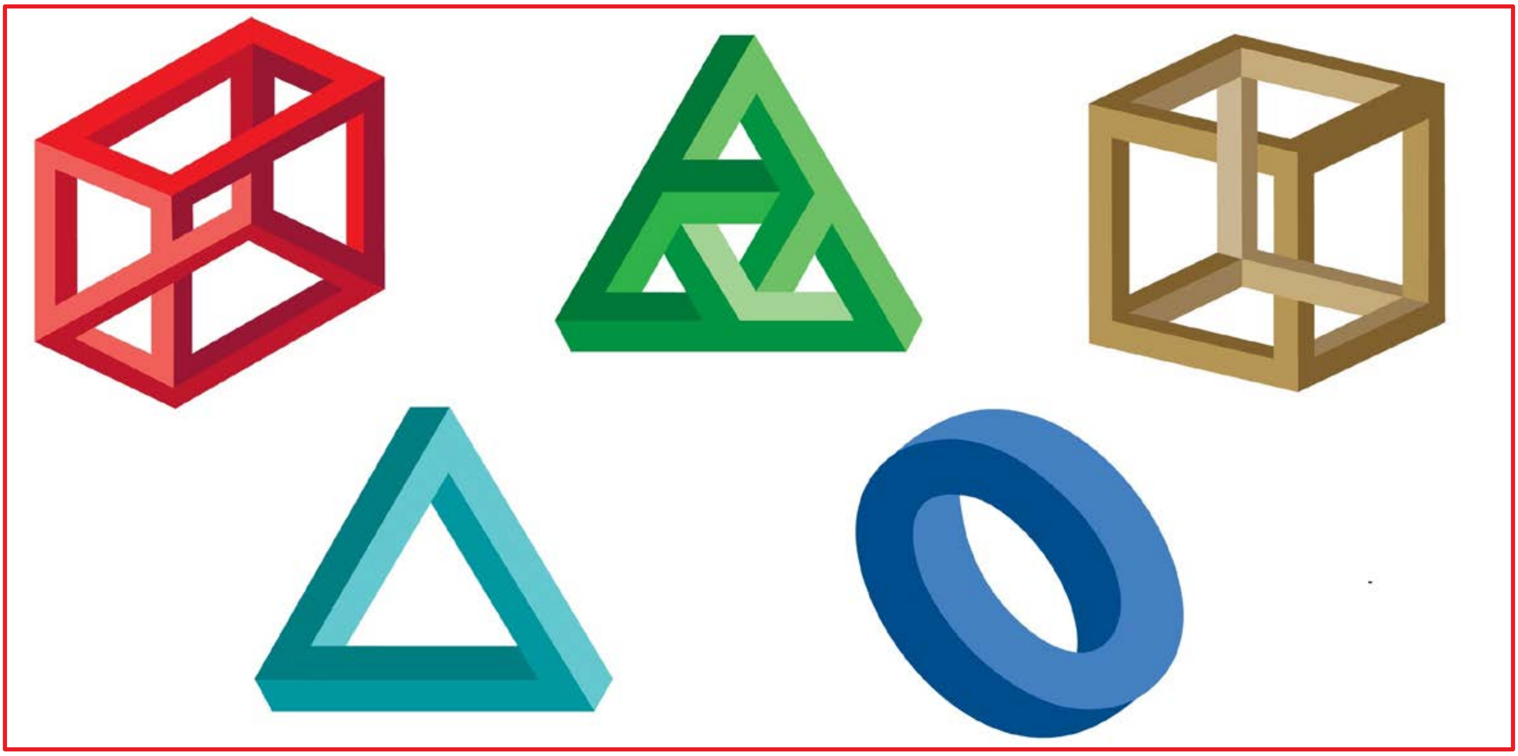

The Illusory Promise of Self-Attestation

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Introduction

As the proposal for a new regulatory framework of European securitisation makes its progress, thoughts are quite rightly turning to the operational aspects of such regulation. To reinvigorate the securitisation market on a safe basis and allow for adequate capital markets funds to flow to the real economy, it is necessary, but it is not sufficient, to create a sound prudential market architecture. It is also necessary, in addition, to work out how such architecture can operate in practice.

From a conceptual point of view, the direction of travel is fairly well established. The working assumption is a regulatory approach built around a definition of "simple, transparent and standardised" ("STS") securitisations. This definition will then be used in various prudential rules to create a bifurcated treatment for individual securitisations dependent on whether or not they meet the requirements of the definition.

Although we have long advocated this approach, its success in creating the conditions for a strong market also remains dependent on the operational infrastructure created around it. In particular, it relies on the belief by market participants that the risk and rewards as well as the costs of participating in this regulated market are worthwhile, both on an absolute and a relative basis.

In this paper we wish to address one proposal about how such operational infrastructure could be fashioned and why we think that, despite its undoubted superficial attraction, it would be very unlikely to revive any kind of securitisation market in Europe. Furthermore, there is a high risk it could result in a market deeply flawed in its fundamental prudential aspects.

Self-attestation and investor due diligence

One proposal[1] as to how the new regulatory scheme could work is to impose an obligation of self-attestation on securitisation issuers: in other words, issuers would have to certify that their transactions met the regulatory standards. This would be combined with a de facto obligation on investors to make their own determination as to whether the securitisations they were buying met the requirements.

At first blush, this seems a very attractive idea. It removes the need for any meaningful ongoing regulatory oversight. (Regulators would only be required to intervene after a problem had occurred).

This proposal also seems to leave the risks and responsibilities where one would expect to see them. The issuers have structured the issuance and have the necessary knowledge to determine whether it meets the requirements of the rules. At the same time, the investors should know what they are buying and so should be expected to perform the necessary due diligence to determine whether the securitisation they are considering to purchase really meets the prudential requirements.

Unfortunately, although superficially attractive, this approach is unlikely to reverse the continued decline of the European securitisation market on its road to oblivion.

[1] This proposal was put forward, for example, by the Bank of England and the European Central Bank in their response to the Commission consultation (https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_response_ec_consultation_on_securitisation20150327.en.pdf).

Costs, risks and rewards

Any revival of the European securitisation market will require a substantial number of new investors. (The old, pre-2008 market was defined by the major involvement as investors of banks and creatures known as "structured investment vehicles" (SIVs). The point of the CMU project is to diminish the role of the former. The latter were liquidated in 2008 and will never - one hopes – be revived).

The current proposals for a new regulatory approach to securitisation have two important characteristics. First, the various proposals for a definition of STS securitisations are fairly complex. Solvency II's existing definition contains 12 separate conditions[2] that require to be met. The EBA's proposal runs to over 50. In addition, these conditions are not always straightforward. In other words, the due diligence of the STS criteria is not trivial.

The second characteristic is that the difference in outcome between the regulatory treatment of an STS securitisation and one that does not meet the standard is likely to be very stark. The differences in capital requirements under Solvency II are very substantial. In other cases, such as the Liquidity Cover Ratios and the likely Money Market Funds rules, the difference is absolute: it is the difference between being allowed to hold the securitisation or not.

Therefore, determining whether a securitisation meets the STS standard is detailed and complex, and therefore likely to be expensive for investors, the consequences of getting it wrong are very costly and the only help investors can expect is from the self-attestation of an issuer who has to adjudicate on a complex issue and has a strong incentive to reach a predetermined conclusion.

The last part is especially important when trying to revive the securitisation market. One of the incontrovertible lessons of the crisis is that misaligned interests, even with the threat of litigation or regulatory sanctions, are a very dangerous element to inject into structured finance. This is why the self-attestation proposal at the end really amounts to an investor due diligence requirement. Since, if the issuer fails in its duty, the losses fall on the investor it is difficult, after the 2008 crisis, to imagine new investors being willing to come to this market based on issuers' assurances of quality. It is not even clear that investors still in the market would be willing to stay on this basis.

As a result, a requirement that investors invest in a product that still retains some stigma, on the basis of fairly complex and expensive due diligence, with severe penalties for getting it wrong and no independent assistance, will almost certainly close the door for all but the biggest and most sophisticated investors. In fact, based on conversations with existing sophisticated investors, the current proposals would lead a number of them to leave the market for other bond markets where such risks are simply not there.

A "market" is not the same as an "investment": the need for a common currency

Another problem with the proposal is that it focuses, as one would expect if one takes a purely prudential and regulatory approach, on the individual investor accounting properly for his or her investment. An investor must be able to take an independent

[2] In fact, as some of those conditions are themselves composed on separate "sub-conditions", the actual number of criteria that need to be met are in excess of twenty.

view of his or her investment and allocate risk and capital correctly based on this view. Once this is done, the regulations have fulfilled their purpose.
However, this approach fails to take into account that capital market investors invest in "markets". They rely on being able to sell their positions if they so wish. To do this, though, they cannot just rely on their own due diligence and regulatory conclusions. They must also have some confidence that other participants in the market, having done their own due diligence, will come to the same conclusions. Since, as we have seen, the proposed securitisation rules are complex, there is a great risk that other investors will come to different conclusions.

This is why, in addition to the risk that an investor will suffer loss from making a mistake in interpretation – resulting in a regulatory re-categorisation of its investment – the self-attestation/due diligence proposal runs the risk that an investor suffers loss - notwithstanding having done what it considers to be an absolutely correct analysis - if other investors have done the analysis differently and reached different conclusions.

The risk of such differing approaches amongst investors is substantially increased in the case of the proposed securitisation regulatory framework since the framework is rightly intended to apply across different industries (insurance companies, banks, money market funds, alternative asset managers,...) each with different historical and institutional approaches and each regulated by different supervisory authorities.

Having to rely on one's own due diligence without assistance is a disincentive to new investors entering into this market. But to have to trust other institutions' due diligence is probably an insuperable barrier.

This is why, in market situations such as these, where the value of an investment is not just determined by the analysis of the investor but by that of the investor community as a whole, reliance is placed on a "common currency" which is both public and shared. The most obvious example is the stock exchanges whose public prices for equities provide investors with a common understanding of the market's view. And this is why the European Union has sought to introduce a similar "common currency" in the bond markets with post-trade transparency rules administered by third party institutions (the CTPs).

In securitisation, the need for such "common currency" is made all the greater by the fact that the market will not be regulated by a single regulator but by many. This leads to the further likelihood that, as each regulator interprets the STS criteria differently, the hope of a single, harmonised and unified European market will swiftly crumble. The existence of a single determinative "list" of STS transactions together with the appropriate level of regulatory supervision and centralisation that such list will require is the best guarantor of a consistent approach across all types of investors.

The practical issues of timing

Even if the analysis of whether a securitisation meets the STS standards were fairly straightforward, the absence of a publicly available list of STS securitisation will pose substantial – and possibly fatal – obstacles to the operation of a proper secondary market.

If an investor wishes to sell a securitisation, he or she will approach trading counterparties and ask them for a quote. Normally, a price is given and – if it is acceptable - the trade takes place. However, the differences between STS securitisations and others is stark. And so the price differential is going to be equally stark. In order to quote a price, the trading firm will need to know that it can unload the position to another investor at roughly the same price (minus the bid/offer spread). For this, the trader needs to know that likely purchasers will also consider the securitisation as an STS.

Few trading firms, if any, will be willing, in the absence of a public list of STS securitisations, to take that substantial price risk on their own books. They will therefore only be willing to broker a sale – find another investor and put the seller and buyer in touch. The buyer, of course, will have to do his or her own due diligence as to whether the securitisation meets the criteria for STS status. This will take time.

So the outcome of a self-attestation/due diligence regulatory approach, even for straightforward STS securitisations, is that every sale will be like that of a complex private placement, matching individual sellers with individual buyers and taking time. This is the anti-thesis of the deep, liquid market the authorities are hoping for.[3]

Consequences

Because of these limitations, the most likely outcome of a regulatory system without a public and recognised list – a "common currency" - is that the hoped for new investors needed to restart a securitisation market will simply stay away. It will shrink any possible European securitisation market to a minuscule, bespoke, specialist market far distant from what it could be and far from what the European economy needs.

The only other approach, i.e. that investors are somehow willing to treat the self-attestation by the issuers as determinative, is even worse. The absence of a third party independently derived "common currency" leads to self-attestations becoming that "common currency". This would re-found the European securitisation market on the very same misalignment of interest that triggered the crisis in the first place. And, with its history, a single failure by a single issuer on a self-attestation is probably all it would take to destroy forever this financing channel in Europe.

Role of independent third parties

Most, if not all, of the above issues of complex due diligence, informational asymmetry and conflicts of interest are not unique to securitisation. We have already mentioned equity pricing, for example.

In many cases where the cost to the buyer, in time and money, of bridging the informational gap is too substantial to allow for a market – financial or otherwise – to arise, the regulatory answer is to provide for independent, and usually regulated, third parties to help fill that gap.

This is ubiquitous, for example, in consumer regulation. Whether a bicycle helmet works is, quite literally, a matter of life and death for its wearer. The obligation on manufacturers of helmets to certify the safety of their product is absolute. But they have a conflict of interest. The wisdom of cyclists doing due diligence is very strong in view of the stark difference in outcomes. But becoming an engineer and buying the tools to test your helmet is clearly too high a cost. So third party bodies are approved by regulators to help consumers by providing quality certifications. The analogy with the secondary market also, to some extent, holds: a retailer would not want to purchase helmets on the basis that they meet the safety requirements to find that customers,

[3] Arguably, the self-attestation/due diligence approach could even result in excluding STS securitisations from those regulatory categories where the focus is on liquidity (eg LCR rules and Solvency II), resulting in exactly the reverse result from that which was anticipated.

having done their due diligence differently, disagree and refuse to buy them. The sticker of conformity provided by a regulated body (called "notified bodies" in EU law) is the comfort a retailer needs.[4]

Of course, it could be argued that the case of securitisation is different since the example provided is about consumer protection; that individual consumers require special protection and simply cannot be compared to sophisticated capital market investors; that such sophisticated actors should be required to "become engineers and buy the necessary tools".

Yet, notwithstanding this, one cannot help notice that it is a legal requirement of companies accessing the capital markets that they publish accounts audited by independent third party regulated accountancy firms. Despite the view that investors should do all their due diligence and fully understand the investments they make, it is also recognised that complexity, informational asymmetries, conflicts of interests on the part of issuers and the need for a "common currency" that allows meaningful comparisons make auditing a practical necessity for any serious equity or debt market to exist.

As with the likely securitisation proposals, it is interesting to note that auditors are private sector independent actors that do not make the "regulatory" rules (the accounting standards) but apply them.

Maintaining responsibilities where they should lie

The attraction of the self-attestation/due diligence proposal is that it leaves the responsibilities where one instinctively feels they should lie: with the issuer for information and respect of the rules, with the investors for due diligence of the products they purchase. The problem is that it is most likely to destroy the market.

An independent regulated third-party providing a "common currency" though does not have to lead to the responsibilities being removed from their natural bearers.

First, the investor is not exempted from the obligation to perform the necessary due diligence to understand what he or she is purchasing. What changes are the tools used to perform that due diligence[5]. In the same way as independent audited accounts are a tool that assists investors, a third party certification which provides the details of how each regulatory criterion is met, assists the investor in performing that due diligence.

Secondly, as with an independent audit, a third party certification does not remove the obligation of the issuer to meet the STS standards. As with an audit, responsibility for the information provided to determine STS conformity and ultimate responsibility for the conclusions remain with the issuer. However, as with audits, a third party independent certification meets the best practice "four eyes" regulatory requirement and overcomes conflict of interest that otherwise rests at the heart of the self-attestation/due diligence model.

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[4] In European law there already exist literally hundreds of such bodies in various areas of safety from medical equipment to food to vehicles and many others fields details of which may be found in the EU Blue Guide (http://ec.europa.eu/enterprise/newsroom/cf/itemdetail.cfm?item_id=7326).

[5] An important aspect of any third party certification, for this very reason, would be that such certification lay out the details that have lead the certification agent to grant the requisite certification, thus allowing each investor to satisfy himself or herself of the key elements of the STS designation.

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