Box 6

REACTIVATING THE EUROPEAN ABS MARKET: CHALLENGES AND POSSIBLE REMEDIES

The European market for asset-backed securities (ABSs) is at an important crossroads. This box addresses the main challenges currently faced by the market and discusses possible remedies and progress to date.

Despite the role of ABSs in the global financial crisis, triggered by the US subprime mortgage market, it is generally recognised that well-regulated, high-quality and transparent securitised products can play an important role in capital markets. These products can satisfy investor demand for secured, highly rated, and liquid debt instruments, and can provide maturity-matched funding for a bank's assets. In addition, the structured nature of ABSs can attract a variety of market participants and help to transfer risks across the financial system, provided these are sufficiently understood, which in turn can help to build resilience against unexpected market shocks. More broadly, ABSs can also stimulate real economy funding, including financing for small and medium-sized enterprises (SMEs).

An efficient and liquid ABS market would also be welcome from a central bank perspective: ABSs' role in "liquefying" difficult-to-sell assets provides an important collateral asset class. This can be crucial in times of crisis for ensuring that sufficient liquidity is provided to counterparties while adequately safeguarding the central bank balance sheet. Chart A below illustrates the sharp increase in the mobilisation of ABSs by Eurosystem counterparties (mainly by the originating banks themselves) during the 2007/08 global financial crisis and the euro area sovereign debt crisis.

Nevertheless, the European ABS market is facing many challenges that could jeopardise its long-term viability, notably its regulatory treatment, a declining investor base, and lastly unfavourable "deal economics" amid a difficult economic environment. These aspects are discussed in turn below.

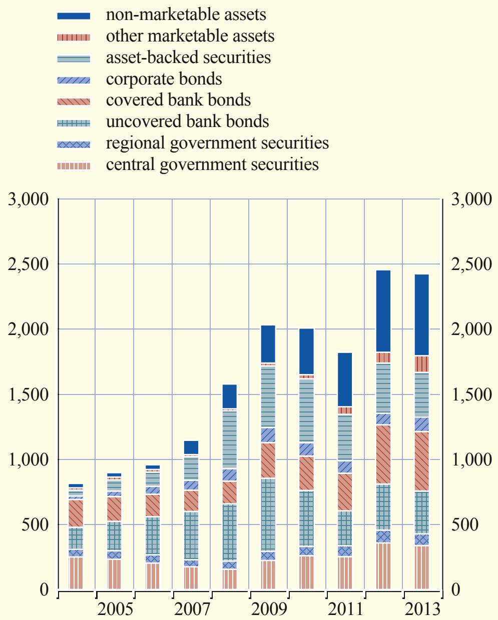
Regulatory measures and central bank actions

There are numerous regulatory and policy initiatives currently affecting ABS markets, including capital requirements, liquidity, governance, due diligence and leverage requirements – these will affect all classes of investors in securitised products (i.e. banks, insurers, pension funds, and asset managers). These regulations aim to correct for deficiencies observed since 2007/08, in particular the lack of due diligence from investors, who often failed to grasp the risks inherent in such products. It must be recognised that designing effective regulations at the global and EU levels that also account for regional differences and variety of ABS products, while at the same time ensuring risk sensitivity and avoiding complexity, is a complicated endeavour.

The current proposals on capital charges for securitisations may have the greatest potential to affect the market. For example, the Basel Committee on Banking Supervision (BCBS) aims to make the banking capital framework more prudent and risk-sensitive, reduce reliance on external credit ratings, and reduce cliff effects.[1] The proposals put forward for consultation in late 2012 would lead to a significant increase in capital requirements, particularly for the most highly rated senior ABS tranches. Elsewhere, the Solvency II Directive establishes a new regulatory capital framework for the European insurance and reinsurance industry, currently expected to be implemented in early 2016. According to this framework, insurer capital requirements for any ABS take into account the credit rating, duration, and a corresponding change

Chart A Collateral pledged with the Eurosystem after valuation and haircuts

(EUR billions)



Source: ECB.
Notes: Non-marketable assets consist of credit claims and fixed-term and cash deposits. Data for 2013 refer to the period January-June 2013.

1 Defined as large jumps in the required capital across small movements along a securitised exposure's tranche structure.

in spreads, calibrated to a once-in-200 years shock. Finally, the European Commission's proposed revisions to the Institutions for Occupational Retirement Provision (IORP) Directive also explore the possibility of introducing similar Solvency II capital requirements for IORPs – though this was put on hold in May 2013 pending further analysis.

There are some concerns that these proposed capital charges may not sufficiently differentiate between high-quality and low-quality products and do not accurately consider ABSs' own historical performance. Indeed, studies of global ABS performance – since both the mid-1990s and also the start of financial tensions in 2007 – suggest that European ABSs have enjoyed far lower default rates (especially at the senior tranche level) and performed far more strongly than similar ABS classes in other jurisdictions.[2] There may also be differences in the legal and institutional treatment of ABSs across jurisdictions that are important to recognise. Furthermore, it is also important to ensure that the proposed capital charges achieve a level playing field compared with alternative asset classes carrying potentially comparable levels of risk (e.g. wholesale loan portfolios, corporate bonds or covered bonds).

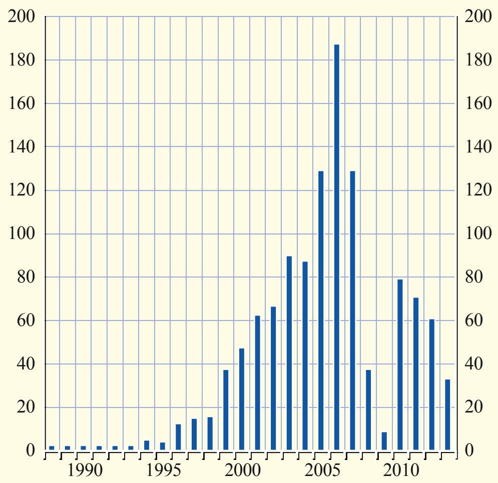
Capital charges must of course be set sufficiently high to ensure that banks and other regulated investors set aside sufficient funds to insulate themselves from unforeseen events. However, it is important that the specific performance and features of European ABSs are taken into account. Unless this is done, these capital charges could unfavourably skew risk-adjusted returns on capital. If this occurs, banks, insurers, and pension funds, who have been some of the main investors in European ABSs, may demand higher yields, which may result in the issuance becoming uneconomic from the originator's perspective. Alternatively, these investors may decide to exit the market due to insufficient risk-adjusted returns on capital. If so, there are unlikely to be enough alternative investors to fill the gap.

Other hindrances: investor uncertainty and the challenging economic environment

After steady and rapid growth since the late 1990s, ABS issuance placed with market participants fell sharply following the outbreak of financial tensions in 2007, as shown in Chart B. Although issuance recovered somewhat from 2010, declining volumes since then illustrate the weak conditions in this market. Chart C below further illustrates the divergence in spreads for similar products across jurisdictions.

Chart B European ABS placed issuance since 1988

(EUR billions; up to 23 August 2013)



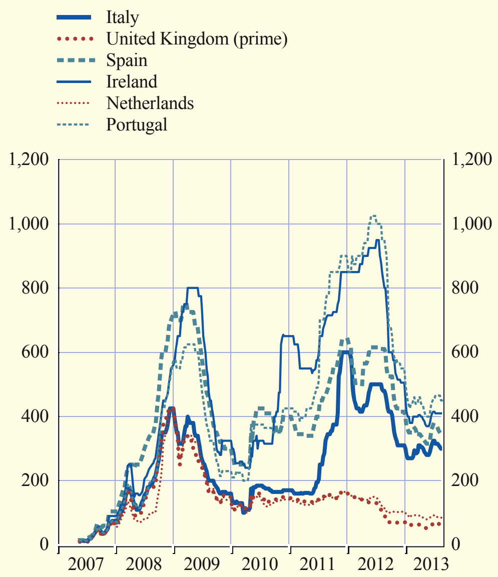
Sources: DB Research, JPMorgan and ECB calculations.

2 For example, Standard & Poor's has analysed cumulative rating transitions and default rates on European structured finance assets from July 2007 to July 2012 and found a cumulative default rate of 1.1% since 2007 on an original outstanding amount of €1,884 billion, in comparison with an overall default rate of 14.8% in the United States. Earlier analysis by Fitch obtained similar results, calculating realised losses of just 1.9% on USD 5.2 trillion of securitised bonds rated by the firm in July 2007. See: Standard & Poor's *"Five Years On – The European Structured Finance Cumulative Default Rate is only 1.1 per cent"*, August 2012; Fitch Ratings *"The Credit Crisis Four Years On…Structured Finance Research Compendium"*, June 2012; and *"EMEA Structured Finance Losses"*, August 2011; as well as reports by Moody's Investor Service covering performance from 1993 to 2011.

Investor uncertainty continues to present a major hurdle in the reactivation of European ABS markets. Such uncertainty exists on a number of fronts, which in turn has suppressed demand for all but the highest quality ABS tranches and has increased secondary market spreads. At the macroeconomic level, a lack of confidence in official data – such as the extent of loans in arrears in certain weak economies – and uncertainty over developments in variables such as property prices and unemployment, have continued to penalise ABSs across the EU, with particular emphasis on economies hard-hit by the sovereign debt crisis.

Chart C Five-year AAA RMBS spreads

(basis points; up to 23 August 2013)



Source: JPMorgan.
Note: Italy RMBS series is 6-7 year maturity; Spain RMBS series is 5-6 year maturity.

There has also been a lack of confidence in the quality of the underlying assets, in turn raising the information cost required of potential investors. This is now beginning to be addressed by the ECB's loan-level data initiative, which has established requirements for transparency and standardisation as necessary preconditions for any ABS to be considered eligible as Eurosystem collateral.[3] It will of course be some time before a sufficient time series of data is built up which can be used for developing credit models for individual loans. Nevertheless, the presence of loan-level requirements has already been recognised by the Eurosystem as reducing some potential risks from accepting ABSs as collateral. This is illustrated by the reduction, announced in July 2013, of both the haircuts (from 16% to 10%) and the minimum rating thresholds (lowered from two triple-A to two single-A) for ABSs subject to these requirements.[4]

The challenging economic environment, as well as low demand for loans and credit supply constraints, also continues to weigh on ABS market activity, and issuance to date in 2013 remains subdued. Spreads have also increased significantly since 2007/08, particularly in weak economies (see Chart C). Although spreads have come down in recent months, many potential ABS transactions remain uneconomic. This is because an originator would have to charge high and unfeasible interest rates to potential loan customers in order to cover the yields paid to investors further along the ABS securitisation chain. Furthermore, many successful issuances appear to have necessitated significant compromise on the part of issuers, for example by providing greater credit enhancement for a comparable securitisation.[5] The difficult issuing environment may have had an impact on new loan origination, particularly among SMEs in

3 The loan-level data initiative is currently being implemented for RMBS, SME ABS, CMBS, Consumer Finance, Leasing, and Auto ABS. The loan-level requirements relate to the assets underlying the ABSs, requiring detailed information on borrower and loan characteristics which can then be used by investors to carry out their own credit analysis.

4 "Triple A" means a long-term rating of "AAA" by Fitch, Standard & Poor's or DBRS, or "Aaa" by Moody's. "Single A" means a minimum long-term rating of "A-" by Fitch or Standard & Poor's, "A3" by Moody's, or "AL" by DBRS.

5 For example, in late July 2013, an Italian SME ABS deal worth €1.6 billion necessitated a 38% credit enhancement (and despite this a senior tranche coupon of three-month EURIBOR plus 240 basis points). Although the size of credit enhancement will be a function of deal characteristics, these high numbers nevertheless indicate a need to provide very large reassurance to investors in order to ensure marketability.

certain weak economies, a challenge recently highlighted in the European Commission's Green Paper on the long-term financing of the European economy.

In this context, several EU institutions have been exploring joint policy initiatives to promote lending to SMEs that would be based on reactivating the ABS market for such loans. The institutions could leverage their respective expertise (for example by providing guarantees to ABS transactions or ring-fencing public funds for specific purposes) to play a catalytic role in this regard. Such initiatives may be helpful for reducing spreads in certain jurisdictions, for facilitating new issuance and the transfer of risks from bank balance sheets, and finally for stimulating lending to firms and households, where this has become severely impaired. In addition, it is important to make further efforts in developing simple and standardised ABS products, which can benefit investors and provide regulators with comfort from a prudential perspective. However, all these initiatives are not a silver bullet for restoring loan growth and reactivating the ABS market, and their success will also depend on wider economic developments and the return to health of the EU banking sector.

Conclusion

The European ABS market has the potential to play a long-lasting and important role in European funding markets and real economy financing. Nevertheless, the turbulence in recent years has led to a number of regulatory initiatives that will play a key role in the viability of the market. These warrant careful consideration in order to ensure that important distinctions across jurisdictions and relative to other assets are sufficiently taken into account. Investor uncertainty and the challenging economic circumstances in many countries continue to present additional challenges. In this context, initiatives to improve transparency and standardisation, with the aim of enabling investors to better assess risk, and to support the real economy are crucial to attract market participants and reactivate the European ABS market.