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AFME Briefing Note

The negative implications of the EBA's proposed approach to securitisation and the LCR

At a Public Hearing held on October 23rd, the European Banking authority published its preliminary findings regarding the treatment of securitisation under the Liquidity Coverage Ratio ("LCR") of the Capital Requirements Regulation ("CRR"). The EBA is required to submit its final report to the European Commission by the end of 2013.

While these findings are formally stated to be "preliminary" in nature, their publication relatively late in the process and with no formal opportunity for the industry to comment further suggests that the EBA's views are well settled.

The EBA published slides setting out their conclusions on their website following the Public Hearing.

For securitisation the preliminary outcomes are very discouraging: securitisation scores worst of all five categories considered, worse even than equities. In contrast, covered bonds are found to perform best – on a par with government bonds.

AFME and its members are very concerned that the EBA is moving towards an inappropriate treatment of high quality securitisation which will hinder prospects for revival of this market in both the near and medium term.

There are many well-known arguments supporting the important role high quality securitisation has to play in helping restore European growth. Steps have been taken by regulators and the industry to address the shortcomings of the past. The regulatory approach needs to be balanced, sensibly calibrated and evidence-based. All this has been acknowledged by many senior policymakers including Commissioner Barnier, President Draghi and (more recently) Governor Carney of the Bank of England and Yves Mersch of the ECB.

Rather than repeat these policy arguments, this paper will focus on the process adopted by the EBA, the methodology being used, the data which is being relied upon and the likely impact.

The process

On 21st February, the EBA issued a Discussion Paper asking the industry to submit its views re the methodology the EBA should use in determining "High Quality Liquid Assets" or "HQLA" under the LCR. AFME submitted a detailed response (the "AFME Response") setting out our recommended approach, methodology and appropriate sources and use of data. At the Public Hearing, written feedback was provided for the first time by the EBA.

While some information regarding the EBA's approach has now been made available, the level of detail provided is insufficient to understand why key considerations raised by AFME and its members are not being reflected in EBA's analysis. Indeed, we believe that the process undertaken so far by the EBA does not analytically address the BCBS and EBA's own definition of liquidity - the ability to raise cash quickly without the incursion of an unacceptable loss.

Methodology

We believe it is important that the methodology used by the EBA should not place excessive reliance on secondary trading data. In our view more practical, simpler measures of liquidity such as bid-ask spreads, the ability to sell high quality assets quickly, eligibility under high quality labeling initiatives such as the Prime Collateralised Securities initiative and transparency of securitisations due to loan level data disclosure at the ECB (and Bank of England), or availability for private or central bank repo, are also very important. We believe it is important to ensure a full analysis of the various liquidity factors to avoid a risk of partial interpretation of the data.

We ask that the EBA considers including in its report analysis that explicitly distinguishes "high quality" securitisations from those which performed poorly during the crisis. The industry has already provided input on this distinction, since it agrees that only high quality securitisations can be liquidated quickly, at or near their marked-to-market value. Given the impact of this decision on the European economy, we feel it is critical that the EBA recognises this distinction in its report –not just for residential mortgage-backed securities but also for other high quality assets.

Choice of data

We do not understand why, in assessing the liquidity of bond instruments, EBA appears to be relying on MIFID/R data.

In September 2012, AFME undertook a detailed analysis of fixed income trading activity to help inform policy makers in the context of the MIFID/R legislative process. Mindful that this data might be seen by the EBA as useful in the context of the LCR, in the AFME Response we cautioned the EBA that this work was done for a very different purpose. AFME's MIFID/R analysis examined actual trading activity over a defined period, and the frequency of such trading. The factors most relevant in the consideration of market characteristics for MIFID/R are very different from those that are relevant to the management of institution-specific liquidity. For example, a high quality securitisation may have a low trading activity (in many cases due to the buy and hold investor base) but is often inherently liquid since it can be sold quickly. Some originators of auto ABS, for example, were able to continue to issue even during the deepest periods of the financial crisis.

Excessive emphasis on certain academic measures to the detriment of simpler, transparent alternatives

Rather than simply collecting and analysing bid-ask spread data, the EBA has used as a proxy for spreads the Roll measure. The Roll measure seeks to infer the gap between notional bid and ask prices from the pattern of autocorrelation observed in transaction prices. We believe the EBA has placed excessive emphasis on this and the so-called Amihud ratio (the absolute price change in a period divided by the transaction volume). It would be better to focus on simpler, more direct measures of transactions costs such as directly-observed bid-ask spreads and price volatility over different time periods and market conditions.

According to AFME MIFID data analysis, generally speaking covered bonds trade little more than securitisations

In a study that AFME prepared in connection with the MIFID/R review, AFME analysed actual trading activity of a sample of various fixed income instruments across a selected time period. Notably, the AFME MIFID/R study indicates that, based on the criteria used, generally speaking covered bonds trade little more than securitisations – which seems inconsistent with the EBA's preliminary conclusions that apparently covered bonds trade significantly more than securitisations. The data is available on the AFME website. This is not to suggest that covered bonds are illiquid, but rather that securitisation and covered bond trading activity is not very different according to this secondary market data. On this basis, high quality covered bonds and securitisations should be treated broadly the same way in the EBA's definitions.

Sample period

Because the EBA has decided to employ only a single dataset available for only a short period, it is obliged to base its analysis entirely on data from the recent crisis. Liquidity affects asset classes more or less depending on the nature and extent of the crisis in question. Focusing on the last few years of data alone necessarily biases the evaluation against securitisation.

It is easy to forget that the market making mechanism for trading activity in covered bonds also collapsed in 2008 - but that market benefited from a public EUR 60 billion buying programme initiated by the ECB. No adjustment seems to have been made for this significant public intervention made for one market, but not another. Further, were different periods to be chosen data can be found which demonstrates that the price volatility of RMBS has been significantly lower than many of the other instruments.

Market Price Performance Jan 2011 – Jul 2013

European RMBS Price Performance vs. Other Instruments - Spread volatility by sector

	2011				2012				2013 to end July			
	CB	Bank	Sovs	RMBS	CB	Bank	Sovs	RMBS	CB	Bank	Sovs	RMBS
UK	0.9%	3.3%	1.1%	0.8%	1.0%	2.2%	1.6%	1.0%	0.4%	1.4%	0.7%	0.6%
France	1.5%	4.3%	3.1%	-	1.2%	2.7%	2.5%	-	0.5%	1.6%	0.8%	-
Germany	0.4%	0.8%	1.3%	-	0.5%	0.8%	1.2%	-	0.2%	0.6%	1.0%	-
Netherlands	0.7%	1.1%	1.9%	0.9%	1.0%	1.0%	1.8%	0.8%	0.8%	1.6%	0.8%	0.7%
Spain	2.3%	6.1%	8.8%	3.6%	3.3%	7.0%	9.5%	4.6%	3.4%	3.9%	5.2%	3.1%
Sweden	0.4%	2.6%	1.0%	-	0.5%	1.6%	1.4%	-	0.3%	1.0%	1.2%	-
Italy	3.0%	6.2%	9.1%	4.3%	2.7%	4.9%	7.5%	5.2%	2.0%	3.6%	5.1%	3.0%

Source: BofA Merrill Lynch Global Research

Understanding liquidity and crises

Although the EBA has yet to publish a detailed description of its methodology or results, findings so far revealed suggest that it has not tried to reflect in its assessment of asset classes a proper allowance for liquidity drivers. Liquidity discounts fluctuate over time in ways closely connected to buyers' assessments about future opportunities to sell. The price of a security viewed as illiquid may, in consequence, drop by much more than the current bid-ask spread. Liquidity may be restored if the security becomes a close substitute for another clearly liquid security. Hence, a security's liquidity is likely to recover if its credit or market liquidity is implicitly or explicitly guaranteed or otherwise supported by a very creditworthy organization.

An example of how observable events or factors affect liquidity is the ECB's 2008 covered bond purchase programme mentioned above. Another is the very different liquidity behaviour of German Pfandbriefe and other European covered bonds with the same rating. This reflects the widespread perception that the former would enjoy credit support from a highly creditworthy sovereign. We would very much welcome understanding the analytical justification for considering all types of covered bonds as more liquid than securitisations, if this view is taken. We are concerned that the mechanical, indicator-driven approach taken by the EBA does not allow for such important factors.

Diversity of market structures should also be taken into account. For example, within the covered bonds market, the parameters, characteristics and commercial dynamics of, say, the Danish market are very different from those of the German market. Factors such as annual re-pricing, reciprocal underwriting arrangements and the ways in which the underlying mortgage risk is priced can differ markedly.

Investor views

Importantly, feedback from investors that AFME has received is different from the EBA's preliminary conclusions. High quality securitisations can be liquidated quickly at prices at or near their mark to market value, which is the EBA's agreed definition. We would welcome understanding whether investor feedback on this essential point has been appropriately factored into the analysis.

Impact on markets

The EBA appears to have concluded (preliminarily) that "no material detrimental impact has been established on the stability and orderly functioning of financial markets, the economy or the stability of the supply of bank lending". We believe such a conclusion for a major, market-wide regulatory change is premature if its conclusions are drawn before the rules which it seeks to measure are defined, and properly tested in the market.

Also, there remain many open questions: did the impact study assume the continuation of the ECB's LTRO or its withdrawal? Were comparisons made between market conditions (i) with or without the LCR and (ii) with or without a LCR when only certain groups or sub-groups of assets were deemed eligible?

If high quality securitisations are not included as HQLA in the LCR, then given the strong public statements from senior policymakers in support of securitisation this will send a very negative and confusing signal to investors. On top of harsh treatment under Basel and Solvency II rules (at least as currently proposed), as well as other regulations – such a result would hinder prospects of recovery in this market.

Indeed, we see ongoing discussions with the BCBS re risk-weighted assets, EIOPA's review of Solvency 2 capital charges and EBA's determination of what assets comprise HQLA under the

LCR as the three most important cornerstones of encouraging investors to return to the market so that sound securitisation can play its part in helping revive European growth.

<u>The right approach</u>

Instead of the EBA's approach to assessing asset class-specific liquidity, we recommend:

1. Use of multiple data sources shedding light on longer time periods and a variety of market conditions;
2. Focus on simpler, more transparent indicators of transactions costs; and
3. Analysis that reflects in a practical way known liquidity drivers such as signals of official willingness to intervene

Despite the late stage in the process, we call on the EBA to consider these factors so as to find a calibration for securitisation that is proportionate, evidence-based and signals investors to return to this market.