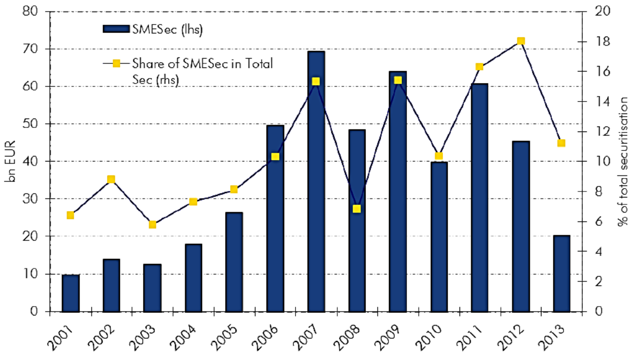


Source: Standard & Poor's 2013

Financing the real economy via SMEs

Policy-makers and politicians across Europe seem to agree that sustainable economic growth and a reduction in unemployment should be SME based, as they are key drivers of the real economy. Therefore it is unfortunate that the SME securitisation volume in Europe has also registered a decline during the crisis.

Figure5: European SME securitisation volumes



Source: EIF, based on data from AFME and KfW

While the European banks have increased deposit funding and generally improved their capital base, increased lending in the future will be driven not only by available liquidity but also long term balance sheet capacity and capital considerations. So it is not surprising that the creation of bank liquidity most notably through central bank intervention has not translated into lending to the real economy. Compared to the peak of EUR 4.6 trillion reached at the beginning of 2009, the volume of outstanding loans to non-financial corporations has decreased by more than 10% to EUR 4.14 trillion in the Euro area in March 2014. We believe that securitisation can be an important tool to consider not only as a liquidity generator but, importantly, to also achieve risk transfer so it can facilitate lending to SMEs and other real economy sectors. We believe that this should be possible to achieve without diluting the key new Basel III rules for issuers, which include among others an obligation to retain 5% of the economic interest in the securitisation – the so-called "skin-in-the-game" rule aimed at keeping an alignment of interests between the bank using securitisation and the investors in such securitisation.

ECB's announcement to buy ABS

Although banks presently seem well-capitalised with no apparent funding issues, we expect that once all Basel III and other regulations are implemented and the economy recovers to a point where credits increase, a new equilibrium is needed in which banks and the economy can benefit from disintermediation structures – such as securitisation – that connect the banks' balance sheets with the capital markets. As such, we believe there is a need for a securitisation market that is well-functioning, i.e. straightforward, transparent, liquid, of high credit quality and containing products that support the real economy.

European policy-makers seem to recognise that in order to revive the ailing European securitisation market, a reversal in regulatory sentiment is needed to an extent that has not happened sufficiently yet. There have been signs of increasing levels of comfort evidenced by inclusion of asset classes such as RMBS in the liquidity coverage ratios ("LCRs") albeit with a haircut. But it is perhaps best described as "too little, too slow". In recognition of the challenging regulatory regime, the ECB is now taking the initiative to buy ABS in order to re-establish a resilient securitisation funding market for banks.

Mr Draghi's address on September 22nd 2014 is a precursor to the official announcement that is expected on October 2nd, and describes the potential scope of the programme (as below). His precursor speech raises some interesting considerations:

- Which asset types? *"Our purchases will include a fairly wide range of simple and transparent ABS collateralised by loans to the real economy. The assets to be purchased would satisfy high standards of transparency and simplicity and are also characterised by low default risk."* In our view, this is likely to capture SME securitisations as well as RMBS and consumer ABS asset classes such as consumer loans and credit cards.

- ECB eligible? *"Regarding senior securities, we would buy only those assets that are eligible for Eurosystem operations. So, we have ample experience with managing and understanding the risks associated with this asset class."* Watch this space. We believe that the ECB's consideration for its overall risk position is understandable. However, the momentum that the programme is able to create may prompt calls for expansion beyond assets currently eligible for Eurosystem operations. Such move will, however, necessitate the ECB to carefully balance its mission as central bank against a role as regular, i.e. long-term, investor in the debt capital markets.

- New or retained transactions? *"The total stock of eligible securities which is currently outstanding – held in investors' portfolios or retained by the originating banks – is already sizeable. We are confident that it will grow as a result of our presence in the market."* Including retained tranches would increase the potential volumes that can be used but may not benefit the market in the long term as we will discuss below.

- Senior tranches only? *"Under the ABS purchase programme we will be purchasing senior and guaranteed mezzanine tranches. As for the guaranteed mezzanine tranches, their intrinsic credit risk would be comparable to that of the guarantor, be it a national or supranational entity."* The ECB responds effectively to the legitimate concern that the initiative's impact will be diluted if the ECB only targets the senior, AAA-rated ABS tranches. We believe that including mezzanine positions begins to facilitate risk transfer and so a freeing-up of bank balance sheets to lend and to use securitisation as an effective disintermediation tool. By insisting on credit protection by a national or supranational entity the ECB, understandably, clearly drew the line as to its role: that of liquidity provider and not of capital-provider to banks and other securitisation issuers.

Now that Mr Draghi has provided an indication of the likely guidelines for the programme, it is helpful to analyse what these entail in terms of transaction structures and to which extent the intended benefit – to stimulate lending to the real economy – is likely to be delivered.

Dress for success

We believe that, within appropriate regulatory controls, securitisation can and should be an effective disintermediation tool to facilitate lending to the real economy, i.e. to businesses and consumers, as long as at least some of the economic risk is transferred to investors. The important question is how will this condition be met and does the ECB programme help in this regard?

Placement with investors

It is evident that the ECB would want issuances to carry the stamp of quality, simplicity and transparency. One of the benefits of the fallout from the credit crisis has been that industry initiatives have been successfully established that deliver these robust standards. Prime Collateralised Securities ("PCS"), the Dutch Securitisation Association ("DSA") and the European Data Warehouse are examples of such initiatives that have been recognised and accepted by a vast group of stakeholders in a short period of time. In our view, the ECB can go a step further by endorsing such structures as part of its eligibility criteria for the ABS purchase programme and, in that way, stimulate a wider investor interest. In this respect, we welcome the Basel Committee IOSCO survey with the objective to present criteria to G20 finance ministers for marketable ABS and thereby assist in the process of creating standards that would encourage non-bank investors to buy ABS. Although the details have not yet been published, its Chairman has pointed out that they have identified 16 such criteria.

The ECB is likely to include retained securitisations in its programme, but often these structures contain structural elements or asset classes that would not be suitable for external investors. We do not think that transactions eligible for ECB repo but not marketable to external investors are ultimately helpful for the long term sustainability of the securitisation market. So, by endorsing and adopting the standards referred to above, the ECB programme would effectively place requirements on issuers to align as much as possible with market standards such as the PCS and DSA that establish best practice criteria to address asset risk, structural risk and investor reporting/disclosure needs, even if a certain securitisation issuance is initially aimed at being retained by the issuer for its repo programme.

Pricing transparency

The pricing for securitisations should, in our opinion, be based upon a (i) reflection of the risk of the underlying asset, (ii) reflection of the risk category i.e. tranche of the underlying asset, and (iii) fair portion of the yield on the underlying asset minus a compensation for the servicing and the origination costs. Such pricing transparency allows both investors and issuers to benefit from securitisation. Again, such pricing transparency will only be achieved when there is a diverse and deep investor base. While the ECB will represent a single investor, its capacity to potentially deal in large volumes could help materially in achieving pricing transparency for securitisation tranches.

The objective of pricing transparency materially dilutes the scope, as suggested by market rumours, for the ECB purchasing senior ABS tranches at off-market prices in order to create a commercial incentive for issuers to increase issuance volumes. That's good, in our view, because the sustainability of such an approach and the artificial mechanism it creates, would be questionable in any event.

Asset derecognition

In order for securitisation to be a reliable and mainstay disintermediation tool – as opposed to solely a funding tool – for issuers, it has to deliver benefits of risk transfer and asset derecognition. This aspect will drive capital relief for banks and allow them to redeploy capital towards new lending. Stricter rules for capital relief have made it more difficult for banks to achieve asset derecognition and, coupled with the departure of investors, the demand for the more junior, mezzanine and equity tranches has also diminished substantially.

Although in recent years the spreads on mezzanine tranches have reduced significantly, which is a sign of stabilisation, it is still not enough to make securitisation viable as a disintermediation tool – the all-in costs for a securitisation are still too high and the investor market is too small.

We believe that the ECB programme will make a material impact on this front by facilitating a well-functioning investor market for these tranches. Guarantees from national and/or supranational entities on the junior, mezzanine tranches prevent the ECB from moving in the direction of being a capital provider instead of a liquidity provider. It will be interesting to see whether sovereigns will participate under such guarantee schemes (France and Germany have not indicated support for such an arrangement) as these are likely to increase their national debt burden and hence be politically difficult to implement. Supranational bodies, such as the European Investment Bank and European Investment Fund, who also carry the objective to stimulate SME lending in Eurozone are obvious candidates and have been highlighted by Mario Draghi as such. Alternatively, rather than relying on government related guarantees only for the more junior tranches, it may also be possible to include private sector parties as eligible guarantee providers as part of the ECB programme, subject to certain rating triggers. After all, such credit wrap will not be an evergreen feature and, at some point, the securitisation industry will need to function without support from the ECB or (supra)national government guarantees.

Conclusion

Based on Mr Draghi's initial indications in his recent address, we are tentatively optimistic about the impact that the ABS purchase programme can have, although it will be key to analyse the details once they are formally released, expected on October 2nd. The programme can stimulate interest from investors in not just senior tranches but also junior and mezzanine tranches. But the ECB can go further, especially by more concretely embracing the initiatives that the market has implemented in support of transparency, simplicity, quality and liquidity. Such measures will help put the industry on a stronger footing for the long term, enabling a self-supporting market rather sooner than later. Hopefully a sustainably vibrant securitisation market will begin to convince policy-makers to look at securitisation in greater detail, i.e. distinguishing "good" from "bad" structures. Without addressing some of the – from a credit performance point of view unduly punitive – capital rules under Basel III and Solvency II for investors in securitisations, securitisation as a disintermediation instrument will not be able to play the role it could for the real economy.

This programme, on its own, will not serve as panacea for the securitisation market. More is required for regulators to revisit their stance over time. Asset derecognition and risk transfer are crucial if the ECB wants its ABS programme to crystallise further bank lending to the real economy. Involvement of other stakeholders (sovereigns, supranational bodies) and their alignment on the principle that securitisation is important for the real economy will also be critical. The question remains if the ECB will be prepared to achieve this soon or whether it will be part of a phase 2 plan. Regardless, the ECB has been the one to blink first and will now anxiously hope others will follow.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you

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