José Manuel González-Páramo: Re-starting securitisation

Keynote speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the Association for Financial Markets in Europe/European Science Foundation (ESF) and Information Management Network Global ABS (Asset-Backed Securities) 2010 Conference, London, 16 June 2010.

*   *   *

Ladies and gentlemen,

I. Introduction

I am very pleased to be here in London to participate again at the AFME/ESF and IMN Global ABS Conference. Today, I would like to share with you some thoughts on the restarting of the ABS markets, in the light of the important role that it should play from a macro-financial point of view.

More precisely, I shall first outline the role which securitisation should play in the financial system and why this role is important. Then, I shall assess in more detail the current situation of the securitisation markets. Finally, I would like to make some considerations on the way forward for the restarting of the ABS markets. In doing so, I shall assess what has been done and what still needs to be done to reach a sustained rebound of the securitisation markets.

II. Current financial market conditions

To set the stage, I shall refer to the ECB's latest *Financial Stability Review*, published on 4 June, which analyses in detail the so-called large and complex banking groups (LCBGs), and the findings of which may, with some caution, be extended to the euro area banking sector as a whole.

Thus, we noted in our latest *Financial Stability Review* that many LCBGs from the euro area have returned to a modest profitability in the course of 2009, and that their financial performance has strengthened further in the first quarter of 2010. At the same time, de-leveraging has continued, while banks have further reduced their reliance on wholesale funding in favour of an increased share of more stable funding sources, such as retail customer deposits and equity.

Notwithstanding this slightly positive note, over the next few years the euro area banking sector will face large funding needs, as most of you are aware of. In particular, the 20 largest euro area banking groups have about EUR 800 billion of long-term debt outstanding that will need to be refinanced between May 2010 and end-2012. This figure represents almost half of their outstanding debt with a maturity of over one year.

In addition, the need for banks to issue medium to long-term debt is likely to increase as a result of new regulatory requirements on stable funding ratios that would come into force at the end of 2012.

Against this background, securitisation can potentially play a vital role, and thereby strongly support the financing of the economy, in two main respects:

- *First*, in order to mitigate the potential funding challenges that I have just mentioned, securitisation may contribute to the broadening of the funding base – both inter-temporally and geographically –, by transforming illiquid assets into negotiable long-term securities (even if these may not necessarily be very liquid). It may thus help to unblock credit supply constraints in an environment of continued de-leveraging by taking regionally or sectorally concentrated credit risk off bank balance sheet and distributing it to a wider investor base.

- *Second*, a proper use of financial engineering techniques, such as securitisation, may provide a better match between the preferences of borrowers and investors in terms of cash flow structure, type of interest rate, degree of risk and currency denomination. This is particularly relevant when the securitisation pool is composed of loans to borrowers who cannot have access to the capital markets on their own, i.e. households and Small and Medium Sized Enterprises (SMEs). In other words, securitisation may function as a bridge between these types of borrowers and those investors who cannot easily access these types of exposures otherwise.

To summarise, if the ABS markets work satisfactorily, they may contribute to the completeness of the financial system by distributing the risks and returns associated with a large range of non-marketable financial assets to a more diversified set of holders, with at least an equal or better capacity to bear these risks. This can contribute to enhancing the efficiency of the economic system. This is why I believe that a rebound of the securitisation market on a sounder footing, including a stable issuance activity of marketable assets remains crucial from a macro-financial point of view.

III. What is the current state of the securitisation markets?

Of course, the state of the securitisation markets is connected with the general situation of financial markets, and we all know that the current financial environment remains challenging. Financial markets had experienced some sort of improvement in 2009 and the early part of 2010. However, in early May adverse market dynamics took hold again across a broad range of financial markets, including several debt securities markets in the euro area, in an environment of diminishing market liquidity. As a result, most funding markets deteriorated rapidly.

As you know, to help restore a normal market functioning again, the Governing Council of the ECB decided to take additional non-standard measures on 9 May 2010, including the conduct of purchases of euro area public and private debt securities in secondary markets, the reactivation of fixed-rate full-allotment long-term refinancing operations (LTROs), and the resumption of US dollar liquidity-providing operations.

Nevertheless, even abstracting from the impact of the adverse developments in the financial markets, the securitisation markets themselves have not satisfactorily developed in the last years, both in terms of broadening the investors' base and of achieving stable issuance volumes.

In both 2008 and 2009, the share of new issuances distributed in the market accounted for 1 or 2 percent of all new issuance. This is of course in sharp contrast with the percentages observed in the years preceding the crisis. For instance, in late 2006 and the first half of 2007 1 or 2 percent was the share of *retained* (as opposed to *distributed*) issuance.

Since securitisation techniques were nevertheless still used substantially in 2007 and 2008 despite the lack of market participants being able or willing to absorb the newly-issued securities, most of this paper ended up being used as collateral with central banks. In the case of the euro area, this process started off indeed already in 2007 and increased more significantly in 2008 when ABS constituted 28 percent of all assets being used as collateral with the Eurosystem. This share decreased moderately to 23 percent in 2009. These developments reflect an important switch in the business model of securitisation, from the "originate-to-distribute" model up to the summer of 2007 to some form of "originate-to-repo" model.

To make things worse, the "originate-to-repo" transactions that took off when the turmoil started in July 2007 have often little in common with the "originate-to-distribute" assets that were marketed before mid-2007. Thus, the “originate-to-repo” securities do not aim at being attractive to investors, but serve a different purpose, namely to generate collateral buffers with the central bank. So, the significantly large volumes of retained issuance are effective indicators of the scale of the continuing dislocation of the ABS market and the vanishing of private markets.

However, it should be obvious to everyone that the issuance of ABS only to serve as collateral with central banks cannot be a sustainable strategy for the ABS market. In normal times central bank operations are intrinsically of a short-term nature and of a limited size, and are designed to implement the stance of monetary policy. By contrast, ABS transactions backed by residential and commercial property loans have much longer maturities and must cover a very sizeable market. In other words, in normal times central banks tend to have a very limited involvement in financial intermediation and only private investors have the capacity and the need to offer long-term funding to originators.

What are the more recent trends? Some developments in the last few months may be interpreted as showing tentative signs of a recovery as new ABS issues were distributed and placed with private investors . Moreover, the volume of placed assets during the first five months of 2010 outpaced the combined placed volumes in 2008 and 2009.

These tentative positive signals are confirmed by the European ABS Investor Confidence Index by JP Morgan, which has remained in positive territory for the last nine months. Our own Bank Lending Survey indicates that for the first quarter of 2010, banks generally reported that their access to wholesale funding became easier.[1] In addition, after a broadly neutral evaluation of true-sale securitisation access for corporate and housing loans in the fourth quarter of 2009, banks assessed the situation as significantly more positive, in particular for the securitisation of housing loans. It should be noted, however, that this survey was conducted before the outbreak of the sovereign debt crisis.

While all these indications may suggest that demand for ABSs is re-emerging, we still need confirmation from the data over the next months. Moreover, the latter developments represent an improvement but are still far from normal market conditions, or even from suggesting that we may be moving towards such conditions.

IV. How do we bring back investors’ confidence?

Taking the stock of the latest information, one should recognise that euro area securitisation markets remain dysfunctional, mainly for demand-side related reasons. And, of course, the malfunctioning of the market has implications also for the supply-side.

- On the *demand side*, the investor base has been and remains severely eroded and many earlier active investors, such as SIVs and money market funds, are not expected to return to the market anytime soon. Europe in particular suffers from a lack of a significant real-money investor base that could step in.
- On the *supply* side, concomitantly, the profit generating potential of securitisation remains insufficient, since spreads for various ABS still exceed the break-even levels from the issuer’s perspective. At the current levels of spreads, securitisation does not make economic sense for originators in most cases. At the same time, it would appear that current yields, with some exceptions, are not attractive to compensate for the perceived risks in the view of many investors.

Therefore, although there are some signs of improvement, the current situation in structured finance continues to impose market funding constraints on banks and to hamper banks in

[1] See “The Euro Area Bank Lending Survey”, April 2010, ECB.

providing credit to the economy. In this sense, securitisation is still certainly unable to fulfil the objectives that I highlighted at the beginning of my speech.

Going forward, the key question is therefore: how do we bring back investors to the securitisation markets? This is tantamount to asking: how can investor confidence in securitisation be restored?

I believe that the development of transparent, comparable and simple securitisation structures, based on high quality standards of underlying assets, and with at least some market segments characterised by high liquidity, is a *sine qua non* condition for a return to self-sustaining securitisation markets.

Indeed, investors need to be able to exercise the required due diligence and to assess the assets that are on offer, with the support of the credit rating agencies, which in turn should have the information and the analytical capacities required for this purpose. This, in turn, calls for a careful definition of the information that should be shared among market participants.

The issue of liquidity is even more complex because of the cumulative nature of the conditions underpinning it. Enhanced secondary market liquidity will make the entrance of new investors more likely. A more liquid market may come as a result of better price disclosure, standardisation and less complex structures. However, without institutional investors, liquidity will not reappear. There is some circularity problem here since at the same time, it is more likely that institutional investors return to the market when market liquidity is proven to be there or strongly expected to be back. Finally, less sophisticated and specialised investors may also enter the market, but this would require an even more material increase in the simplicity, standardisation and transparency of securitisation markets.

V. The Eurosystem's contribution to restoring the ABS markets

Let me dwell on the requirement of enhanced transparency of the underlying asset pools. I would like to elaborate on the Eurosystem's contribution to enhanced disclosure through its initiative to make loan-by-loan level data on ABS transactions widely available. Let me say from the start that this initiative alone will not suffice to re-open the market, but it would become an important building block along the path towards standardisation, simpler structures, and better post trade price transparency.

As you will remember, in December 2009 the ECB launched a public consultation in order to gather market and public feedback on a proposal to introduce requirements on loan level data in ABS transactions and make this an explicit eligibility criterion, should the ABS be used as collateral with the Eurosystem.

This initiative may trigger a structural change in the way the different market participants interact within the securitisation markets. By increasing the transparency, availability and quality of the information on the underlying assets, and by ensuring a regular updating of the information, market participants will have a sounder base on which to build valuation, risk and surveillance models.

The public consultation included six questions on the general advisability of the initiative as well as on technical details of the implementation. At the end of the consultation period on 26 February 2010, 53 responses from different investors, market data vendors, credit rating agencies, financial service providers, audit firms, stock exchanges, law firms, public authorities, and central securities depositaries, had been received. The responses revealed a strong support from market participants, mainly because of its potential contribution to increasing transparency, which is seen as an essential ingredient for more informed risk assessments and to restore weakened confidence in ABS markets. In addition, respondents issued a number of recommendations to the Eurosystem regarding specific implementation aspects that should contribute to a smoother introduction of the loan by loan level data.

From a timing perspective, the Governing Council of the ECB will assess during the autumn the results of the final technical preparatory phase that has already started, also taking into account the recommendations put forward during the public consultation, before deciding whether to proceed with the final phase of the introduction of ABS loan by loan data requirements. This decision is envisaged to take place during the fall 2010. In case it is decided to proceed, a twelve-month phasing-in period – in line with the feedback received in the public consultation – would be sufficient for originators and issuers to adapt their systems to provide the required data.

It should be noted that the Eurosystem's initiative on loan level data is in line with certain amendments introduced by the Second Capital Requirements Directive ("CRD II") that will enter into effect on 1 January 2011. Amongst other things, CRD II provides that the sponsor or the originator must ensure that investors and prospective investors have readily available access to all materially relevant data on credit quality and performance of the individual underlying exposures. Thus, CRD II views information on individual underlying exposures (i.e. loan-level data) as necessary for investors to be able to make reasoned investment decisions.

However, I want also to make clear that, along with policy initiatives, the structured finance industry has an essential role in restarting the European securitization markets and setting them on a sounder footing. The industry cannot realistically expect that the return of investors' confidence will be just a question of time and implementing regulatory action. Likewise, certainly confidence will not be restored by introducing minor changes to the instruments and the functioning of the markets. On the contrary, confidence in securitization will return among private as well as public stakeholders only if market participants and their associations are able to materially enhance market standards and practices.

Let me stress also that the industry cannot expect public authorities to accept merely cosmetic changes to the instruments and the markets. This, for example, applies to the Eurosystem's collateral framework. In a context in which outstanding ABS represent almost 25% of the total collateral deposited by counterparties with the Eurosystem, it is imperative for the Eurosystem to be prepared to perform a proper assessment of risks whenever needed. In this context, loan-level information will enable ratings agencies to produce meaningful surveillance reports, which could in turn help the Eurosystem to diligently assess the risks implied by the collateral accepted in our refinancing operations.

Industry-led initiatives aimed at revitalising the European securitisation market are inspired by high level principles, which typically meet immediate consensus. However, when these principles are transposed into specific provisions in some market convention, consensus becomes less easy to reach. In fact, aligning all the stakeholders' incentives often proves to be difficult and there is the risk of only reaching a very low minimum common denominator. Certainly, this would not be sufficient to win back the confidence of public and private players in securitization. I therefore invite the industry to continue and to strengthen its efforts in this vital area of work.

VI. Concluding remarks

Let me conclude by saying that, if managed in good order, securitisation should be a welfare-improving tool, because value is created by secured funding that is correctly structured and allows to adequately distribute financing and funding, and the related risks among households, enterprises, banks and investors. When it works properly, securitisation may represent a significant step towards more complete credit markets, thereby contributing to enhancing the efficiency of the economic system. The revival of securitisation markets is needed in many countries to support the provision of credit to the real economy, particularly to households and small business.

While it is essential to define new market standards in terms of simplicity and transparency, more actions may be needed to re-start the securitisation market. There does not seem to be one single and simple solution that can unlock the securitisation market. This is natural since structured finance is a combination of manifold features such as different asset types, a variety of interest rate products with diverse maturity profiles and structures, and a variety of legal regimes and market arrangements. Thus, restoring the securitisation markets requires a combination of initiatives, both from the private and the public sector.

The Eurosystem is contributing, first of all, by accepting structured finance assets as collateral. This proved and still proves a great support to this market segment during the crisis, as it helped and continues to help to avoid a sudden and disruptive unavailability of funding to originators of ABS. Second, as mentioned earlier, by introducing a loan level data requirement to our set of eligibility criteria, we may contribute to increasing the disclosure standards for the market at large. However, more needs to be done, as many of those required steps, for example enhancing secondary market liquidity, go beyond the scope for direct action by the Eurosystem.

Looking ahead, a self-sustained revival of the ABS market requires fundamental changes. It is high time to raise to the challenges of transparency, standardisation and product simplicity. This is where the industry has to step up its efforts in order to help decisively in restoring confidence in the securitisation markets.

Thank you for your attention.