ASIFMA Structured Finance Conference 2015

Keynote address by Richard Hopkin: 'Building markets and funding growth: Can simple, transparent and standard securitisation deliver?'

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Introduction

Thank you Patrick, and thanks also to all my colleagues at ASIMFA for their kind invitation to address you today.

It's nearly 25 years since I was last in Hong Kong, and it is a real pleasure to be back. Things here have certainly changed a lot. Perhaps a little bit like the securitisation markets, but we will come to that. I'd also like to recommend to you ASIFMA's paper "Securitisation in Asia 2015". It's an excellent piece of work with strong contributions from many of our members present here today.

Now securitisation in Asia has had a sporadic history. Before 2007 there was some activity in specific markets, then issuance took a hit as the global financial crisis unfolded. Since then, as markets have recovered, securitisation has resumed and some markets – notably China - have seen very strong growth. There is certainly a lot of interest in securitisation, as evidenced by this conference and your presence here

But securitisation has something of a mixed reputation. It has been seen as being at the heart of the financial crisis. More recently, and especially in Europe during the last 18 months, the tone has changed, such that certain types of securitisation – specifically Simple Transparent and Standardised Securitisation – are now seen as important contributors to helping to restore funding for growth, widening and deepening our capital markets and strengthening our banks.

And securitisation has – at least in some parts of the world – bounced back. Volumes of issuance in the US asset-backed securitisation market: credit cards, auto loans, and securitisations of other forms of consumer finance are healthy. In China, last year the volume of domestic ABS issued grew to approximately RMB 280 billion, a ten-fold increase year on year. In Europe, though, despite the improved tone of policy and apart from the CLO market, issuance remains moribund at under EUR 100 billion a year since 2010. A small fraction of pre-crisis volumes.

So where does the truth lie? Is securitisation a pariah? Or is it a saviour? Does securitisation have a future – both globally, and here in Asia? How important is regulation in this context, and should it encourage or dissuade securitisation? How should regulators strike the right balance between market activity and financial stability? And will the new framework in Europe succeed in reviving the markets?

Well, the plain and simple truth is that the truth is rarely plain and never simple. But let me try to answer these questions in a way which is as simple, transparent and standard as possible.

Does securitisation have a future?

I'm very confident that the long-term trend for securitisation globally, and particularly here in Asia, is a positive one. In five, ten, fifteen years' time I am sure that securitisation will be providing a significantly greater proportion of funding to projects, businesses, banks and consumers than is the case today. There may be some challenges along the way but the long term trend is good. The reason is growth. And growth needs funding.

Pretty much all economists agree that the Asian markets are set to outperform the West in economic growth over the next 20 to 30 years. This means more people buying their own homes. Furnishing their homes. Perhaps buying their first family car. Including 1.4 billion people in China. It means more large and small businesses springing up to serve the needs of these new consumers. And much more infrastructure: roads, railway lines, airports, electricity, gas and green energy projects, and so on.

This means a greater need for banking services to provide the funding for this huge growth in economic activity. And banks can't provide all the funding required on their own. If there was one thing the global financial crisis taught us it is that there are limits to the size of bank balance sheets.

The Basel Committee is imposing higher capital requirements on banks. Providers of bank capital are seeking higher returns and tougher terms. And bank profitability is being challenged, making it harder for banks to build their own reserves. Even to the extent that banks stay at the heart of lending decisions and the consumer relationship, they will need to squeeze many more earnings from every dollar of capital they raise.

Securitisation is the perfect product for this scenario. It is a bridge between bank balance sheet and the capital markets. It enables banks to diversify their funding sources, transfer risk and free up capital, and match fund to maturity. I'm pleased to say that this view is now widely accepted by policymakers and many regulators in Europe.

Europe is rightly seen as overly dependent on bank funding: about 80 per cent. of funding in the European economy is provided by banks, with only some 20 per cent. from the capital markets. The position in the US is the reverse – one reason why the US market has recovered better than Europe. Indeed, when Europe's banks sneeze, the whole European economy catches a cold.

We need to change that, and make it easier for Europe's infrastructure projects, businesses and consumers to get the funding they need from the capital markets - whether directly or indirectly.

The same challenges exist here in Asia. Banks, rather than capital markets, tend to dominate funding – for example in the PRC National Interbank Bond Market. In its recently published Global Financial Stability Report the IMF commented that banks in the developing world tend to have thinner capital cushions relative to those in more developed markets, and that in China banks have only recently begun to address the growing asset quality challenges.

Securitisation can help address both these challenges. So the economic fundamentals exist, which should guarantee the need for more, not less, securitisation – both globally and here in Asia – in the coming decades. Provided we have the right regulatory framework.

So what regulation do we need? Securitisation, rightly or wrongly, was seen as being at the heart of the global financial crisis. Well securitisation was certainly present at the scene of the crime. Indeed, some of its harshest critics would go further, and say that securitisation was caught red-handed, holding the dagger. But is that a correct, or fair, conclusion?

A more measured, and in my opinion more correct, view is that securitisation played a role, but was just one of many factors which contributed to the crisis. After all, securitisation is just a tool which can be used well or used badly. We all use cars to get from A to B, and we can choose to drive safely and carefully, or recklessly and dangerously. The same is true of securitisation.

Further, the causes of the crisis included all kinds of things which had nothing to do with securitisation *per se*. First, poor to non-existent underwriting of risk, particularly in the sphere of sub-prime mortgages, played a huge part. As any commercial or retail banker will tell you, if you don't underwrite your risk prudently you will lose money – whether you fund your assets through securitisation or some other way.

Second, misalignment of incentives between originators and investors. It was clearly not sensible for huge volumes of mortgages to be originated by entities with little or no interest in how those mortgages would subsequently perform.

Third, excessive leverage put stability at risk. This manifested itself in all kinds of ways – yes, partly through the abuse of securitisation techniques in the form of CDOs and SIVs, but also in the "irrational exuberance" seen in many other markets.

Fourth, over-reliance on credit rating agencies by investors, underwriters and even regulators themselves created the impression of firm foundations when in reality some structures – notably CDOs and SIVs – were built on sand.

So what are the true lessons we can learn from the crisis? What is the right balance?

I would identify three key areas where we need good regulation: whether in the US, Europe or Asia. I see these as universal requirements.

First, transparency and disclosure. Securitisation is asset-based lending, so it goes without saying that investors should understand the nature of, and the risks of interruption to, the cash flows of the deal. Good disclosure regulation should require information that is of value to investors, not information for its own sake. Loan level data for highly granular assets such as trade receivables or credit cards adds nothing. Some data can be commercially sensitive or impinge on customer confidentiality; reasonable allowance should be made for this. And both compliance by issuers, and access by investors, should be easy and quick, using widely available software. Disclosure should take place on a single, known website with appropriate IT back up and support.

Second, risk retention or "skin in the game". Securitisation involves a sale of assets by an originator to a bankruptcy-remote entity. Common sense suggests that to ensure alignment of interest and therefore good underwriting practices the originator should retain some of the risk of the assets sold. I found it instructive that Special Purpose Trusts in China require a similar 5% risk retention as has been the case in Europe (since January 2011) and the US (more recently).

Third, prudential capital and liquidity rules. These have a key role to play at both ends of the securitisation process. For issuers (especially banks), capital requirements for on-balance sheet assets, and the rules for freeing up this capital through transferring the risk through securitisation, create the incentives (or not) to securitise. For regulated investors, the capital allocation for the securitisation investment creates an incentive (or not) to invest in securitisation (or covered bonds, or whole loan pools).

While it is sometimes easier said than done, good prudential regulation should be broadly consistent globally, and should not discriminate between assets with broadly similar credit profiles. There is a long way to go, both globally under Basel and in Europe, to achieve this. Indeed, the whole new approach in Europe of Simple Transparent and Standardised Securitisation is in part a response to last December's very harsh Basel capital proposals for investment by banks in securitisation.

Sensible regulations in these three areas provide a strong underlying framework for issuers and investors to go on to make their own decisions. However, going further than this – micro-managing the decisions that rightfully and sensibly should be made by issuers and investors, for example by creating reporting for its own sake that adds little or nothing to investor protection, or calibrating regulation with little regard for strong and demonstrated historic performance, can seriously damage markets.

Simple, transparent and standardised securitisation

Now turning back to Europe. As I said, the direction of policy in Europe has improved markedly, and continues to improve. Last week we saw the publication of the European Commission's new proposals for Simple Transparent and Standardised ("STS") Securitisation. These proposals are part of a much wider effort by the European authorities to build a Capital Markets Union better to connect issuers and investors across Europe.

Three key motivations lie behind the STS proposals. First, the acknowledgment that Europe needs to build up stronger capital markets that securitisation has to be part of that and that many European securitisations did perform well through and since the crisis.

Second, the acceptance that some aspects of securitisation regulation to date were too harsh, and need to be adjusted.

Third, a continuing concern not to unpick key prudential safeguards, or risk returning to the pre-crisis, largely unregulated, world. These are all good reasons and this is a significant step forward – even if there are many details still to be clarified and adjusted.

So what is STS all about? STS essentially sets out a framework – a list of criteria – against which every securitisation transaction can be measured. I emphasise "can" be: STS is not a compulsory regime, and eligibility is optional. But the effect will be that the market will be divided into transactions which meet the STS criteria, and those which do not.

The criteria are quite detailed – I will summarise them in a moment – but essentially they seek to address and incorporate the lessons of the financial crisis and draw a line around those securitisations which, since and through the crisis, have performed well, and exclude those that performed badly.

The criteria set out requirements for good underwriting, for aligned incentives, for limited leverage and required due diligence.

Transactions which meet the STS criteria will, it is hoped, receive certain benefits: for example, better regulatory capital treatment for bank and insurance company investors. Transactions which do not meet the STS criteria will not receive these benefits. They will not be prohibited, but they will be treated differently.

STS is not a rating or a hallmark of quality: all tranches of a securitisation may qualify for STS, not just the senior tranche. Rather, STS is a label that designates that certain basic standards have been met, and that sufficient information is available to enable investors to undertake due diligence for themselves.

So how do you qualify as STS? First, the securitisation must be simple. This means only traditional "true sale" cash securitisations will qualify (at least for now). There are also requirements for homogeneity of asset pools, and strong underwriting standards. Transactions with complex structural features such as reliance on future asset sales to repay investors, or active management of portfolio assets, are excluded.

Second, the securitisation must be transparent. This means issuers must deliver historical and loan level data, pools must be externally verified, and cash flow models and legal documentation must be available providing all the information that the investor needs.

Third, the securitisation must be standardised: this means it must meet rules for risk retention, hedging, payment priorities and conflict resolution.

So will STS be enough in Europe to bring the market back? Well, "You can bring a horse to water but you can't make it drink." STS is a means to an end, not an end in itself. For STS to be successful first it has to work, second it has to be attractive to issuers and investors, and third it has to be practical.

For the regime to work it has to include a meaningful portion of the market. There is no point in creating a STS regime if only 10 per cent. of the market will qualify to use it.

For the regime to be attractive the rewards for using it have to be significant. So if investors only benefit slightly in regulatory capital terms by investing in STS then it is unlikely to create enough of an incentive to bring them back to the market.

For the regime to be practical both issuers and investors have to be able to determine quickly, clearly and consistently whether a transaction is STS or not. Especially if the consequences of being inside or outside the framework include different regulatory capital treatment.

There needs to be uniform interpretation of this across Europe, and the designation has to be stable. There is an ongoing debate about how this will be achieved: should it be left to issuers and investors, or should a third party of some kind, perhaps under regulatory supervision, be given the job?

So what has the market reaction been to the STS proposals? There remain many open issues, but overall there has been a qualified welcome. STS represents a significant step forward, albeit with more work to do to clarify the criteria, the practical issues of compliance and – most importantly – how big will be the benefits in terms of better capital and liquidity treatment. The latter is still very much work in progress.

In the US, on the other hand, neither the industry nor the regulatory community yet see the STS approach as right for their market. The US markets are in better shape, with less capital pressure on investors, so they see less need for a prescriptive regime like this.

Conclusion

So to sum up I think the fundamentals are most definitely there for securitisation to have a bright future in Asia: just like in Europe, capital markets will be key in providing the funding for growth Asia will need in coming years, and in enabling Asia's banks to manage their balance sheets, transfer risk help build infrastructure and meet their customers' needs.

Regulation should strike a sensible balance: China has already been an early adopter on this with its risk retention rules, and as regulatory approaches elsewhere in Asia perhaps become more flexible and move from a "consent" approach to a "registration" approach, there may be scope for more precise targeting of regulation.

We need to move on from the poor practices of the past. If we focus on securitisations that are simple, transparent and standard, this is how we will all meet the needs of borrowers and the real economy, support and strengthen our banks and broaden and deepen our capital markets.

Richard Hopkin is Head of Fixed Income at AFME. This speech was delivered at ASIFMA's Structured Finance Conference 2015, which took place 15 October 2015 in Hong Kong. Full event details can be found here: http://www.asifma.org/structuredfinance2015