# Securitisations, Europe's categorical imperative

***Note written by Ian Bell for Eurofi***

Enlightenment philosophy explicitly intruding in financial markets policy discussions is hardly an everyday occurrence. But in November of last year, Christine Lagarde did just that in a speech where she called for a Kantian shift in Europe's approach to capital markets[1]. Those of us with an interest in securitisation could not fail to notice that, together with suggestions for a better regulatory and market infrastructure, the only market segment singled out to play a decisive role in the creation of a deep capital markets' union was securitisation. For those who see securitisation as, at best, a useful emergency capital management tool for banks in difficulty, this focus by as eminent a person as the president of the European Central Bank on the potential transformative role of this financing channel might appear strange. In this article, we will try to show why, on the contrary, it makes enormous sense.

## The challenges

In finance, the challenges facing Europe are well known.

First, we must finance the enormous green and digital transformations of the continent. The Commission has estimated the necessary *additional yearly* funding at €620 bn for the former, €125bn for the latter.

Secondly, the world is becoming a more unforgiving place where large economic blocs appear to be turning their back on globalisation and cooperation. If Europe wishes to preserve its values and economic health, it will need to give itself the means to hold its own. These challenges extend well beyond the realm of finance. But it has at least two financial components.

One involves innovation. The tales are endless of European innovators unable to raise finance to move to stage two of their development. They fly to Silicon Valley and raise the necessary funds. But the cost is almost invariably relocation to the United States from which they sell their product back to Europe as an American corporation. An important and often overlooked point is that these European innovators do not raise this finance from US banks but from US funds. Banks in the US fund start-ups when they have already some success (stage 3). Innovation in the US is funded by the capital markets via private equity and joint-venture funds. The second involves the international footprint of European banks. There are no EU banks in either the top or second tiers of "global systemically important banks" as ranked by the FSB[2]. There are only two out of ten in the third tier. There are twice as many Chinese banks in that third tier as EU. The price to book ratio of almost every EU bank is below one and for many, way below one. Neither is this state of affairs an artifact of temporary stock exchange blues. It has been the case unbroken for over twelve years. For that whole time, the world equity investors have been telling European banks that they do not have the capacity to create value. If being a major player in international finance is a form of soft-power, Europe is failing that test.

## Europe's advantages and the key to exploiting them

The good news is that Europe has the money. Europeans save and have done so for a long time.[3]

The bad news is that without a capital market, there are few places for this money to go. OECD figures show that US households hold only 13.4% of their financial assets in currency and deposits. Despite the creditable 13.5% of Danish households, no EU county achieves this level. France is at 31.3%, Italy at 31.8%, Germany at 42.8% and Greece at a staggering 58%.[4]

1. https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp231117~88389f194b.en.html
2. Technically, these are the second and third ranks since the first rank is always, as a matter of policy, left empty by the FSB.
3. EU savings rates for 4Q23 were 13%, compared to 3.9% in the US.
4. OECD Data - https://data.oecd.org/hha/household-financial-assets.htm#indicator-chart

Europe's problem is "plumbing". We have a large pool of savings. We have enormous demands. But of the large twin pipelines available in the United States to shift finance from where it to is where it needs to be, banks and capital markets, Europe lacks one – capital markets – and finds the other too small in size for the volumes it must carry.

The size constraint on banks is, of course, driven by capital constraints. This is unlikely to be resolved though by traditional capital raising. The below one price to book value and analyses of banks' implied cost of capital versus their actual return on equity indicate that issuing equity is going to be both challenging and very costly. Recent problems in the market for subordinated bank debt are not making this source of capital very attractive either.

To achieve its ambitions, Europe must increase the width of the banking channel and create a proper second channel with a real capital markets union.

Securitisation is, in our view, the only means to achieve these twin goals at speed. This is why this article bears its Kantian title of securitisation as a categorical imperative.

**Note:** There is, of course, another crucial limb to the capital markets union project in the form of the development of equity markets. This article only seeks to deal with fixed income but in no way seeks to downplay the importance of the other side of the capital market equation.

## Securitisation and banks

Securitisation can provide banks with funding. But this is not of great interest. Between deposits and covered bonds, banks can raise funding. That does not mean that securitisation should not be used as a prudent form of diversification of funding, as we show below in our discussion of securitisation as a systemic stabiliser. But this is not its primary function *vis-à-vis* the banking system.

Securitisation primary purpose in Europe is as a safe form of capital management[5]. Through securitisation, banks can remove risk from their balance sheet. This, in turn, frees capital that is no longer required to "insure" the bank against the now removed risk. One sometimes hears the concern that securitisation allows banks to conduct lending without adequate capital. This though misunderstands how capital in the banking system operates. Capital is made up of assets available to meet unexpected losses. Traditional capital is made up of assets owned by the bank itself – equity or deeply subordinated loans. A bank can reduce capital requirements from securitisation either by a traditional true sale securitisation or by a synthetic securitisation (a form of credit insurance). In the former case, the assets leave the banking system altogether and are transferred to the securitisation investors. That does not mean there is no capital against those assets in the financial system as a whole. The holders of the junior tranches provides "capital" against those assets but do so from outside the banking system. In the case of a synthetic securitisation, the investor agrees to pay for losses on the securitised assets. This payment commitment is an asset from outside the banking system available to meet unexpected losses within the banking system. This means that traditional bank capital is replaced by the non-bank capital provided by that synthetic securitisation investor. Capital in the system has not been reduced but shifted from the banks' balance sheets to the non-banks' balance sheet.[6]

Banks can then use the freed-up capital to make additional loans. Securitisation widens the banking funding channel in Europe.

But it does more.

By allowing European banks to make additional loans on the same traditional capital base, securitisation will increase their return on equity since the returns on these new assets are additive to banks' existing returns on the same equity.[7]

Securitisation is also a generator of fee income – *i.e.* income that does not need to be backed by scarce capital. This is because, insofar as the assets securitised are still serviced by the bank – which they almost invariably are – the bank receives a fee for that servicing without this income stream incumbering its capital base. This additional fee income also increases banks' returns of equity.

Finally, securitisation is a generator of investment banking fee income. By generating tradable securities, it creates additional services that banks can charge for (arranging, underwriting, trading, derivative provision, fund management, etc.). Again, this is additional fee income that does not require capital (or a lot less capital) and so can boost the profitability of banks.

5. Securitisation can also underpin a non-bank financial institution ecosystem and add value in this way. This though is a matter for another paper.
6. In fact, because of the non-neutrality of the CRR capital requirements for securitisations, after a synthetic securitisation, the total amount of capital in the system is increased.
7. Although this is not the place to develop this, this effect results from the technical concept of "excess spread".

These additional features of securitisation explain, in part, the much better financial performance of US banks. By importing these to Europe, securitisation will, in the longer term, increase European banks' capacity to raise traditional capital. It will also allow them to hold their own place in the global financial markets.

## Securitisation as systemic stabiliser

Securitisation can not only increase the volume bearing size of the European banking channel but can also, at the same time, strengthen its resilience. This is because securitisation is also an important systemic stabiliser.

In times of building stress in the banking system as occurs during economic recessions, when capital is eroded by losses, a deep and safe securitisation market allows banks to maintain healthy capital ratio's by sharing risk with non-bank investors.

During times of more acute stress when doubts are raised about the very solvency of banks, the securitisation market is a source of liquidity for troubled institutions when other source dry up. During the 2011/2012 sovereign crisis in Europe, some banks found that they could not issue bonds (either on a secured – *i.e.* covered bond – format or unsecured format). But they were able to issue securitisations since the risk of those bonds was not tied to the survival of the issuing bank.

## Securitisation and capital markets

At its most basic, securitisation generates a capital market simply by creating investable capital market instruments. But this is not just a quantitative benefit – *i.e.* more investment instruments for EU savers. Securitisation is also ideal to kick-start the growth of a meaningful CMU because it creates the right kind of investment instruments. EU investors are risk averse. To be successful, a deep capital market needs to generate a large volume of safe investable instruments to meet those retail investor needs. Through tranching, securitisation allows the creation of large pools of safe, AAA, STS securitisations with stellar credit performance. These can be bought by conservative savers whilst the lower, riskier tranches can be bought by high(er) risk/ high(er) reward funds[8]. If Europe wishes to mobilise all those savings currently in cash deposits, such safe instruments must be made available in substantial amounts.

Securitisation is not the only source of high credit quality instruments. Covered bonds also provide this type of investment. However, covered bonds are a bank product. They involve investors lending to banks and taking bank risk. In other words, rather than creating a second funding channel away from banks, they reinforce Europe's reliance on the banking sector. Rather than creating an independent second financing channel, they create only a capital market extension of the existing bank channel. And since covered bonds cannot recycle existing capital, they cannot by themselves widen that existing bank channel.

## Securitisation and innovation

The ability of securitisation to generate large volumes of extremely safe investments is also key to the CMU's hope of funding innovation within Europe.

The rationale here is that Europe needs to create a retail investor ecosystem (primarily and, certainly at first, mediated by funds) that is attractive in terms of returns whilst still conservative in terms of overall credit risk. The way this is achieved in the United States is by investing in a blend of instruments. Typically, and depending on one's risk appetite, one would invest for example 85% of one's savings in conservative, safe but low yielding investments and 15% in riskier but high yielding bonds. The private equity, joint-venture type funds that finance innovation are clearly in the latter category. But to attract investors into that 15% sector, one needs to have the 85%. To build a capital market solely or primarily on risky investments will only lead to investors turning away from that market as it becomes seen, not entirely unfairly, as a high-risk casino for people willing to gamble their retirement savings.

By creating the safe but low yielding part of the capital markets in sufficient volume, securitisation can allow the riskier but high yielding part to flourish and finance European innovation *in Europe*.

## Why securitisation?

Although securitisation can generate this growth in capital markets, other instruments such as corporate bonds, SME bonds and project bonds are also available. Why should we focus on this particular instrument in a priority manner? Why was this the only instrument specifically mentioned in Ms Lagarde's speech?

8. We are not suggesting that securitisations should be sold directly to retail investors. Securitisation remains a fairly complex instrument that requires professional due diligence. However, we would envisage retail investment in AAA senior STS tranches mediated by funds such as UCITS.

The answer, we believe, is that in an economic bloc where 80% of financings are generated by banks and have been for many decades, banks are where financial assets exist in large quantities. At the end of 2022, according to the ECB, EU headquartered banks held almost €31 trillion in assets. To build out in volume any other instrument will take time as new borrowings must be generated. Bank borrowings already exist ready to be turned into securities.

If we look at the needs of the European economy, including the green and digitisation transformations, these are not only large, but they are urgent. We cannot afford to build out a market able to mobilise savings over decades. In addition, none of the other candidates to kick-start the capital market union provide for increased flow of funds from both available channels via the positive effect on bank capital.

## Why is there only a small EU securitisation market?

The European securitisation market in 2023 saw issuance of public securitisations of around €120 bn including the UK. This is much smaller than the volumes in other jurisdictions.

Although many reasons have been put forward for the small size of the market, none save one are very convincing. They are not convincing because almost all point to conditions that also exist in all the other jurisdictions from Canada to Japan where the securitisation market is broader and deeper than in the EU. The one that is convincing is that Europe has a uniquely penalising regulatory framework.

## What must be done?

Although it is not possible to guarantee a flourishing securitisation market following an improvement of the regulatory framework, it is clear that without any change in that framework, the outcomes are exceedingly unlikely to be different from what they are now.

The good news though is that despite the need for a deep securitisation market to create globally competitive banking and capital markets, there is no need for "special treatment" or modifications to the prudential regulatory treatment of securitisation away from a prudent, fact-based approach to ensuring the safety of the financial system. To allow securitisation to grow, all that is required is to finalise the reforms already brought into being in Europe. The current punitive regime was imposed as a first step and in acknowledgement of the agency risks potentially embedded in securitisation and how these, coming from the US, had devastated the financial world in 2007/2008. A second step, enshrined in the STS Regulation, was the removal of the most egregious agency risks for all securitisations through "skin in the game" retention and a ban on re-securitisations and the creation, in STS, of a new standard from which all such risks were effectively excluded. Although some modifications were made to CRR and Solvency 2 at the time, the missing third step is to see through to their logical conclusion the removal of agency risk for STS and calibrate both CRR and Solvency 2 to the actual, evidenced performance of these instruments. Another required step – in line with the issue of competitive disadvantage – is to level the playing field with other asset-based products so that disclosure and due diligence requirements are equalised across asset classes.

For a detailed analysis the reader can check earlier publications such as "Securitisation: the indispensable reform"[9]

## Conclusion

To meet with confidence the challenges it faces, the European Union needs to widen the two financing channels available to mobilise the available savings of its citizens. Securitisation can do this.

It can widen the bank channel by allowing banks to bring into the financial system non-bank capital and thereby both increase their lending envelope and their return on equity. The former generates more funding for the economy, the latter generates the type of returns on equity necessary for European banks to compete on the global stage with their US and Chinese counterparts. This securitisation can do whilst also providing systemic stability to this broader banking system.

It is also the only tool that can widen, within a reasonable timeframe and in sufficient volume, the European capital markets so as to convey the substantial savings of EU citizens to their own economy and their own climate and digital transformations.

To do this, though, a miscalibrated and punitive regulatory framework must give way to a sound, evidence based and coherent one.

9. Eurofi Policy Note: https://www.eurofi.net/wp-content/uploads/2021/12/securitisation_the-indispensable-reform_ljubljana_september-2021.pdf