Forgiveness of sins

Now there is a better understanding of what makes a good securitisation, this market should be encouraged to play a full role in the economy, says **Ian Bell**

Securitisation was demonised during the financial crisis but now appears to have been born again. It is, says the International Organization of Securities Commissions, "when functioning properly… a valuable financing technique". Michel Barnier, the EU internal market commissioner, has expressed a wish to find a way "to give a second wind to the securitisation market" and senior voices in the ECB, all the way up to Mario Draghi, its president, have called on securitisation to help fund small and medium-sized enterprises (SMEs).

Why has securitisation been redeemed? Is it that policy-makers and bankers only ever paid lip service to the notion that securitisation was an evil?

In reality, two developments explain the renewed tolerance.

First, as the existential crises that wracked Europe subside (ranging from questions over the solvency of banks to the survival of the euro), policy-makers are looking at a further time horizon. What they see there is many years of bank deleveraging, leading, quite possibly, to a decade or more of economic stagnation. After all, banks that are less leveraged also lend less. The only way out of this bind would appear to be that capital market money replaces the missing bank funding. However, non-corporate borrowers (small and medium-sized companies and consumers) cannot access the capital markets, which is why there is an interest in securitisation as a way to finance them.

The second development is the realisation, five years into the crisis, that not all securitisations are created equal and that traditional European securitisation, in fact, performed incredibly well. In the classic "plain vanilla" asset classes (mortgages, SME loans, consumer loans), total losses from all European securitisations so far, through the worst crisis since the second world war, amount to 0.08 per cent. In the safer senior tranches, losses are still, to this day, zero.

So, if we need securitisation to help stave off stagnation, and it can be done safely, why has the European market not recovered in the way that its US sibling has? The issues around reviving securitisation can be divided into immediate and, hopefully, temporary problems and longer-term, potentially serious ones.

The immediate problems are the rocky macro-economic conditions and the presence of huge and virtually free pools of central bank liquidity. As the economic crisis endures and banks find fewer creditworthy borrowers at the same time as they are taking a conservative approach to capital preservation, lending is being reined in. In addition, to avoid a repetition of the 1930s, central banks have made large amounts of virtually free money available to banks (for example, Funding for Lending or the Long-Term Refinancing Operation scheme). As a result, what little lending the banks are willing to undertake will be financed from these pools of free cash, making securitisation an unnecessary and, in relative terms, expensive funding alternative. In time, the economic cycle should start to turn and the central banks will have to devise an exit strategy from their role as lenders of first resort.

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The longer term problems lie in a raft of regulatory proposals whose cumulative effect, should they all be implemented, could easily close the door to any meaningful hope of a revival in European securitisation. These suggestions centre on the capital requirements for holding securitised investments. The difficulty is that they look at securitisations as an undifferentiated mass and calibrate all rules based on the worst performers.

The proposals include the Basel Committee's new global capital standards for banks investing in securitisations; the Solvency 2 EU proposals for insurance companies; and the possible new capital rules for funds to be implemented in the Alternative Investment Fund Managers Directive (AIFMD). Other proposals concerning the definition of liquid assets for the purposes of the new bank liquidity ratios, introduced in the EU's Capital Requirement Directive (CRD4), and proposed collateral requirements for swaps also add to the dismal prospects for securitisation.

We should not forget, of course, that the proposals are still the subject of quite heated debate. However, with the benefit of time to analyse the crisis, we now have a much better understanding of what went wrong in securitisation. This allows us to understand what makes a securitisation weak and vulnerable, as the US subprime issuance was, and what makes a securitisation strong and resilient, such as UK or Dutch mortgage issuance. By not taking this analysis into account, the present regulatory proposals incorrectly treat everything as if it were US subprime. This is simply wrong.

There must be change to take into account the lessons of the crisis. If not, it will be very difficult to revive a securitisation market that should, and could, prove one of the most important bridges to ensuring that the European economy sidesteps long years of stagnation.

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