Securitization market faces up to the end of Libor

afme Finance for Europe

The securitization market has faced its fair share of existential challenges in the past decade, but 2017 brought a new issue to the fore – the potential end of the Libor and Euribor benchmarks.

The GlobalCapital and Association for Financial Markets in Europe (Afme) roundtable discussion this year therefore included a senior regulator, Edwin Schooling Latter as well as the usual distinguished panel of market practitioners. Latter, who heads markets policy at the UK's Financial Conduct Authority, was able to share his views on the transition away from long standing reference rates.

The new EU securitization Regulation also raises problems for the market. It sets up the long-anticipated standard for Simple Transparent and Standardised securitizations (STS), but the details aren't easy, and other areas of the regulation threaten to create problems for sponsors seeking to securitize legacy assets.

But there are reasons to be cheerful as well. Stronger European growth, and the dialling back of extraordinary liquidity are helping deal flow in consumer assets, while the CLO market continues to build momentum. Securitization is also a tool to tackle Europe's non-performing loan problem, with expectations are running high for deal flow, peripheral politics permitting.

Politics remains a problem in the Brexit negotiations as well. Afme and IMN have recognized its importance in scheduling keynote speakers at Global ABS this year and last, but if the most intractable issues can't be solved, we could all be discussing it in Barcelona next year again, at Global ABS 2019.

Participants in the roundtable were:

Rob Ford, portfolio manager, TwentyFour Asset Management

Richard Hopkin, managing director and head of fixed income, AFME

Edwin Schooling Latter, head of market infrastructure and policy, Financial Conduct Authority

Alexandre Linden, senior transcator, BNP Paribas

Janet Oram, head of European ABS, BlackRock

Pablo Portugal, director, AFME

Damian Thompson, head of UK financial institutions, NatWest Markets

Jonathan Trup, managing director, Morgan Stanley

Owen Sanderson, moderator, *GlobalCapital*

GlobalCapital: As it's a new topic on the agenda and we have a special guest from the FCA with us, shall we start off with the risk-free rates issue? How will securitizations cope with benchmark reform and the move away from the Ibor rates?

Richard Hopkin, AFME: It's particularly important for securitization transactions becausemost deals are floating rates off Libor or Euribor. Securitization has always had the added complexity that there are usually embedded swaps within the structure so the derivatives aspect of benchmark reform is also very relevant. And lastly, lots of European banks also have large books of retail mortgages and SME loans linked to Euribor on their balance sheets which often form the underlying for securitization.

Edwin Schooling Latter, Financial Conduct Authority: As Richard says, ABS is obviously one of the many markets in which the Ibors are deeply embedded. What's very striking about many of the markets in which Libor is embedded is that it's often used because it has been available, and because of the liquidity in other Libor-related financial instruments, rather than because Libor is actually the best possible benchmark you could create for those markets.

I think there are questions about whether it makes sense for most of the borrowers whose loans are packaged into ABS to have a variable bank credit quality-related element in their interest payments. Whether it makes sense for their interest payments to go up when confidence in their banks declines. That's horribly pro-cyclical.

I think there's another question — and other

Edwin Schooling Latter
Financial Conduct Authority

panellists will be the experts on this – as to whether what most investors in ABS really want from their interest rate benchmark is something that hedges interest rate risk to a degree, and whether they are really after something that's hedging bank credit quality in the way that Libor does.

The fact that Libor may no longer be available beyond the end of 2021 when the agreement the FCA reached with the current 20 panel banks to continue to maintain the rate ends, has obviously been a major area of focus.

The reason that Libor's availability appears time limited is not an FCA choice, by the way. That's obviously because the underlying market that Libor has been measuring is no longer very active so there simply are very few term unsecured interbank or wholesale lending transactions these days. And there's no sign that the market is going to revive.

That obviously creates particular challenges for legacy securities that reference Libor, and indeed for the transition away from Libor in the markets that use it.

Legacy securities I think are particularly difficult. It's my understanding that it's relatively unusual, particularly for older securitizations, to have easy mechanisms for changing reference rates. It may require noteholder consent and so on. And that's in many cases possibly not practical, or at least economic.

So absolutely we recognise that, and I think it's understandable if people look at whether ICE Benchmark Administration can produce some sort of Libor rate in the absence of panel bank submissions. I think that's a question worth working through but we all need to be realistic about what such a rate might look like.

It's probably very difficult for it to have all the properties of the current rate, for example a dynamic credit risk premium.

For new securitizations, there's an opportunity and indeed a need to include a practical mechanism for changing the reference rate if it starts off with Libor. I should commend the work that Afme has already done on template language. It has produced model wording for benchmark rate modifications, a pretty long document that was clearly a very thoughtful piece of work.

Personally however I think that a really interesting question is not so much about legacy assets but about the future.

We're almost certainly moving to a world in which liquidity in interest rate derivative markets is centred around the chosen overnight risk-free rates — Sonia for sterling, Sofr for US dollars, Tonar for Yen and so on.

Given that ideally you would never have to use fall back provisions in contracts to effect the transition from Libor to another rate, but would choose those other rates from the outset, if we do see tighter spreads in the overnight rates in the relevant currencies than in Libor, how quickly will that change the way that securitizations work? What impact will that have on the underlying assets in the securitization, the floating interest rate payable on the securitized loans and promised to investors?

Rob Ford
TwentyFour Asset Management

Rob Ford, TwentyFour Asset Management: I guess the real issue is about transition. We've got a marketplace now which is centred around mostly three month Libors, with some one month, and the transition needs to be as seamless as possible without any step changes.

I also worry about step-like changes in a new benchmark, particularly as that benchmark is at the very short end of the curve, where rates seem to move much more in a step-like manner.

You've only got to look at changes that Sonia made over the last interest rate change here in the UK compared to Libor. There was a nice, gradual run up in Libor over the weeks leading up towards the new rate and yet Sonia stayed exactly flat at the old base rate until 24 hours beforehand and then it moved by about 25bp.

That might be something we just need to understand and learn to deal with, but when existing deals move from the old product to a new product, a big step change could have a significant effect. Even if it is only 20bp or 25bp between where an overnight rate is currently trading and the Libor rate. We have no idea what the shape of the curve will be at that point in time.

If you go back to 2012, the difference between Sonia and three month Libor was nearly 1%, so you could have a huge step differential with whatever happens going forward, if the market decides to move towards a shorter rate.

Of course we've done work on some transition language for new deals, but we equally need to make sure that the transition for those legacy deals is as good as it can be.

I think another thing I have a concern about is that we can't simply have a predetermined differential. The average over the last five years has been 20bps between Sonia and three month Libor. But I just don't think it works to just pick something like that as a number.

There needs to be a real term premium. The rest of the term structure going out from three months to six months to one year is a proper yield curve, and we can't just not have a yield curve between zero and wherever the first point of the term structure is.

So the market needs to find a way of defining a premium and I'm sure the swaps and derivatives markets are racking their brains about that. I haven't personally seen any data on where that might be coming out. Any insights you might have would be really helpful.

Latter, FCA: The question about the potential volatility of any interest rate benchmark is quite interesting as you say. The overnight rates tend to track central bank rates quite closely — perhaps not surprising because they are backed by lots of transactions.

Sonia for example has on average 375 transactions a day feeding into that benchmark. As we highlighted in some of our public remarks, for one of the Libor currency tenors there were only 15 transactions in the entire year.

So one of our concerns is that with a very small number of transactions, particularly if there are also a small number of panel banks, you could see increased volatility in the Libor rates.

I think there are some interesting questions about how you address the potential absence of really robust term rates. Of course there are backward-looking compounding type ideas that can smooth things out, but clearly forward looking term rates are used very widely not just in securitizations but in syndicated loans, in bonds and across the financial system.

So there is ongoing work about what term rates can be created.

There is going to be a consultation from the Risk Free Rate working group that the UK industry has put together on options for term rates. So that will be out there.

But two remarks — one is that if the whole financial system just moved from Libor to another term rate that probably wouldn't be a successful transition, because we wouldn't have got away from the problem that the market on which we built the foundations of that massive building are just too slim.

Second, I think it's likely that in future, term rates would be a much smaller part of an overall market and those who choose to use term rates are doing so for real economic or operational reasons, not just because there's quite a lot of liquidity in three month Libor.

Ford, TwentyFour: When we look at the underlying assets, we all pay our mortgages monthly, we pay our credit cards monthly, and we pay our car loans monthly. I think it's perfectly reasonable that as an industry we could move to a monthly payment, taking a lead from the underlying assets. But you still have to get from a one day or an overnight rate to a one month rate and a one month point on the term curve.

That said, other financial assets which are securitized, like CMBS with commercial property and in particular CLOs with leveraged loans need to be based off of a longer term rate. Underlying bank loans are usually quarterly, so again, maybe that market needs to move or needs to change as well.

As you mentioned in your earlier remarks about interest rate hedging, many investors do consider ABS securities with a floating rate coupon to be relatively interest rate benign. A portfolio of ABS with a mixture of three month and one month rolls probably equates to a total duration of something in the region of 25 to 30 days, pretty irrelevant in the grand scheme of things.

But investors don't want to be in a position where a bond has a coupon fix on one day at the prevailing rate and then interest rates change by 25bp the following day. That's no form of interest rate hedge.

GlobalCapital: Are issuers coming up with these remedies? Are these the sorts of concerns that clients are looking at?

Damian Thompson
NatWest Markets

Damian Thompson, NatWest Markets: I think it's fair to say that the derivative markets are a very long way ahead of where both the loan and the bond markets are at the moment. For many of our counterparties, certainly for the UK banks thinking of sterling, Sonia is now probably the preferred floating leg of much of what they are doing simply because if they're hedging their assets and liabilities it tracks their own interest rate exposure much better. So there's a huge amount of liquidity now in Sonia-based transactions.

But also I think from a practical point of view, derivatives traders and derivative trading systems are much more adept at dealing with Sonia and just the practicalities of the daily accrual of a rate and the way interest rates are set.

I think particularly in the loan market there's a lack of awareness and engagement with the inevitable changes that are coming. So I think it is a problem to us in the securitization market, but it's actually a problem for the very much larger debt and loan market.

I think we're all fascinated to hear what's going to come out of the working group around term structure. On the question of whether the basis is fixed, the underlying market is so huge that the basis point value of that premium is a very, very large number.

Ford, TwentyFour: A very large arbitrage

Thompson, NatWest: Exactly, and so it's partly an issue for legacy and partly an issue of how a market gets designed. Are we just going to go to a bond market where you do a daily accrual interest rate on every single future floating rate transaction?

It's important for us, but we are only a small component of this overall story. Just by definition that basis point value is going to have to be a very broadly accepted market solution that we will be part of.

GlobalCapital: Are any issuers using the Afme language yet or coming up with any other solutions?

Janet Oram, BlackRock: The Afme template started off as a consolidation of language that different lawyers had put into different deals. What we sought to do was bring it all together, add in a few bits that seemed to us to be missing and get everyone on the same page. So it's only been out a few weeks.

The last deal I saw had all but the last amendments in it, so people are definitely looking at it, definitely considering putting it in their deals. I think there probably will be fairly wide take up – as long as people are pointing issuers to it, which we certainly are.

On the transition, obviously it's important to identify whatever rate we're all going to move to and I think you're right, it will be a market consensus. The rates market will do what the rates market does and then everyone else will seek to find something that works. But from our perspective it's not that simple. It's not just "what do I do with that legacy transaction?", it's "what do I do with legacy transactions in a portfolio?".

That portfolio becomes much harder to manage, because rather than having a mixture of one month and three month Libor on my portfolio, I've got all sorts of different things.

If it's a segregated mandate there may be other restrictions that may or may not allow me to hedge basis risk within that portfolio. So then that comes onto the question of what I'm actually targeting for the client and how can I do it?

GlobalCapital: Is there anything that the market community has come up with here that you'd like to come back on Edwin?

Latter, FCA: I definitely agree with the point that particularly in securitization, it's very obvious that there needs to be a fit between the underlying loans and the way the securitization works.

So an interesting question is how fast some of those underlying loans will move away from Ibors towards alternative reference rates, and whether those will be new term rates as they develop, or sometimes overnight rates, perhaps done in a more backward-looking way with compounding, perhaps done over different periods so they can be smoothed out. And I think it's also interesting to see the degree to which those things are then mixed up into the same securitization? Or you will see a legacy Libor securitization market here and a new one where underlying assets are more commonly on the overnight rates?

All of you will have a better feel for how likely that is and how quickly that will happen than we will, and the extent to which people will follow the main swaps market because that has economic logic to it.

Ford, TwentyFour: It's important to realise that whether it is securitizations or other floating rate bond instruments, for the most part, investors see them as being a perfect way to take a pure credit play — do the work on understanding the credit and they don't have to worry about the interest rates going up or going down.

Latter, FCA: It's incredibly important that whatever substitute rates have to be called upon, if they do have to be called upon, that they are fair and don't involve a material transfer in value at least at the time they kick in.

If they can't be dynamic in all ways, then there may be some change in value over time but not one that you knew about up front. So that will help address the gaming point.

The rates need to be fair and I think the earlier that they are transparent to everybody so that there are no surprises the better.

GlobalCapital: Thanks very much. So shall we turn to new issuance — Janet, you must be shown more or less everything in the market?

Janet Oram
BlackRock

Oram, BlackRock: I'm cautiously optimistic, but I'm not sure I'd get to the point where we say we've turned the corner.

Issuance levels, depending on how you account for them, might have just about beaten last year's levels.

We're seeing more deals, we're seeing more different types of assets, we're seeing some of the originators that we have not seen regularly issue because they had access to central bank funding coming back to the market. So I guess that's all positive.

The reason I'm not jumping up and down

because I'm not sure we've got a whole load of new investors. Sitting on the investor side, I don't see who is participating in all the deals, but until there are more investors actively coming back to the market, I'm not sure I'm confident that we're going to have sustained growth in issuance.

Ford, TwentyFour: Just to pick up on the investor point, I do actually think there are more investors coming into the market but not necessarily as individual entities. The regulatory changes that we've seen over the last three or four years have created a massive barrier to entry for people to actually carry out the investing themselves. But that doesn't mean that we, the asset managers, can't do it on behalf of others.

We are definitely seeing more people investing in the market via the asset management community, which is broadening the end investor base but without there necessarily being a huge growth in the number of people buying transactions every day.

The question I ask myself is what's the right kind of issuance? We could see a trebling in volumes, but if it's all boring – new benchmark plus not very many basis points or senior only with all the junior pieces retained – then that really isn't going to make a lot of difference.

I think we need to see issuance across a larger part of the capital structure. The levels of oversubscription at the mezzanine and junior end over the last couple of years are far, far higher than they are at the senior end.

A big increase in volume at the senior end only is probably not going to do the market any good. Equally, we also need to see growth come from places outside Northern Europe, where yields are already low.

As banks that have been taking advantage of the various central bank funding schemes gradually get weaned off, they'll move back towards using securitization as part of their funding armoury.

But it's really important that it spreads right across Europe and that we don't just continue to see the Italians, the Spanish and the Portuguese just using the ECB repo mechanism in order to bring entirely retained deals.

Pablo Portugal, AFME: I did want to come back to Janet's point that not enough new investors are in the market at this point.

The recovery of the investor base is critical to bringing back a healthy market. Non-bank investors in particular need to play a central role – this will be a key test to assess the success of the new securitization framework. The regulatory work is not yet done on the investor side. The calibrations for securitization investments under Solvency II are under review – these are crucial to bringing insurance company investors back to the market.

Jonathan Trup, Morgan Stanley: I don't think we've turned a corner in terms of volume of issuance, but we are seeing securitization serve parts of the market which other products cannot serve.

Products like CLOs, CMBS, and NPL securitizations are providing a solution where other approaches may not be able to produce as good a result for both buyer and seller.

But I think for the market to grow, you need to see a continued pickup in economic growth and lending growth.

Alexandre Linden
BNP Paribas

Alexandre Linden, BNP Paribas: I would say that the sentiment we've seen in the market has been positive for more than a year now, and the product is viewed now as a growth product, and something that has come out of all the issues from the crisis.

And when I look at the numbers, I see that last year was a very strong year in the US and globally there was almost a €1tr of issuance. In Europe it was not yet a growing market but we can see in the first quarter of this year that the numbers have been very positive.

We have seen publicly placed issuance of about €25 billion, which could lead to almost €100bn for the year, a big rise from previous years.

We're seeing strong auto ABS issuance at €8bn, UK RMBS coming back, CMBS coming back, CLOs still very strong, so it's early days, but there is a positive momentum both in sentiment and in issuance.

GlobalCapital: Would anyone like to pick up on Rob's point about more issuance down the capital structure?

Linden, BNPP: It's a very good point, and actually, we have seen transactions where the full stack has been sold. And the oversubscription was three or four times on the mezzanine compared to maybe two times on the senior.

There is definitely appetite for yield in the current environment and I'm sure we're going to see more of these transactions this year.

Thompson, NatWest: I think there are definitely good signs, and it's no coincidence that the end of the Bank of England's funding scheme has coincided with some reappearance of sterling issuance in the market.

That £127bn is going to have to come from somewhere in the next four years and everyone is going to have to look very hard at securitization. The question of whether it can all come out in the sterling market is obviously a very interesting question for global issuance from those institutions.

But I would come back to Rob's point. I think when it comes to the more interesting, the more specialist stuff, unfortunately, I don't think we've really seen a lot more new investors in the market. I think that becomes self-perpetuating because if those issuers are the kind of people that might want to bring the deals and haven't got the confidence around the number of investors are there to buy them, they're less likely to try to take that deal to market.

And I think until we see some real clarity on how the new regulations will apply in practice to banks and insurers, I think people might be reluctant to invest in the necessary skills and resources. They might buy through the asset management community, but at the moment, when it comes to that UK buy-to-let triple A tranche, it's the same investors that were looking at it two years ago looking at it today.

Ford, TwentyFour: But the mezz tranches are four times oversubscribed. It is a bit chicken and egg. If I was sitting with an issuer hat on, I would be thinking it's a very expensive process to go about putting your first securitization together, and to take a chance that you're going to get an entire transaction sold at a reasonable level.

So I can see where that issue is, but some people have done it.

The Credit Foncier French RMBS deals were groundbreaking in a different way in that they were full term structure as well as being full capital structure, so they've created a marketplace with longer dated assets. Which, if we ever get any decent capital calibrations for Solvency II, might be really attractive for the insurance industry because they will have a much more interest in something with a bit more credit duration to it, as it will suit their asset/liability matching purposes much better.

Oram, BlackRock: I think there's one other 'problem' with the mezz market. Obviously a lot of the issuance, as Rob says, is very heavily focused on the senior tranche, but I'm with you — it's massively oversubscribed which shows that there is demand for it.

But the other thing going on is that the old transactions, where pretty much every deal except the UK prime guys placed mezz, are being called, they're amortising down, they're going away, meaning the mezz market shrinks disproportionately.

Portugal, AFME: What we have seen in the most recent Solvency II proposals subject to consultation is not very encouraging regarding the mezzanine space. We are explaining that the mezzanine and junior tranches should not be unduly penalised as insurers have an important role to play in those areas.

Linden, BNPP: On the full stack structures, this supply of new transactions where you sell the mezz and junior as well as senior is going to be encouraged by the new capital charges. It could be quite efficient to do a cash transaction, selling all the tranches, not only for funding purposes but for capital relief, as an alternative to going synthetic.

GlobalCapital: How will central bank tightening and withdrawal from purchases affect the market?

Trup, Morgan Stanley: I think it's likely that as central bank withdrawal happens, we will see volatility going up and an increase in liquidity premia, but we see securitized products probably being one of the more insulated asset classes.

If you think about STS and non-STS deals, probably STS is going to be more insulated given its flight-to-quality characteristics. Some of the non-STS product may be correlated with other credit products in the market and may be affected at an earlier stage.

Ford, TwentyFour: We haven't even seen the ECB stop buying yet, let alone reverse anything, and it's going to be a very long time before the repo mechanisms change in any significant way. I think you will continue to see those high quality shorter-dated consumer assets being originated and financed through the repo mechanism. That's not going to change for ages – even without TFS, TLTROs or any other longer term mechanisms, the short term function is there and it's not going away.

Linden, AFME: I agree it would be good if there were more of these assets going into the public market. I think there is something like €350bn of assets eligible for ABS which are with the repo facility of the ECB. So it would be a boon for the market if these could be recycled into publicly placed ABS, but it's unlikely the ECB is going to remove this facility in the near future.

Ford, TwentyFour: The ABS purchase programme has been relatively irrelevant in the grand scheme of things. They've bought about €25bn of ABS, €249bn of covered bonds, €148bn of corporate bonds, and €1.9tr of public sector. So I don't think there'll be a major direct effect on the ABS market.

But it's worth considering that when they stop buying covered bonds, we might see a back up in covered bond spreads, which might mean that the relative value differential between the ABS market at the senior, eligible end, and covered bonds, might suddenly go away. And so we could then potentially see a back up in ABS spreads just on the back of the fact that covered bond spreads may widen.

Thompson, NatWest: Really, there are two things embedded with all the repo and purchase programmes.

The major impact is on macro policy, but what a central bank wants to do in terms of overall monetary policy may be quite different to what it wants as prudential regulator.

You could well see prudential regulators putting pressure on the banks to demonstrate that they can source private sector funding in whatever form.

GlobalCapital: So shall we turn to STS at this point? How should we evaluate the new rules?

Portugal, AFME: It remains to be seen how the new framework will perform in the marketplace when it goes live on January 1 2019. We at Afme have been supportive of this framework and we think that its long term impact will be positive. After years of stigmatisation, now we have a framework for securitization that has the full support of the regulatory community.

It was important that securitization was made the first priority of the capital markets union. It sends a positive signal that the political class and regulators believe that this is a market that needs to be reinvigorated in the EU.

But the new STS framework is not yet finalised. We have important Level II technical standards being developed by ESMA and by the EBA. And as we mentioned earlier, there are related regulations that need to be put in the right place to facilitate a recovery of the investor base and the conditions for the market to grow again, particularly Solvency II and the Liquidity Coverage Ratio.

It will not going to be enough to just have the STS framework set up. The overall regulatory treatment of securitization needs to be looked at and put on a level playing field compared to other fixed income products.

GlobalCapital: What are the big issues still to be decided in Level II?

Richard Hopkin
AFME

Hopkin, AFME: The EBA and ESMA between them have got something like 30 mandates to execute coming out of the STS regulation.

A number of consultations came out in December and we responded to many of them, covering issues like disclosure, homogeneity of assets required for an STS securitization. And then more recent consultations around broader STS criteria.

I think those consultations are going reasonably well. We've had a lot of engagement with the EBA in particular around homogeneity. They've been very keen to reach out to the industry and hold roundtable discussions about these kinds of things. I think the framework that is emerging around that particular criterion is going to be manageable.

On disclosure I think there's been a lot of good progress and engagement with ESMA. One of the big successes from the work that Afme undertook in the Level I process was to get a recognition of private transactions in the disclosure regime.

But the devil is in the detail in these things, so there's still a lot of work left to do on things like disclosure templates.

The last big one to mention is risk retention. The proposals from the EBA are building very much on the existing framework, and I think it's very important to keep the market practice that has built up over the seven or so years since we've had the risk retention regime.

Linden, BNPP: One of the key priorities for advanced banks is to clarify the use of the 'top down' or advanced formula for securitization transactions. There is work between the EBA and banks starting on this topic. And it's quite important because at the moment the advanced formula is used very little in Europe and much more used in the US. The plan is to broaden its use so we need to clarity how this can be achieved.

One of the technical issues in the text which came up a bit lately on risk retention is having non-EU subsidiaries of EU banks, having to comply with EU regulation. This was not the intention but could potentially have damaging effects on business in the US for instance.

So it's something we're trying to fix.

I think on homogeneity and STS criteria, the latest EBA papers helped, but to me it's still not very clear if certain asset classes will be STS-eligible, for instance, leases which have residual value risk. Most mixed pools are going to be excluded which could be an issue in some jurisdictions.

There are still some areas which need to be worked on to make the scope of STS as large as possible.

Hopkin, AFME: Alex, you reminded me that when we were putting together some of our recent responses, we had some difficult conversations around homogeneity.

More than one member came to us and said 'we can't agree with that because it changes our business model. This isn't how we do things.'

Now mostly we've managed to avoid serious impacts on business models, and the EBA don't want to be disruptive in how they implement this homogeneity criteria.

But those conversations were an example of the rubber hitting the road. A regulator would probably say, well what did you expect? The whole point of this regulation is to change things a bit.

Portugal, AFME: The issue Alex mentioned

Pablo Portugal
AFME

about the treatment of non-EU subsidiaries of EU banks is a very important matter that needs to be resolved in the coming months. We think there was probably an oversight in the drafting of the text that could be addressed in a relatively straightforward manner, but that remains to be seen of course.

Regulators will be paying close attention to how the STS framework performs in the market. I think it's clear that the regulatory community wants the market to move towards the STS standard. The clear policy objective is for that standard to become the mainstream of the market in the future.

Latter, FCA: Quite a lot of references to regulators and regulatory communities there, so I feel I should say something.

The first thing to say and it's obviously the good thing is that there's clearly wide consensus across all the different legislators.

There's a prize to be won here, in terms of freeing up financing for the real economy and having a financial system in which risk is properly diversified and distributed into the places that are best placed to handle that risk. That's the good side.

Obviously there is a very difficult balance to strike here in terms of regulation that gives investors confidence and has the transparency that will support that confidence, at the same time as not being too onerous and impractical for issuers.

Now I doubt that we'll get that 100% right first time, but at the very least we should get some valuable evidence of what has worked well and where there are bits that could do with some fine tuning and revision.

The issue on consolidation of non-EU subsidiaries is definitely on our radar as something that needs looking at. I think the best fixes for it are Level I fixes which is difficult at this stage, but is definitely worth thinking through what can be done there. Because I think there is a win-win to be achieved.

But keep the feedback coming because the review process is real.

Thompson, NatWest: There's a great opportunity here to end up with something that is both the final rehabilitation of this industry but also is a huge and powerful tool for governments and central banks to help shift some of the funding burden they've taken on back into the private sector – but it's only going to work if it works all round.

It's very clear that it needs to be practical at the issuer level, but equally if that's all made perfect and it works very well but we still see neutral to punitive regimes across various regulations in LCR, Solvency II and Basel III, I think that won't bring investors back.

And without investors we will all be wasting an awful lot of time here.

Ford, TwentyFour: Yes we came very close to scoring some massive own goals as the final part of the regulation was being put together and we probably just about got away with it. But somehow we still seem to have a few of our shoelaces tied together and if we're not careful we could still end up with something which doesn't work.

I completely applaud your comments Edwin saying that we need to keep the feedback coming. And I almost certainly agree that we won't get there first time around. That's expected by everybody.

I also think there are regulators out there who are slightly less open minded than yourself and so I remain concerned that we end up with a well-meaning but ultimately over conservative, overly onerous, overly complex, set of regulations that means that it just doesn't get off the ground.

GlobalCapital: Is anyone seeing issuers already starting to make changes to their deals in anticipation of STS?

Linden, BNPP: If issuers start to work on transactions today they will definitely want to see to what extent they are compliant with the criteria and be ready for the new framework.

I think the market is starting to focus on the actual implementation. In this respect it's good that we had one year of transition to prepare.

One issue with the STS framework is that there are many criteria to meet to have the STS label and there are additional criteria to meet for a bank to benefit from the capital reduction associated with the label.

For instance you need to ensure that concentration on a specific borrower does not exceed 2% in the pool, or in a conduit, across all transactions. This may be practical for granular pools with consumer assets, but for SMEs or for trade receivables it can be extremely difficult.

I think there is a missed opportunity maybe for the STS to extend to these asset classes especially in conduits and this should be reviewed or maybe differentiated.

GlobalCapital: How about non-STS asset classes? Will they be left out in the cold?

Trup, Morgan Stanley: We don't think so. Clearly STS may anchor part of the market and might attract increased investment focus but I think the intention of the market was always to have STS sitting alongside non-STS.

We do see that for a number of investors who are not necessarily bound by the same capital rules as banks and insurers, non-STS product can offer an interesting diversification when it comes again to products such as CLOs, CMBS and others.

Portugal, AFME: The non-STS part of the market should be seen as complementary to STS, not competing with it. For STS to grow, the whole market needs to grow and that includes non-STS which will include legitimate asset classes like CMBS as well as NPL securitizations which will not be STS-compliant. Securitization can be among the tools to help address the NPLs problem in parts of Europe. That's one of the reasons why non-STS is important.

Trup, Morgan Stanley: We talk about the growth in the number of investors. I think in that respect it's a virtuous circle. The growth of the STS market should be positive in terms of the opportunities available in the non-STS market as well by seeing more investors return to the market and looking to add diversified portfolios.

Oram, BlackRock: It would be a great shame if the non-STS deals withered and died, because it's a separate pool of cash than is going to be looking at the STS.

There might be some overlap but that's where the interesting securitizations are. It's where you've got your esoteric assets that make really neat off benchmark investments for some of our benchmark funds.

If you are sufficiently experienced and you know what you're looking at, actually, it's a great place to put money to work. And the market never stands still. There are going to be different asset classes, different jurisdictions.

It would be a very sad day if the securitization technology, which is actually a really flexible way of funding and giving capital markets access to small originators or lowly rated corporates, was confined to STS issues only.

Ford, TwentyFour: The second largest part of the European securitization market, CLOs is outside of STS right now. I would like to think that maybe in the future there could be a place for CLOs or some CLOs to come within STS

And they're certainly not going to go away in the next few months just because STS is coming along so I think there's a very healthy future for non-STS.

Even CMBS, which has been largely missing from our market for the last few years, is non-STS, but there's every reason to think that that could come on board and that there could be a place for CMBS within STS at some point further down the line.

As we see how STS actually works and whether it is practically implementable, we can see if it can be expanded to other asset classes.

Latter, FCA: I'm certainly with those who say that STS and non-STS should work in a complementary way rather than competing with each other, in the same way that a sovereign benchmark bond and corporate bonds coexist, usefully side by side – with one being used as a reference for the other. I don't see why it should be different in this space.

GlobalCapital: Any appetite, many years hence, for CLOs and CMBS to come into the framework?

Latter, FCA: Well there will be a review of how the regulation works and we should do that review properly, looking to see that we have chosen the right set of criteria. I'd separate the question of whether that's exactly the same assets and same set of criteria as at the moment, on which I would have an open mind, from the question of whether CLOs and CMBS have sufficiently similar properties to currently eligible assets to be included.

GlobalCapital: Turning to NPLs, how can the securitization market help deal with Europe's problems?

Trup, Morgan Stanley: Fixing Europe's NPL and non-core asset problem should be a key objective for the capital markets and for regulators alike. I think this is one key area where we see securitization as one of the most efficient tools to help to solve the problem – whether it's in private or public securitizations. We're seeing over €100bn per year of NPL deleveraging. The risky part of these NPLs clearly should not be returned to bank balance sheets. So externalising the equity component of NPLs outside of the banks into the capital markets makes a lot of sense. On the regulatory side there are some challenges that we need to overcome. There is some uncertainty being created through the Securitization Regulation and we would like to see some increased clarity in order to continue to assist the market to find solutions to the NPL problem over the medium term.

GlobalCapital: What specifically is the concern?

Trup, Morgan Stanley: I think clearly there are some applications of the Securitization Regulation which apply to STS and non-STS alike, particularly aspects of due diligence requirements and what needs to be done in order to permit a securitization to be issued after January 1 2019.

We do need to try and iron out some of those questions to provide that certainty during what could be a very busy period for NPL deleveraging.

Latter, FCA: I think in the specific NPL context all the arguments earlier about the case in favour of securitization freeing up finance for the real economy and ensuring that risk is properly placed within the financial system, while maintaining investor confidence, are exactly the same but just magnified.

This is obviously a particularly tricky set of assets because of the non performing nature.

But I don't think we should shy away from that challenge. It's very important that we get that bit right because whilst it's not alchemy – it doesn't turn non-performing loans into performing ones – it is a way of diversifying and giving people the risk exposure they want.

Hopkin, AFME: I think Jonathan was referring to what is now Article Nine of the Securitization Regulation.

It's a little bit of a tricky one because it's very important to stress that the industry isn't saying that due diligence standards should be diluted at all.

It's simply a question about what is appropriate in analysing the credit of a particular pool of assets. And the factors that go into that can be very different for an NPL book than for a performing portfolio.

Jonathan Trup
Morgan Stanley

Trup, Morgan Stanley: A lot of the rules were written in the context of new originations. The Securitization Regulation tracks the nature of the originations as being sound and well defined.

You then think about that in a legacy context – assets that were originated many years ago that for whatever reason are now not performing. Banks need to clean them up, and investors want to take exposure on those assets.

But the actual origination standards of those loans may be different to what's done today.

Going through the due diligence to identify if they meet all the tests that were envisaged for new assets is clearly not appropriate, so how do we find a solution to that within a way that doesn't stifle the market, and, by implication stifle the recovery of some of Europe's banks?

Portugal, AFME: During the debate on the securitization framework we did flag to the policy makers that we had concerns about this new due diligence standard for acquirers of NPL portfolios that was being introduced.

Some changes were made late in the process but we are not sure that they will resolve all the issues. This issue was caught in the complexities of a difficult and politicised debate.

So it is something that we will continue to raise in the coming months because clearly at a European level tackling the NPL problem is a priority.

GlobalCapital: Are the regulatory difficulties changing how banks are underwriting NPL deals?

Linden, BNPP: There is another issue which is linked to the regulations governing NPLs for banks. In a typical deal, private equity funds bid on these pools and would request senior funding from the banks to purchase the pool.

One of the issues we've identified recently is that, in the same way as the rules around due diligence have not been designed for NPLs, the formula to calculate capital has not been designed for NPLs as well. They don't really work well whether with the advanced method or the standard method.

We only have the rating method available that would work from an economic perspective, but these transactions are private, especially at the time of bidding, so it's not practical to seek a rating.

There is something to be done and we are working with other banks to propose a solution.

GlobalCapital: How is the market looking at Brexit? Are there issues for securitization?

Portugal, AFME: During the debate on the STS framework, we did raise concerns about the lack of a third country equivalence regime for non-EU STS securitizations. This was not included in the Commission's original proposal.

Then we had the UK Brexit referendum. The outcome of the vote led to a greater emphasis on including a third country regime because we think that the STS market would benefit from the share of STS securitizations that would potentially be issued from the UK.

This would provide more liquidity and scale to the future STS market, which any market needs to take off. The European Parliament included in its proposals some helpful amendments to that effect.

But the issue was hostage to the politics of Brexit and we ended up without a third country regime. So we will see how two possible parallel regimes for STS, one running in the EU and one in the UK, will interact with each other.

I think there is potential there for fragmentation which is not helpful to anyone. It's unclear whether UK securitizations would get STS recognition in the EU, among other uncertainties.

I would be interested to hear from the FCA if this issue features at all in the Brexit thinking that the authorities are doing in the UK or not.

Latter, FCA: As you say Pablo, there's no equivalence regime in the current regulation. I think that if you want to maximise the depth and liquidity and diversification opportunities in this space, which people do, then there is a potential win/win from having some sort of equivalence arrangement.

So I think it's something worth working on, but clearly that has to be part of the wider higher level political discussions about the future relationship between the UK and the EU.