afme/ Finance for Europe

# From words to action: AFME's fight for ABS pragmatism in Europe

The European Central Bank has billed itself as securitization's champion since Mario Draghi threw his weight behind the sector barely a week before last year's Global ABS conference. But as Rachel Dawes constantly reminded Bruce Wayne, "it's not who you are, but what you do, that defines you".

Ask most ABS market participants and they'll agree that financial regulation is lagging the will of the ECB. Harsh capital requirements, risk retention and an imagined hangover from a rash of defaults that never materialised after the financial crisis have led to a constantly shifting battleground in the fight to make securitization the engine of European economic growth.

The Association for Financial Markets in Europe has been at the front line in this fight, and it has now begun to see progress. But misunderstandings and inconsistencies still abound as Europe's legislative machine works its way towards recovery.

The ECB's ABS purchase programme has helped propel new issuers and regions into the securitization market, and successful issuers — including some from Europe's periphery — are finally unloading full capital stacks of deals.

But there is a long way to go for Europe to put its money where its mouth is. AFME assembled a crack team of its members in London to tackle the issue head on.

## Participants in the roundtable were:

**Rob Collins**, head of funding, Nationwide Building Society

**David Covey**, head of European ABS strategy, Nomura

**Rob Ford**, portfolio manager, TwentyFour Asset Management

**Steve Gandy**, head of DCM solutions, Santander

**Kevin Hawken**, partner, Mayer Brown

**Richard Hopkin**, head of fixed income, AFME

**Kevin Ingram**, partner, Clifford Chance

**Graham Bippart**, fixed income editor, GlobalCapital (moderator)

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**GlobalCapital: Only a few short years ago, securitization was viewed with suspicion or worse by regulators. Why has the tone changed?**

**Kevin Ingram, Clifford Chance:** I think the tone in Europe changed when President Sarkozy wasn't re-elected in France and the policymaking community — particularly in Brussels — came to realize that there had to be something put forward to the electorate other than pure austerity. There had to be growth as well. Securitization was identified as a potential tool to support that growth in Europe. So the political debate moved from 'how do we box in this thing that is potentially dangerous?' to 'how do we use this tool to assist funding the real economy?' At the same time the groundwork had been prepared by the industry to show that securitization could be safe and not regarded as toxic anymore.

**Steve Gandy, Santander:** There was a recognition that the SME sector in particular needed financing. When politicians started getting complaints about the lack of lending to small and medium enterprises, due largely to the fact that banks were deleveraging because of the new capital requirements, that was a wake-up call to regulators and politicians, and they recognised that banks need access to securitisation funding in order to lend into the real economy.

**Richard Hopkin, AFME:** The other factor is that the authorities in Europe have looked across the Atlantic and seen how the American economy has had a much stronger and quicker recovery since the financial crisis over there. And they noticed that, in Europe, we are far more dependent on our banking system than on capital markets — around 70-80% bank funding versus 20-30% capital markets funding in Europe—


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**Richard Hopkin**
AFME

whereas it is the other way round in the US. And securitization is very much seen as a way to increase the reliance on capital markets and reduce reliance on banks, therefore making the banking system more robust and better able to deal with future crises.

**GlobalCapital: How much of the change in tone is due to the industry's focus on creating and supporting the idea of high quality securitizations (HQS)?**

**Gandy, Santander:** Well, clearly there's the Prime Collateralised Securities (PCS) initiative, which most of us in this room were involved in creating, to establish a label defining market best practices for transactions that feature high quality elements and filtering out the elements that went bad during the crisis. Regulators really responded to that positively.

**GlobalCapital: What are some of those elements that you've filtered out?**

**Rob Ford, TwentyFour Asset Management:** The PCS process gave us the opportunity to look at different asset classes more carefully and identify how they performed through the crisis. One of the reasons that some of the hostility from regulators and politicians went away is that people really have sat down and looked — particularly at the European market — and realized that, actually, performance has been pretty damned good. That is particularly true in the more granular, consumer-based asset classes.

One of the things PCS effectively excluded was commercial mortgage-backed securities. Not by explicitly writing 'NO CMBS' in big capital letters, but rather by including criteria which essentially removed very non-granular asset classes from eligibility. And if you look at asset performance in the CMBS market, it is one of the few places where there have been some major defaults and some losses right up through the credit curve.

**David Covey, Nomura:** I don't really think the tone has changed because of PCS or the High Quality Securities [HQS] label. I think rather those labels came as a result of the tone changing. And the tone was changing because of the very strong performance of securitization in Europe, as well as, as Richard was saying, the desire to move away from an over-reliance on banks for lending — while they were deleveraging — and towards capital markets funding of loans.

Understandably, if the regulators' tone is changing on the one hand, they also don't want to go back to a pre-crisis situation like we saw in the US subprime market, where there isn't risk retention, there was questionable alignment of interests and weak underwriting standards. The HQS serves that goal: to help keep the good securitizations and to weed out the abuses you saw in the US market, but which frankly didn't come to Europe in any real size or form.

**Gandy, Santander:** Yes, it is important to stress that PCS wasn't necessarily establishing new rules or new criteria, but rather identifying the criteria that was related to the very good performers in Europe. It wasn't creating anything new. We already had a lot of the criteria in practice.

**Ingram, Clifford Chance:** You could go further on Dave's point. The market was already adjusting to a number of the practises and asset classes that had been problematic. For example, I don't think investors would have been buying a lot of 'CDO squared' deals, even if we did not have regulations penalising re-securitization.

**Kevin Hawken, Mayer Brown:** The asset classes that are still active in Europe have really always been high quality. But the regulators have taken in the evidence and recognised that the performance of securitization in Europe has really been very good all along. And what PCS and HQS started out to be was a means of identifying the characteristics that make securitizations high quality. Not to necessarily add more requirements, but to validate the practices that were already going on.

**Rob Collins, Nationwide:** That's an important point. What PCS enabled us to do was to have a proper voice into the authorities and to describe what had already become good practise. Much of the best practices regarding disclosure, provision of loan level data, underlying transaction documents and cash flow models, for example, were already well established, certainly in the UK. PCS was a way of making that known to a wider audience.

**GlobalCapital: Was there a feeling that people outside the industry had not taken the time to examine how ABS was really performing after the crisis?**

**Gandy, Santander:** I was at a conference and I had made a comment that the vast majority of European ABS were performing just fine, thank you very much, and most of them had retained their original ratings — there was very little rating migration, especially in the higher classes. And a journalist came up to me afterwards and said: "I found that very interesting, Steve, because I thought all the ABS had defaulted." That was what people thought from what they had read. There was a need to show that that was simply not true.

**Ford, TwentyFour Asset Management:** Importantly, PCS gave us the opportunity to take all of the good practices we had started to adopt and put them into a framework, which stopped the potential for future structural creep away from those best practices and into either more risky or less stable practices.

**Ingram, Clifford Chance:** It also encourages more standardisation which makes things more transparent and so easier for investors to understand and compare.

**Ford, TwentyFour Asset Management:** If you compare standard corporate bonds, where senior debt is senior debt is senior debt — it can't change, it's just what it is — with securitization, you could certainly see the development of a gradual creep in credit enhancement or the types of assets going in to deals, for example. And I think we saw that prior to the crisis, not just in securitization, but also in products like [constant proportion debt obligations] outside of that market.

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**Gandy, Santander:** All of these labels, whether Simple, Transparent and Comparable (STC), PCS, or HQS, establish a benchmark so that new investors coming in can look at it, analyse the deal they want, and compare it to a benchmark. It sheds light on where any given deal might be cutting some corners. It's a constant reminder of a good standard that people need to shoot for.

**GlobalCapital: So has this idea been convincing to most of the market? Are there any parties that would disagree that the bifurcation afforded by these labels is an appropriate one? Any regulators, for example?**

**Gandy, Santander:** Yes, definitely!

**Ingram, Clifford Chance:** I don't like the word 'bifurcation'. I'd prefer 'differentiation'. There is a whole range of responses out there. And one of the dangers at the moment is to damn those who are outside of the high quality tent.

There are perfectly good transactions and asset classes that just don't qualify for these labels. More and more people, including investors, want to know what the benefits are from being inside the tent and what the downsides are from being outside — that isn't clear at the moment. As a result, it is hard to make a judgment on whether those responsible for the regulations are being pro or anti-securitization particularly in relation to other investment products. If you have a regulator who makes good noises about being pro-securitization but then hits you with significant capital charges for a 'qualifying' securitisation, that's not so good. On the other hand, even if a deal doesn't qualify and it does get worse treatment, but the worse treatment is marginal, then that's not necessarily such a bad thing. There's quite a long way to go on this debate at the moment. There's a lot of positive rhetoric at the moment, but the devil will be in the details.

**Covey, Nomura:** Yes, there's a massive way to go on this debate. Neither the industry nor the regulators have decided how much should be included in that tent. We have to figure out what the right foundation criteria are first and then there will be modular criteria added on to that for specific purposes.

There's general agreement that this is the way forward in Europe, but after that high-level agreement there's a lot of disagreement, and a lot of details have to be ironed out.

We should point out that the US is not going down the route if assigning labels. They may not see their market as functioning perfectly, but they do see it as functioning better, and it is. They are more aligned on transparency requirements and risk retention requirements that meet the same goals Europe is aiming for. They don't want a repeat of the subprime crisis any more than Europe does, but they are going about it a different way. They don't see a high quality label as the best way to go about it.

And that's a fair point. If you have transparency requirements, certain lending guidelines and risk retention, how many more criteria do you need for the foundation of what is a high quality securitization? That will be hotly debated in Europe for some time.

**GlobalCapital: What is behind the difference in approach between Europe and the US?**

**Gandy, Santander:** Europe has gone through the label approach partially as a result of the fact that we don't have a capital markets union (CMU) yet. We don't have a standardised way of doing things. In the US, a mortgage is a mortgage. They will all look almost exactly the same no matter what state you're in. Here, all the assets are different according to the country they're in. The practices of origination are different, the legal environments are different, so there's less standardisation.

There is also the fact that American investors have been credit investors for a lot longer than European investors, and they are used to doing the analysis and their own due diligence on a much more thorough basis than here in Europe. The label approach is a way of giving at least a benchmark for investors to distinguish the really good stuff from the stuff that doesn't really meet the test.

**Ford, TwentyFour Asset Management:** Yes, but if you look at what we've seen at the senior end of the CMBS market, defaults have been virtually zero — a very small amount. So should they be treated significantly worse than the seniors backed by those assets that are going to meet the HQS or PCS label? Yes, there should be a differentiation that takes into account that CMBS are less granular assets, so there is an increased likelihood of default in those securities. But the big danger is the cliff effect. You'd expect the difference in treatment to get bigger as you do down the capital structure, but at higher ends of the capital structure, you don't want to see an enormous cliff, because that will throw those markets to the wall.

**David Covey,**
NOMURA

**Covey, Nomura:** There is the concern, and I think it's the view in the US, that, if you have a supervisory authority or regulatory entity providing a label to securities, it becomes rigid. It's like having a government rating agency, and you don't want to rely solely on rating agencies or inflexible rules. But HQS could become a slippery slope towards that.

**Gandy, Santander:** I think there's a fear that if you put this label in place, there will be a moral hazard: no matter how much you put into the rules that investors need to do their own due diligence, they might use it as a crutch, and substitute buying the label for doing their own due diligence.

**Ford, Twenty Four Asset Management:** You also have the potential of subjectivity around implementation of the label. How many arguments are we going to get into over what is eligible and what isn't?

**Hawken, Mayer Brown:** Yes, that's one of the big questions. In the US, they don't like the idea of an independent third party making a determination as to what is high quality and what isn't. There, it would be more likely that the originator has to step up and say whether their deals comply or not.

There's been a lot of scepticism in the US over what they see as the idea of bifurcating the market through labels. Particularly for capital requirements, they feel there ought to be one framework that can deal with a whole range of deals, and it doesn't


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make sense to differentiate between 'good' and 'bad'. That's not what we're trying to do, but that's the way that it could go if the criteria aren't designed correctly.

The market is also relatively healthy in the US, so they don't need to look for a solution to try to make the market work better. But regulators and industry are paying a lot of attention to the HQS and qualifying securitisation movement because they realise it is going forward in Europe and they need to deal with it. Both the US regulators and the industry there will want to come to an understanding with Europe, because no one wants a whole different regime in Europe. That could result in European banks getting a better deal. American banks and regulators would be concerned if European banks had a different and more favourable treatment.

**Ford, TwentyFour Asset Management:** I think the US investor base have never viewed securitisation with suspicion. They knew it caused some pretty big problems in 2007. But it was all about risk, and investors doing the work and understanding the risk. Over here, it's always been about the perception of securitization as a market. The perception has been, since 2007, that securitisation is fundamentally a bad thing. One of the things that a qualifying securitisation framework does is start to take away that negative stigma or perception. That's why Mario Draghi was successful in launching the ABS purchase programme [ABSPP]: he was able to talk about simple, standard, transparent, qualifying securitisations. The framework for qualification is relatively small right now, but as it gets developed that will continue to evolve around the eligibility criteria for the purchase programme.

**Collins, Nationwide:** We are running up against a time limit to define that framework, though. We keep having these discussions and saying that time is running out, but we don't seem to make much progress, overall. It's difficult, because, certainly in our institution, we are keen to continue to issue securitisations, we're keen to continue to invest in securitisations, but there is going to be a tipping point where there's either not issuance big enough audience, or, on the buy side, there's too much uncertainty over how holdings will be treated from a capital perspective, and therefore how efficient they are as secondary liquidity.

So our number one concern is: when do all of these discussions land in a tangible way? The securitisation element of the European Commission's CMU green paper was helpful in that it was the first sign we'd seen on paper that various disparate discussions around what qualifies as high quality are converging into one place. It remains to be seen how successful the Commission's paper will be in trying to bring all of that disparate information to a conclusion, and of course that's only at a European level. As Kevin said, there's a whole global angle to this that we can't just dismiss in the context of the European discussion, particularly as the larger active issuers tend to issue in multiple currencies in to multiple jurisdictions.

**Hopkin, AFME:** Yes. One of the things AFME said in our response to the Commission's green paper was that we think a lot could be done to help revive this market through a relatively limited number of fairly technical regulatory steps. If there is political will, we believe the Commission can largely deliver. They could fix the penal and disproportionately harsh capital requirements that securitisation suffers from, particularly compared to covered bonds, under Solvency II. That would be wholly within the remit of the Commission because Solvency II is a European regulation. The Basel situation is a little bit more complex, but the European authorities have already shown that they are willing to depart from a Basel standard if they feel that that's the right thing to do.

They did that with the liquidity requirements last year, for example. The current regulatory framework for liquidity is slightly better than for capital, since certain types of high quality securitisations do fall within the definition of 'high quality liquid assets' and thus within the liquidity rules. But the haircuts are still disproportionately harsh, and that could be fixed fairly quickly by the Commission.

And then there is risk retention and transparency, which again are predominantly European rules. A lot could be done at a technical level to deal with all of these things. It could feasibly be done by the end of this year, if the political will is there.

But it remains to be seen if that's the approach the Commission wants to take. One of the questions they asked in the Green Paper, for example, was whether we need an overarching regime for securitisation, or a new definition of European securitisation. We don't think that effort is best spent on a 'big project' right now. You can achieve a lot with technical fixes that can be done in a regulatory context, obviously with appropriate prudential safeguards.

If by the end of the year the capital and liquidity parts of regulation were fixed and there was more clarity and a sensible approach agreed with the industry around disclosure, we'd all feel very encouraged by that.

**Kevin Ingram**
CLIFFORD CHANCE

**Ingram, Clifford Chance:** This is a key year for this discussion. As Rob [Collins] rightly said, a lot of ideas have been kicked around, but somebody's got to make a decision and work out which products are left out, appropriate capital charges, liquidity qualification, work out who the relevant players are in any certification scheme. By the time we're back at Global ABS in 2016, I would have thought a lot of this will be much more concrete. It has to be. We can't keep kicking it around, we have to choose a game to play.

**Covey, Nomura:** We are running out of time, yes. The market has shrunk for seven straight years. And it will be fairly surprising if it doesn't shrink again this year. It's been going down by about 10% a year, and now we're at less than €600 billion outstanding excluding retained transactions. If this keeps dragging on, the ABS market risks becoming irrelevant to fixed income investors and the broader financing markets in Europe. I don't think the regulators want that to happen, nor does the industry. But we're running against the clock.

**Gandy, Santander:** The concern over attrition is very real. ABS rightly needs to have a lot of due diligence performed by its investors, and it takes people with experience and knowledge and understanding to do that. If there's not enough supply, those people are going to be redeployed elsewhere and you're going to see the investor base losing its ability to

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invest in these things because they don't have enough experience to understand them properly. So that's why it's critical to get this moving.

And, Rob [Ford], I'm sure you would agree with this: I hear from investors regularly that they love to invest in securitisation. The investors participating now understand how to analyse it and think it's a good product and think it provides good diversification. So why do we want to take away something that investors want?

**Rob Ford**
TWENTYFOUR ASSET MANAGEMENT

**Ford, TwentyFour Asset Management:** Quite right. And it can go both ways. It can provide diversification within a broader portfolio of fixed income securities, and it can also help if you're looking to mix and match with investments in bank paper, or in corporates, or in high yield — whatever it might be. Depending on where you're investing in the capital structure, we certainly manage portfolios where we'll have junior pieces of ABS sitting alongside high yield bonds, for example, in a broader fixed income portfolio. Not only do they add diversification in terms of risk, asset class and exposure to different industries, but they also give you the option, since most are floating rate, to mix them against longer-dated fixed rate securities, which allows you to manage your duration within your portfolio as well.

And there is obviously a place for dedicated ABS portfolios that are concentrated, with more narrow mandates in any number of ways. It might be RMBS only. It might be Northern Europe only, for example. It might be only senior tranches, or mezzanine tranches. But you can target your investments to different investor needs — different return profiles and different risk profiles. It's a perfect product for doing just that. It's the only product, really, other than perhaps senior and subordinated bank paper, where you can target a different risk profile and different return profile whilst doing the analysis within the same framework.

**Gandy, Santander:** We hear a lot of regulators talk about covered bonds, and there's a large group of policymakers who think: 'Why do we need ABS? We have covered bonds. Just put everyone in covered bonds: it's a safe product, it's never defaulted".

**Ford, TwentyFour Asset Management:** It doesn't yield anything!

**Gandy, Santander:** Yes, but other than that, it's also more highly correlated, right?

**Ford, TwentyFour Asset Management:** Yes.

**Gandy, Santander:** You have an ABS product that's completely non-recourse to the issuer. It's like a separate risk compared to a covered bond.

**Ford, TwentyFour Asset Management:** Yes, the vast majority of covered bonds are issued in fixed rate form, as well. So if you're an investor who can't do swaps then you can't take your duration risk out. There's also only one investment point and that's at the top of the structure. I would say covered bonds are a very, very different investment. Covered bonds are covered by a pool, but they still sit at the top layer of a bank's capital structure. You could buy tier one debt in a bank, but you'd be exposed not just to the cover pool but to everything the bank does.

**Collins, Nationwide:** We sell covered bonds and RMBS backed by essentially exactly the same credit (in terms of underlying mortgages), but the diligence that buyers put into your RMBS bonds is much more detailed than that which goes into the covered bond product.

For a pretty simple business like ours, which does mortgages and savings and which funds itself primarily with retail deposits but also uses senior, RMBS, and covered, the dual recourse provided by covered bonds is neither here nor there. Investors only ever rely on it when one form of recourses (i.e. the issuer) has fallen over. So ultimately, if the firm fails, you still end up with a portfolio of mortgages to pay the liabilities whichever product you're invested in.

**Covey, Nomura:** And at the same time, if you get to the point where your senior RMBS is looking at losses, then your bank has almost certainly failed too — barring a bail out from the government. The on-balance-sheet losses would be too high across the board to have the bank still standing. So the difference between a senior prime RMBS and a covered bond from the same originator is really that there is perceived put-back to the authorities with covered bonds, and that they will bail out the bank. Other than that, though, the dual recourse to the bank from a covered bond really isn't economically worth the paper it's written on to investors. I always found that somewhat ironic.

**Collins, Nationwide:** And if you look at how rigid the Bank Recovery and Resolution Directive is, it's very clear that all of your programmes would survive failure of the firm in any event. So that adds more to the argument that you kind of end up in the same place with both instruments in a resolution.

**Gandy, Santander:** Santander UK is also a big believer in having diversified funding sources. So we use some senior unsecured, some covered bonds, some ABS, deposits, etc. Back in 2010 or 2011, when we had the first Greek crisis, we were shut out of all of the markets except for ABS. That was the only paper that we could sell to fund our business for a space of about nine months. I think regulators have to remember that. You can't pile everybody into one source of funding without creating unintended consequences.

**Collins, Nationwide:** In our recovery plan, we specifically talk about RMBS and covered bonds being potential recovery levers. You can't foresee the specific circumstances of a firm's failure or near failure and what might drive it. So you have potential situations, as the market has seen in the past, where one of those markets is closed to an issuer whilst the other one remains open.

**GlobalCapital: How much has the ECB's ABS purchase programme helped to make securitization an economically viable funding alternative for European banks and businesses?**


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**Gandy, Santander:** The ECB will always remind you that they're not a regulator, not a policymaker. They're a central bank, but they obviously have a lot of influence. And the fact that they put their money where their mouth is and are buying ABS is a very positive signal for the market. We can talk about the potential problems that could arise about crowding out the private market, but I think that, in general, it's had a positive effect — certainly on the issuance side. You do get investors complaining about the tightening in spreads a bit, but...

**Ford, TwentyFour Asset Management:** Well, you can't have one without the other, can you? That's the problem. It's all about balance. We almost certainly need to see spreads generally tighter, certainly for issuers outside of Northern Europe. I'm really pleased to hear in a lot of talk from people about Southern European issuers starting to think about coming back to the market.

We saw a Spanish deal a couple of weeks ago, and I hear there's a number of others thinking about it. They aren't necessarily in the pipeline, but under consideration. I'm expecting to have a lot of meetings with potential issuers from that part of the world at Global ABS this year, as well as with other issuers from the UK, Holland, Germany and France who haven't come back to the market yet but who are considering it. And it is all as a result of the fact that spreads have tightened, making the economics of securitisation, as a funding tool or a diversification tool, viable.

The cost of ECB funding will rise in the future, and issuers will need to be able to diversify without it costing an absolute fortune. But if they can do it for a reasonable cost, then diversification makes sense. From an investor's point of view, yes, I wish spreads were still 100bp wider — that would be absolutely great. But the reality is there has to be a balance. Some of those investors we brought into the market in 2010 and 2011 will go away again, because they came in when spreads were much wider. But once spreads normalise — even if it is a 'new normal' — the asset class won't work for the likes of hedge funds, for example, just as it didn't work for them in 2007 and before.

What really worries me is that there has been a lot of talk from the regulatory and policymaking community about how we need to bring real money investors into this marketplace — the insurance companies and the pension funds are the names that are often talked about. And yet they were never investors in this marketplace prior to the crisis, largely because most securitizations were relatively short-dated, floating rate, high quality — and thus lower yielding — securities.

Because we're starting from a low interest rate base there is an argument for the pension fund industry to invest in floating rate securities, which at least give them some kind of inflation hedge and can be seen as a proxy for inflation as rates go up.

But if you're a life insurance company or a pension fund and your sweet spot is 15 years of duration, ABS is not really for you, historically. You might take a short view for a period of time, especially in the rising rate environment. But this market isn't going to be creating 15 and 20 year securities, it's not going to happen.

**GlobalCapital: We've spoken about the heavy capital charges on securitisations being a bit of a drag but are there any places specifically where existing regulation could be made clearer or better, or are there any major inconsistencies that should be brought to the attention of regulators?**

**Hopkin, AFME:** One obvious one is risk retention. It's a bit ironic because we've always had retention of risk within European securitisation deals. We have never had, in any material way, outside some relatively small and very specific market sectors, the originate-to-distribute model seen in the US. So when the idea of risk retention was first brought in on January 1, 2011, there wasn't any objection in principle from the industry. But there has been has been a huge amount of work, effort and energy put into all the details. And the rules have kept changing, as well. We've had about three or four iterations of the rules over the last four years, so it would be good if things settled down a bit.

We also have different risk retention rules for different types of investors. Bank investors have a different set of retention rules from insurance companies and alternative investment fund managers and so on. There is a lot of scope to standardise and harmonise those rules as much as possible. Clearly, there may need to be some specific differences that reflect the different nature of a bank investor from a fund or an insurance company. But we don't need to have three different sets of regulations and different pieces of legislation all saying broadly similar, yet slightly different, things.

**Kevin Hawken**
MAYER BROWN

**Hawken, Mayer Brown:** Regulators should always remember to use the right tool for the job. For example, they shouldn't try to use credit rating agency regulation to prescribe disclosure requirements for a product, as they've done in CRA III, Article 8b. You already have rules that deal with disclosure requirements for ABS, and you already have due diligence requirements in the banking regulations and so on. They've just added new requirements on top of that that haven't necessarily been thought through and are not really designed to work well with existing rules.

Another example of regulation being used for a purpose it wasn't designed for relates to large exposure limits, which aim to limit banks' exposures to particular counterparties or groups of counterparties. We already have a very broad regime in place for that in Europe. The way it applies to commercial paper conduits in the UK severely restricts banks' commercial paper conduit business because the regulators have applied large exposure rules in a way that serves to address bank liquidity risk, even though that's not what those rules were designed to address.

I think there needs to be more coordination between regulators in different sectors, as well as in different jurisdictions, to make things fit together. In the last few years, particularly in Europe, there's been much greater effort by regulators, for example, the insurance regulators and the banking regulators, to try to have more consistency in some rules that apply to both. There have also been efforts between regulators internationally.

But there should be more effort between Europe and the United States to keep regulation consistent, or, alternatively, to recognise one another's regulations so that participants aren't


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having to comply with a number of different regimes that are inconsistent. And that means that, on each side, the governments and regulators have to accept other countries' regulations as being good enough.

**Hopkin, AFME:** Rob [Collins], you and I have sat in meetings with the SEC to talk about risk retention rules in the past. You're an issuer that frequently taps the US market, so having two sets of risk retention requirements, one European and one US, must be an enormous challenge.

**Rob Collins,**
NATIONWIDE

**Collins, Nationwide:** There's certainly frustration at having two sets of rules to play to, especially since we aren't from a market where there is an aggressive originate-to-securitize model. I have a tenth of my mortgage portfolio in a securitization programme because it's a handy way of doing some of our funding. It gives you different levers to pull.

There should also be consistency around who the onus is on to make the determination of compliance with risk retention. If the burden is on investors to be certain that their investments are compliant, then that obligation should be quite clear. Conversely, if it is on the issuer, it should be clear that they have to demonstrate whether or not the retention is met. The authorities have swung to and fro a lot on that issue.

**Gandy, Santander:** Yet another example is the different templates for providing loan-level detail. Can we not just harmonise that or just accept there are two different models, as long as the basic information is there? The US has one template, the Bank of England has another one and the ECB has another one. The BoE and ECB have tried to harmonise theirs, but then you have the US separately.

**Ford, TwentyFour Asset Management:** Actually a question for you, Steve: have they made efforts to re-harmonise templates, having started off harmonised and then diverged?

**Gandy, Santander:** It seems there is some recognition that they need to be harmonising the main fields. So we'll see.

**Ford, TwentyFour Asset Management:** There are also instances of creating regulations with good intention which then cause issues in other areas. For example, on risk retention, regulators are talking about further tightening of some of the language around the definition of originator. The intent, quite rightly, is to make certain that the market doesn't develop into an originate-to-distribute model — which we saw with CDO squared deals, for instance, prior to the crisis.

But, unfortunately, what could end up happening is the complete removal of the ability to securitize pools of assets that get sold between originators. If a lender sells a pool of mortgages, the buyer can no longer securitize it because essentially it's considered originate-to-distribute, even though that isn't the case.

**Hawken, Mayer Brown:** And that question arises because of issues with market-value CLOs. It's a particular kind of transaction with a particular kind of structure. Regulators want to fix problems with those instruments by changing the definition of originator — which is a definition used not just for risk retention rules but for all the capital requirements. So it really could have unintended consequences if they play with that.

**Gandy, Santander:** I'm generally very pleased with the direction we're moving in with high quality securitizations and regarding regulators' recognition of problems with capital requirements. But I'm concerned about how the rules will be interpreted once we have them. There will be 1,000 grey areas cropping up on almost every deal, at least initially, and if an issuer wants to comply with the rules but they're unsure what the rules mean and they can't get guidance from the regulator because it's relatively new, or the regulator is cautious, or they don't have the authority to give it — then we might get into paralysis, which I hope can be avoided.

**Covey, Nomura:** But going back to the earlier question of what the features of an HQS framework should and shouldn't be, that's why it's so critical that the foundation criteria just set the minimum standards. They need to be clear, they need to be few in number and they need to be focused on transparency and alignment of interests.

**Ford, TwentyFour Asset Management:** Yes, simple, standardised and transparent needs to be applied to the structures just as much as it does to the regulations.

**Covey, Nomura:** I think we wrote once that one of the proposals for simple securitization was anything but simple. And yes, it's a complex problem, but at the end of the day we need them to be inclusive and flexible, but very much focused on transparency: loan level data being provided; clear definitions of the terms used in documents; risk retention for alignment of interests. After that, if you want to layer on other criteria for specific purposes, like allowing only senior ABS for liquidity purposes, that's sensible. But the foundation criteria should be simple and very straightforward so people understand what they need to do to meet them and, on the transparency side, so that investors have what they need to understand the risks of investing.

I'm a firm believer that there should be virtually nothing related to the credit risk of the underlying assets in the foundation criteria, other than that normal lending standards apply. So I think making sure the originator isn't cherry-picking the loan portfolio, and not allowing self-certified loans, are both valid foundation criteria. But outside of that, when you start going down the road of too many rules and too many guidelines, particularly on credit risk, it's a slippery slope that can end up handcuffing securitisation and the benefits this market can provide to the Capital Markets Union and funding of the economy.

**Gandy, Santander:** And there should be a willingness on the part of regulators to provide prompt responses to enquiries from industry participants when there is a grey area. Because if they can't then the market could get paralysed.

**GlobalCapital: At the real economy level, channelling more capital markets funding to SMEs is a key priority of AFME's initiative, but how can securitisation help? Is it a full solution or only partial one? Also, to what extent is the ECB's efforts in ABSPP**

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**actually translating to financing for SMEs or the real economy?**

**Gandy, Santander:** Some regulators have proposed some ideas around SME securitisation. One of the ideas is to come up with some way to standardise a rating system for SME collateral, because they recognised that you have different countries with different rules. The SME lending sector is not standardised. You have lines of credit, you have term loans, floating rate, fixed rate, secured, unsecured, amortising, bullet — many variations. Each is tailor-made to the particular needs of a specific SME, so it makes the collateral not very homogenous. That's been a problem for rating agencies trying to rate these products. So coming up with some sort of rating system will certainly go part of the way towards helping there. It's a complex issue and securitization is not going to be the panacea to solve all of it, but it can help get financing to SMEs.

**Steve Gandy**
SANTANDER

**Ford, TwentyFour Asset Management:** The reality is that it's fairly easy to securitize mortgages, or credit cards, or consumer loans — whatever it may be. It is more difficult to securitize SMEs, though not impossible, and it's also a less well known product to investors. Securitization could provide a bit of a stepping stone that frees up funding and frees up capital that could help get lending to the SME sector, which isn't there right now.

Just addressing your ABSPP point, I think that's really interesting because ABSPP has come in for all kinds of criticism and yet, despite the fact that it's only been about €6.5bn of purchases in six months — compared to covered bonds at €10bn a month — it has achieved its aims, to a certain extent. It has brought spreads in across most Northern European and much of the Southern European securitization sector at the senior end. There's been some variance, but it has in many ways achieved its aim just because it's there. Even if the ECB hasn't bought a huge amount, the fact is: it's there and the fact they are willing to pay the price to buy the assets has made a difference.

Yes, they've built a somewhat onerous investment programme for themselves, which is slightly bizarre given that their eligibility criteria are quite simple and standardised, but this is a bit of a fob to the securitization doubters. They've ended up having to put in a large amount of manual overview, which has slowed the process up. You hear stories that the consultants they've hired to do the investing work for them have got to write 60-page credit reports on every asset they want to buy. Then it has to be reviewed by somebody in the ECB, which ultimately makes the call. But they haven't crowded out the market, and they've driven in spreads. Though it hasn't resulted in SME issuance.

**Gandy, Santander:** The key component of getting lending to the SME sector is being able to transfer risk and free up capital. And for that you have to sell the subordinated tranches. But SMEs are a riskier asset class so the relative cost of freeing up capital is higher for those assets. I don't think the ABS purchase programme, since it's just set up to buy the senior tranches, will be able to remove that hurdle.

**Collins, Nationwide:** We have a small SME business, but if we were asked to quadruple it in size next week, it would be within our ability to securitize something else — not SME loans — that would actually fund that. But there is also the question of where the capital comes from to support that lending. Do you go and raise some capital inorganically or have you got enough reserves to eat into?

**Hopkin, AFME:** I think we do need securitization to come back to help fund SMEs, absolutely we do. But it's a bit like losing weight: you can't lose weight just off your tummy, much as you might like to. You have to lose weight everywhere. And similarly, to get SME securitisation back you've got to get the whole market back and to get the whole market back you've got to fix these things like capital, liquidity and risk retention so that securitisation can divest risk and help free up capital on the balance sheet for lending — especially more capital intensive lending like lending to SMEs.

**GlobalCapital: So what is the one change that would most help the securitisation market recover – regulatory, macroeconomic or political?**

**Covey, Nomura:** Capital requirements.

**Ford, TwentyFour Asset Management:** Regulation, regulation, regulation.

**Covey, Nomura:** In my view, securitisation isn't working simply because senior tranches are too expensive. And it's too expensive because there are regulated buyers out there who would like to buy this low-risk product, but who can't because they're essentially being told not to via punitive regulation. Capital requirements are probably the biggest regulatory constraint, but really it's death by 1,000 cuts. You have a higher liquidity haircut for ABS, a lower liquidity limit, and higher NSFR requirements as well.

**Hawken, Mayer Brown:** Higher due diligence requirements, also.

**Covey, Nomura:** Yes, and all sorts of stigma to deal with. But if you change that, and you give these buyers a rational, level playing field on which they could evaluate the risk and rewards of different types of securities, demand for senior securitization would be much stronger. Spreads would come in significantly and you'd end up having a growing, sustainable securitisation market.

**Gandy, Santander:** And I think it's important to recognise that regulators are most worried that the problems that arose in the US subprime market might sweep across the entire world and affect other asset classes which — like securitization in Europe — in reality were doing just fine.

But hopefully all of this regulation — the new transparency requirements and the due diligence requirements — will help investors distinguish the good stuff from the bad, so that if there is a problem in this area it doesn't have knock-on effects elsewhere. And regulators do need to recognise that they cannot regulate risk completely out of the system. There is going to be a deal that fails. ▲


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