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Regulation Flash

Madrid, 14 April 2014
Economic Analysis

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High quality securitisation

Separating the wheat from the chaff

The Bank of England (BoE) and the European Central Bank (ECB) published last Friday a joint paper ahead of G20/IMF Spring meetings. The paper has been released amid renewed political discussion on the need to support the recovery of securitisation, as it could be beneficial to fill the long term financial gap for the real economy, especially for small and medium-sized enterprises (SMEs). The regulatory stance towards securitisation appears to be changing from an overall penalising framework to a new approach of ensuring a preferential treatment to high quality securitisation. A longer discussion paper will be jointly issue in May.

Overview

- **Both central banks hint that the overall stigma of securitization is not justified for high-quality securitisation**, that is, simple and transparent structures versus complex and opaque ones.
- **They highlight the need for revitalising European securitisation markets**. It would help filling the funding gap and would support the transmission of the monetary policy action in a moment where the bank lending channel is impaired.
- **According to their analysis, the cumulative default rate** on European Asses Backed Securities accounts for 1.5% (July 2007-3Q 2013) while US ABS default rate stands for 18.4% (same period).

Regulation measures

- **The BoE and the ECB call for the easing of "unduly generalized punitive" regulation**. They suggest that there is a need for a differentiated preferential regulatory treatment for high quality securitization.
- **Regulatory measures still penalising securitisations:** The Basel capital and liquidity framework punish securitization. It envisages a high capital consumption for ABS regarding solvency and most of ABS (other than RMBS) do not qualify to meet the Liquidity Coverage Ratio.
- **Measures already adopted to improve transparency:** A minimum 5% risk retention requirement by originators together with the loan by loan reporting data initiative to all major ABS are relevant initiatives to enhance the level of transparency and to align risk incentives in this market which should contribute restoring investors' confidence. Moreover, some private initiatives, such as Prime Collateralised Securitites, are aimed at consolidating a label of high and transparent securitisations.
- **Recent European public actions:** The Eurosystem collateral policy was modified in July 2013 so as to decrease haircuts on ABS with transparent and standardized structures EIOPA has already distinguished between securitisations of type A (high quality) and B (complex) for Solvency II, the European Commission in its recent Communication on long term financing has also committed to give a preferential treatment to those assets and EBA is analyzing the definition of the high quality securitization.

- **The paper does not enter into details but recommends concerted policy action in various fields and involving a range of official entities.** The way forward is to distinguish between high quality securitizations versus the others. The central bank eligibility criteria should be a useful starting point for the definition of high quality securitization.
- **According to recent European initiatives, the key aspect to define a high quality securitization might be concepts such as:** simple structure, granularity or exposure, level of transparency and information, and lower dependence on rating.
- **Assessment:** A preferential treatment for high quality securitisation is very positive and welcome as a catalyzer of funding, especially for SMEs. A first step to kick start this market is to differentiate simple and transparent securitisation from the rest. Nevertheless, credit ultimately relies on more structural fundamentals of the economy.

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