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What's Holding Back European Securitization Issuance?

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What's Holding Back European Securitization Issuance?

Over recent months European policymakers have increasingly called for measures to help revitalize the securitization market as a means to support economic growth. These comments have come from a widening array of official bodies and think-tanks, including the European Commission, the European Central Bank (ECB), and the Bank of England.

Many commentators seem to now accept that not all securitizations have behaved like the pre-2007 products linked to U.S. subprime mortgage loans that contributed to the financial crisis. Considering the European market in particular, data from Standard & Poor's Ratings Services highlight that very little securitization issuance has actually ever defaulted, especially in vanilla asset classes such as residential mortgage-backed securities (RMBS). Several new industry standards have also sought to safeguard against conflicts of interest between originators and investors and to ensure that post-crisis securitizations are more transparent.

Overview

- Many official bodies and think-tanks have recently called for measures to help revitalize the European securitization market as a means to support economic growth.
- Opinions differ as to why European securitization issuance volumes remain significantly down on the levels seen before the financial crisis.
- In a recent joint paper on the topic, the ECB and the Bank of England provided their diagnosis, listing proposed regulatory changes and a reliance on credit ratings among the roadblocks that they believe are currently preventing more substantial new issuance.
- We believe that it is the wider macroeconomic and banking system backdrop that has held back issuance volumes in recent years, rather than any specific securitization industry issues.
- Looking ahead, however, we agree that current regulatory proposals pose a major threat to the viability of the European securitization market.

Nevertheless, aggregate volumes of investor-placed European securitization issuance are significantly down on the levels seen before the financial crisis: Annual issuance has ranged between €60 billion and €80 billion since 2010—down from a high of about €500 billion in 2006. Opinions differ as to why this might be. In a recent joint paper on the topic, the ECB and the Bank of England provided their diagnosis, listing proposed regulatory changes and a reliance on credit ratings among the roadblocks that they believe are currently preventing more substantial new issuance (1).

In our view, it is the wider macroeconomic and banking system backdrop has held back issuance volumes in recent years, rather than any specific securitization industry issues. We include ongoing economic weakness, low underlying credit origination volumes, bank balance sheet retrenchment, and plentiful cheap alternative funding sources.

Looking ahead, we agree that current regulatory proposals pose a major threat to the viability of the European securitization market. By contrast, we believe our current rating methodologies are justified, and we don't think that

they are significantly constraining securitization issuance prospects.

We note that policymakers' recent comments on securitization have varied in emphasis and ambition. Some seem focused on rebuilding the European securitization market in its existing image, i.e., as mostly a wholesale funding tool for bank originators. Others appear more ambitious, in our view, for example contemplating the use of securitization to underpin a shift toward greater capital market, non-bank funding for European small and mid-size enterprises. Absent any further policy details, the latter raises several unanswered questions, so in this article we focus on the former.

Securitization Technology Is Alive And Well, But Macroeconomic And Banking System Weaknesses Have Hampered Volumes

Some policymakers continue to characterize the European securitization market as close to dead. In our view, the reality is more nuanced. The aggregate volume of investor-placed European securitization issuance may be significantly down on the levels seen before the financial crisis. However, the health—or otherwise—of issuance volumes in Europe varies widely between the different component asset classes and countries in the region. We should also judge issuance volumes in the context of the broader economic and credit backdrop, in our view.

Some sectors have fully recovered. For example, the aggregate annual issuance volume of northern European asset-backed securities (ABS)—mainly transactions backed by nonmortgage consumer debt, such as auto loans and credit card receivables—has returned to pre-crisis levels of about €20 billion since 2011.

The two largest markets for RMBS—the U.K. and The Netherlands—have not seen such a return to pre-crisis volumes. However, viewed in the context of sharply lower underlying mortgage lending, RMBS volumes in recent years do not appear unhealthy. For example, Dutch RMBS issuance of about €15 billion in 2013 may have been down by 50% on the volume in 2006, but gross mortgage lending in The Netherlands was also down—by more than 55%—over the same period. Therefore, relative to underlying lending activity, we could view Dutch RMBS issuance as continuing at a reasonable level.

Admittedly, some areas of the pre-crisis European securitization landscape are still dormant. Most notably, the Spanish and Italian markets—which in 2006 together accounted for nearly €100 billion, or 20% of all European securitization issuance—are not currently active, with only €4 billion of issuance in 2013. However, these are also among the markets that continue to face the greatest challenges in their broader economies, as well as their banking systems. In fact, we expect that weaknesses in the wider European economy and banking system—as well as cheap funding from central banks—have been the main contributors to relatively depressed securitization issuance in recent years, rather than a lack of investor demand or any other issues with securitization technology.

Investor demand—while doubtless nuanced by sector—appears to remain relatively robust for now. A recent J. P. Morgan survey of European securitization investors suggested steadily improving sentiment over the past several years. As many as 85% of survey respondents classified themselves as current securitization buyers, rather than merely observing the market or liquidating legacy portfolios.

Few experienced European investors appear concerned by securitization's association with the financial crisis. In fact,

the track record of European securitizations arguably supports the idea that the poor credit performance of products related to U.S. subprime mortgage loans may have had more to do with the market structure and underlying loan origination practices at the time, rather than any inherent weakness in securitization technology itself. In Europe, the cumulative default rate of structured finance that we rated and which was outstanding in mid-2007 was only about 1.5% to the end of 2013 (when aggregated by original issuance volume), and for vanilla asset classes such as RMBS, the default rate has been substantially lower still.

Rather than centering on investor demand, we expect the factors depressing European securitization issuance in recent years have been on the supply side. Many European banks that previously originated securitizations have been retrenching for some years, shrinking their balance sheets as part of a strategy to raise capital ratios, and thereby also reducing their need for new wholesale funding issuance. What new funding they have raised has included a large slug of borrowing from cheap, subsidized official sector programs, such as the ECB's three-year long-term refinancing operations (LTROs) and the Bank of England's Funding for Lending Scheme. While positive in many ways, these schemes may have effectively cannibalized new issuance volumes for many types of capital market debt funding—not just securitization—including senior unsecured and covered bond issuance. This has likely been especially true in the two major pre-crisis markets where investor-placed securitization has yet to re-emerge in earnest—namely Italy and Spain—and where the banking systems remain large users of the ECB's LTROs.

Despite currently low issuance volumes, there are some positive signs. We note that the European securitization market continues to diversify along product and geographic lines, while attracting both new and seasoned participants. Recent years have seen various "firsts"—including the first public European auto dealer floorplan ABS and the first Swiss lease ABS, for example. Some weeks have seen established securitization originators issuing from well-known platforms with a track record based on dozens of previous transactions, followed within days by issuance from debut originators turning to securitization technology for the first time.

All of this suggests that—far from being a financing tool in terminal decline—securitization technology is alive and well in some areas, despite currently limited issuance volumes. At least, there is little evidence that originators who wish to tap capital markets are disproportionately shying away from securitization technology in their funding decisions, or that investors have lost their appetite for this asset class. We therefore believe that the European securitization market has the capacity to once again take on a larger role in the region's financial landscape, once economic conditions normalize and central banks withdraw. However, there is a risk that this situation could change, given certain regulatory proposals that could hurt investor demand.

Proposed Regulatory Changes Are A Key Structural Threat

Policymakers' recent calls for a revitalized European securitization market have, ironically, coincided with the culmination of several regulatory projects that could significantly reduce investor demand. In particular, a number of proposed changes to banks' and insurers' regulatory capital and liquidity requirements treat securitizations rather conservatively, in our view, relative to their observed performance and relative to some other credit asset classes, such as covered bonds and whole loan portfolios.

For example, in proposed revisions to the Basel securitization framework for bank capital charges, the risk weight for typical 'AAA' -rated securitization exposures under some calculation approaches is up to eight times higher than under current regulations (see "Proposed Revisions To The Basel Framework Could Deter Banks From Investing In European Securitizations," published on April 3, 2014). Under the latest public draft calibration of Solvency II—a regulation for European insurers—the proposed capital charges for certain securitization investments remain very high compared with some other fixed income instruments. For example, some 'AAA' -rated securitization tranches would attract charges more than 17 times higher than a similarly-rated covered bond. Counterintuitively, an insurer holding a 'AAA' -rated commercial mortgage-backed security could require more than four times as much capital as another insurer holding the unenhanced portfolio of mortgage loans backing that security (see "EIOPA's Revised Solvency II Calibration Still Risks Turning European Insurers Away From Securitizations," published on March 19, 2014).

We agree with the ECB's and the Bank of England's conclusion that these changes are a roadblock to the future growth of securitization volumes. In fact, in our view, these pending regulatory changes are by far the largest structural threat to the future of the European securitization market, as they could deter banks and insurers from holding such securities, potentially switching off demand from a large portion of the investor base. That said, there may still be some scope for changes as the regulatory texts become reflected in law. For example, the European Commission is working to define what it considers to be "high quality" securitization, and could make some of the rules more lenient for these types of transactions.

Current Rating Methodologies Shouldn't Be A Significant Obstacle To Issuance

Regulation aside, the ECB and Bank of England's recent paper argues that one of the remaining structural roadblocks preventing investors and originators from returning to the securitization market may be a reliance on credit rating agencies. In particular, the paper mentions that "rating agencies now require far greater levels of credit enhancement to achieve a given rating" on a securitization tranche than they would have done some years ago—and that this makes securitizations "more costly to issue". The paper also refers to the fact that—in some European countries—rating agencies currently limit the highest rating that they will assign to a securitization tranche, with this "rating cap" derived from the rating on the respective sovereign, but "not related to the underlying collateral quality". As a result, 'AAA' ratings are generally not currently achievable in securitizations backed by underlying collateral from Italy or Spain, for example, regardless of a tranche's credit enhancement or the underlying collateral quality. The paper implies that this could be problematic, given that 'AAA' ratings were historically the "benchmark" in the securitization market.

Given that our ratings on securitization tranches represent an opinion regarding the tranches' creditworthiness, we believe that their general decline over recent years is a justified and necessary reflection of the riskier economic environment, as well as some lessons from the crisis, which may have caused us—and other market participants—to reassess certain risks. We would, in any case, contest the idea that a shift toward lower ratings should necessarily constrain securitization issuance.

"Requir[ing]…greater levels of credit enhancement to achieve a given rating" is equivalent to assigning a lower rating for a given level of credit enhancement. In other words, for a given securitization tranche, the rating today may be lower than it was some years ago. We note that this situation is no different to many other classes of credit instrument.

Indeed, of our European securitization ratings that were outstanding in mid-2007, we had lowered about 55% (by number) by the end of 2013. This is little different to European financial institutions, where we lowered 65% of our ratings over the same period, or European non-financial corporates, where we lowered 50%. The equivalent figure for global sovereigns was 45%.

This simply suggests that our opinion of debtors' creditworthiness across a wide variety of sectors has generally fallen over the past six to seven years, or, equivalently, that credit risk has generally increased, in our assessment. This is perhaps unsurprising, given ongoing depressed economic conditions and dysfunctional banking systems across large parts of Europe.

However, we question whether the decline in securitization ratings has materially reduced originators' incentives to use securitization relative to other capital market funding sources. Even though the all-in risk premium that originators have to pay for securitization funding may have risen since the pre-crisis period—given higher credit enhancement requirements and higher credit spreads—the risk premia on originators' other funding options have risen too. This is in line with a general repricing of risk to levels that are arguably more realistic than was evident in the run-up to the financial crisis before 2007. In that sense, the rising cost of securitization funding may not result in a relative disincentive for originators to use it. In fact, since 2010—a period during which we have generally raised our credit enhancement requirements—we estimate that securitization's share in the mix of European banks' investor-placed wholesale funding issuance has remained fairly steady.

Finally, we consider the specific point regarding sovereign-related rating caps, and question whether the current inability to achieve 'AAA' ratings in some countries should necessarily be a significant factor holding back issuance.

We have long considered country risk as an important factor in our ratings, including those on securitizations (see, for example, "Weighing Country Risk In Our Criteria For Asset-Backed Securities," published on April 11, 2006, and previously "Assessing Sovereign Risk In Structured Finance In Emerging Markets," published on June 15, 1998). In practice, for long periods when country risk in most European markets was low, this consideration didn't generally constrain our securitization ratings. However, as country risk has risen in some areas over recent years, this situation changed. An early example of country risk considerations coming to the fore was when we lowered some of our ratings on senior tranches in Greek securitizations on Feb. 19, 2010 (see "'AAA' Ratings Lowered In Greek Structured Finance Transactions Following Reassessment Of Country Risk").

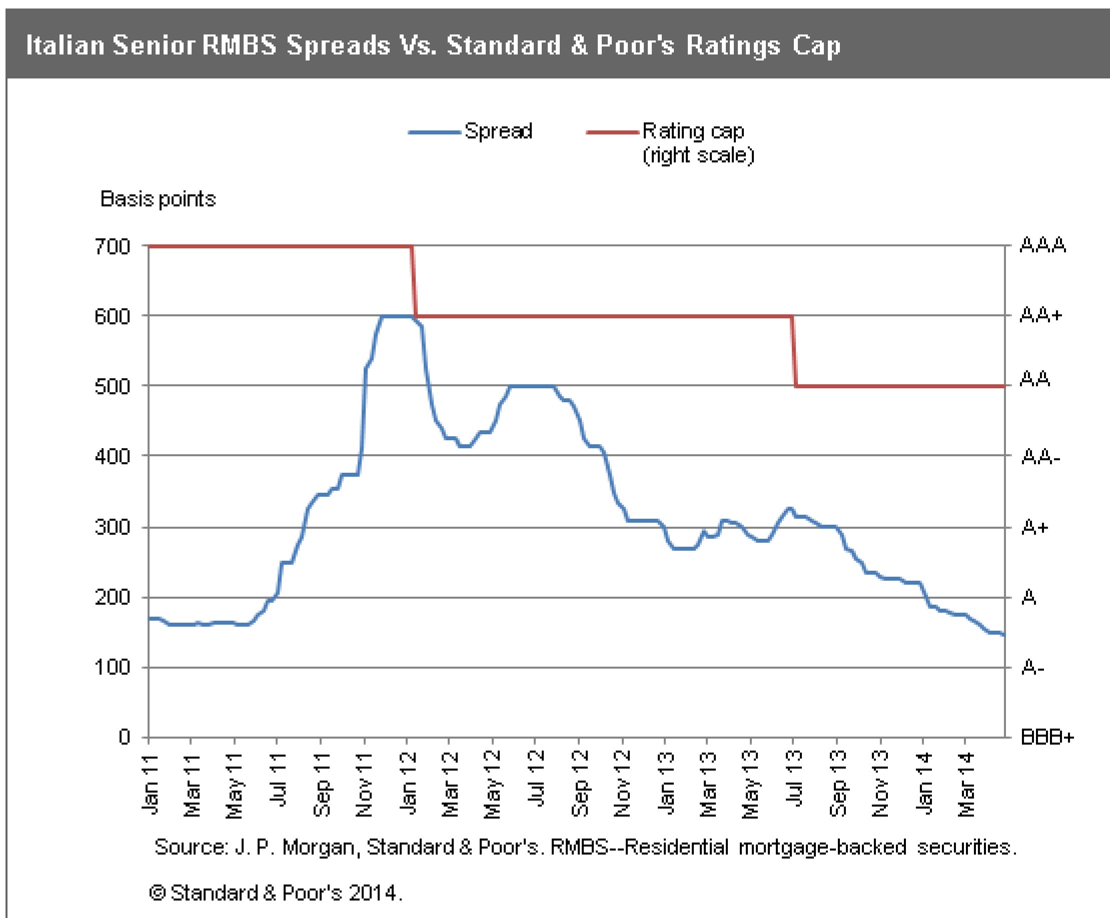
When we lower any of our ratings—whether on a corporate, a bank, or a securitization tranche—as a consequence of a related sovereign downgrade, it is because we believe the creditworthiness of the instrument or entity in question has decreased due to higher country risk. In such cases, we believe a downgrade properly reflects the increased likelihood of certain "tail events" for debtors in that country. For example, the risk of a deposit freeze, capital controls, liquidity disruption, or a disorderly exit from a monetary union and devaluation of any new currency.

However, the fact that 'AAA' ratings are generally not currently achievable on securitization tranches in some countries may not necessarily hurt investor demand, in our view. While 'AAA' ratings may have been the benchmark in the securitization market historically, investor sentiment could evolve, recognizing that ratings in the 'AA' and 'A' categories, for example, still represent very strong or strong capacity to meet financial commitments, according to our

rating definitions. The covered bond market may already be demonstrating such a shift: Nearly all Spanish and Italian covered bond programs used to be rated 'AAA', but issuance has continued despite the fact that ratings are now lower. Investor demand for securitizations from these countries also appears to remain strong. In fact, spreads on senior RMBS from countries where 'AAA' ratings are generally no longer achievable have actually tightened substantially over the past three or four years, despite country risk increasingly constraining our senior tranche ratings (see chart 1, for an example).

In summary, we believe that the securitization market is currently well-placed to once again take up a more significant role in the European financing landscape, once fundamental conditions improve and the official sector withdraws its funding support. That said, however, pending regulatory changes risk substantially derailing such a return to higher issuance volumes, if implemented without material amendments.

Chart 1



Related Research

- Transition Study: European Structured Finance 12-Month Rolling Default Level Drops To Its Lowest Since Mid-2010, April 28, 2014
- Securitization Regulation In Focus: Proposed Revisions To The Basel Framework Could Deter Banks From

Investing In European Securitizations, April 3, 2014
- S&P's Response To The December 2013 Consultation On The Basel Securitization Framework, April 3, 2014
- Securitization Regulation In Focus: EIOPA's Revised Solvency II Calibration Still Risks Turning European Insurers Away From Securitizations, March 19, 2014
- 'AAA' Ratings Lowered In Greek Structured Finance Transactions Following Reassessment Of Country Risk, Feb. 19, 2010

Note

(1) The Impaired EU Securitisation Market: Causes, Roadblocks And How To Deal With Them, ECB and Bank of England, April 11, 2014

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