Repairing the EU Banking system and the role of securitisation

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Repairing the EU Banking system

Market sentiment and banking sector indicators

Stock index - Euro Stoxx 600 banks share price index and CDS Index

Expected default frequencies – EBA EU bank CDS Index, average Dec 2011=100

- Several indicators showing positive market sentiment and confidence returning, both EU Banks CDS index and expected-default frequencies (EDF) decline substantially
- EU has made significant progress in implementing structural reforms at EU wide and national level
- Institutional changes have played an important role
Following EBA’s recapitalisation exercise in 2012 and EU-wide Asset Quality Review (AQR) and stress test exercise in 2014, EU banks capital positions have continued to maintain an increasing trend.

Eurozone banks raised over EUR 80bn in capital in 2013 and expect to raise over EUR60bn in 2014.

In addition, EU banks are issuing Additional Tier 1 or Tier 2 bonds via contingent convertibles (CoCos) to strengthen their capital base.

EU banks capital positions are now in line with major international peers.
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Income and profitability

Banks with a return on equity (RoE) lower than 8% continued to increase and represented 75% of the total assets in December 2013.

EU banks income and profitability levels remain subdued, mainly due to balance sheet clean up and litigation costs.

EU banks have seen their net interest margins compressed and the fragile economic environment continues to provide limited new lending opportunities.

Banks are still reviewing business models and adapting to the new business environments, cost-cutting (overhead and staff costs) still remains the most important driver to increase profitability.
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Asset side

- There is a continuing reduction of balance sheet and loan books across the EU and quality of bank’s loan portfolio deteriorated in 2013 and Q1 2014
- Deleveraging and de-risking continued to be very important components for the fixing and strengthening of the EU banking sector
- Completing action of balance sheet repair (AQR) is pre-condition for kick-starting lending to the real economy
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Liabilities side

- Overall funding conditions have improved in 2014 and global activity has been relatively high. Market funding continued steadily to replace early repayments of the two three-year refinancing operations (LTRO) provided by the ECB, by March 2014 almost half the funding provided had been repaid.

- For EU banks substantial net negative issuance is expected in 2014, due to strong deposit base and deleveraging process.

- The sovereign-bank link in EU seems to persist despite some signs of weakening correlation and some banks still face continued structural funding challenges, in particular in countries having experienced some sovereign stress.

- Banks have started to adapt their funding and capital structures to the new regulatory requirements.
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Concerns

• Significant challenges with the EU banking sector continue due to large debt overhang in the public and private sector, ii) persistent asset quality deterioration and iii) squeeze net interest margins and profitability concerns

• Dislocation between financial markets and the real economy continues to be observed and risks to the EU growth outlook still weight more heavily on the downside

• Financial fragmentation continues, although it is receding, and retrenchment to home markets is still a concern

• The distress in emerging markets may raise risk aversion and affect capital flows
Role of Securitisation

Importance of the Securitisation Market to the EU Banking system

“EBA believes that the European securitisation market can play an important role in meeting the funding needs of the originators and the asset diversification needs in Europe in the future. The PCS label could be an important component to re-establish a sound and well controlled market for securitisation in Europe. The EBA will continue to monitor the securitisation market closely once the PCS label starts to be operational.”

Andrea Enria, Chairperson of the European Banking Authority (June 2012)

The EBA recognises that securitisation can be used as an effective credit risk transfer tool and for risk management purposes. If certain criteria are met, including the SRT requirements, originator institutions of a securitisation may consider the credit risk transfer in the calculation of own funds requirements.

EBA website, Guidelines on SRT for securitisation transactions (December 2013)
Role of Securitisation

State of the Securitisation Market

The securitisation market in the EU continues to be impaired

- For the full year 2013, EUR 180.8 billion of securitised product was issued in Europe, of which only EUR 76.4 billion was placed
- At the end of Q4 2013, 1.50 trillion was outstanding, of which 788.7 billion (52.5% of outstanding) was retained, presumably for repo or other secured financing
- Since the peak in the third quarter of 2009, values of outstanding have fallen 33.8%

Banks are reluctant to use securitisation as a funding tool

- Cheaper to refinance asset portfolios via central banks market operations that to fund them through the capital markets
- Need for additional funding has diminished, due to weak economic recovery and banks deleveraging process
- Change in rating agencies methodologies and assumptions have made it uneconomical for banks to fund certain assets types via securitisation

Investors are reluctant to invest in securitisation products

- Complexity and opaque of some structures, exceptional historical losses in some securitisation transactions resulting in stigmatisation of the whole market
- High levels of uncertainty of regulatory treatment of securitisation in the near future and un-level playing field vis-à-vis other secured funding products
Role of Securitisation

Historical credit performance of the securitisation vs. corporates

- 69% of all securitisation ratings relate to US RMBS and US CDO (37% US RMBS subprime, 24% US RMBS others, 8% US CDO), which performed very bad compared to corporates across the whole rating spectrum and stigmatised the reputation of all securitisations.

- EU RMBS (3% of all securitisation ratings) outperformed corporates, in particular during the crisis years.

Source: S&P, CEREP, EBA
One of the most important lessons of the 2007-2009 crises is that risk and losses of securitisation products have been substantially different between products and regions.

Most EU securitisation products, in particular EU RMBS and EU ABS, performed well with almost zero losses during the crisis.
Historical credit performance of different securitisation products

- Also at BBB level, EU RMBS and EU ABS preformed very well
- The global securitisation default curve resembles very much the US RMBS default curve and is delinked from EU securitisation historical loss performances
- A securitisation regulatory framework that is not sufficient risk sensitive and doesn’t differentiate between products of asset classes within the global securitisation market could penalise the best preforming securitisations
Role of Securitisation

Policy responses

To date, new EU regulation has been put in place to address the shortcomings of the securitisation market and de-stigmatise the securitisation product

- Risk Retention Rules (“skin-in-the-game”) and due diligence requirements were introduced in 2011
- EU Credit Rating Agency legislation in 2013, making rating agencies more transparent and accountable
- Loan-by-loan data templates on underlying assets have been introduced by ECB and BoE

Despite the recent positive regulatory activities to enhance the protection of the securitisation investor, more attention from banking regulators and central banks is necessary to revive a sound and well controlled securitisation market in Europe

- Following a call for advice from the Commission the EBA is currently working on a technical paper on the potential development of a safe and sound securitisation market in the EU
- EBA is currently finalising its Guidelines on Significant Risk Transfer for securitised assets in order to provide a clear framework for banks and banking supervisors on how securitisation can be used in a prudent way to transfer credit risk
- EBA is currently working on Technical Standards of SF mapping of Credit Rating Agencies SF ratings (which are recognised to issue SF rating) to Credit Quality Steps in the CRR
Role of Securitisation

Potential development of a sound and controlled securitisation market

The EBA sees a number of compelling reasons justifying the development of a sound and controlled securitisation market

- Reflecting the actual historical credit performance of EU securitisations
- Increasing the risk sensitivity in regulation to differentiate between securitisation products
- Reducing the reliance on external rating agencies in the regulatory framework

Clear objectives should be outlined from the start and be aligned by politicians, central banks and prudential regulators

- Promoting simple, transparent and standard securitisation market to increase traditional investors base and perhaps develop market for new investor base
- Equalising the regulatory level playing field and central bank market operations treatment of securitisation transactions with other funding products with similar risk characteristics
- Promoting the funding for the real economy by maintaining at all times a well calibrated and consistent prudential treatment of securitisations
Role of Securitisation

High level concerns with potential development of a sound and controlled securitisation market

• The development should not be used as a quick fix to mitigate some of the current or expected securitisation regulations which are perceived as “excessively” conservative by market participants resulting in an overall watering down of the prudential requirements

• Co-ordination between regulators and central banks needs be intensified in order to ensure consistent securitisation regulation and well functioning market going forward

• Different timelines and definitions of a potential development of a sound and controlled securitisation market might lead to increased regulatory arbitrage and disruption of the securitisation market

• Criteria for the development of a sound and controlled securitisation market should ensure that there is no stigmatization or fragmentation relating to securitisation products/tranches that will fall outside the definition
Role of Securitisation

Final remarks

• Securitisation in a well defined prudential framework is beneficial to banks and could be an important funding tool and increase funding to the real economy. Furthermore it is a useful tool to realise credit risk transfer and risk-sharing in the financial system and to help in the current deleveraging and de-risking process of EU banks without triggering an excessive contraction to the real economy.

• The securitisation industry, via the establishment of the PCS association and label, has shown to regulators that it is capable of imposing some level of self-control on the development of the securitisation market. It is important that the securitisation industry continues not only to function within the letter of the law but also within the spirit of the regulation as we know that securitisation if used inappropriately, can cause a significant and long-lasting shock to the whole financial system.