# Securitisation: ghosts of crisis past

## How key aspects of Europe's securitisation regulation are shaped by factors that have ceased to exist

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The European Commission is currently reviewing the regulatory framework for securitisation. That the changes brought about by the coming into force of the Securitisation Regulation in early 2019 have not resulted in the anticipated and wished for revival of the European securitisation market is universally acknowledged. The reasons for this are at times argued over but the role played by flaws in the regulatory framework is sometimes underplayed, with regulators and policy makers often preferring to point the finger solely at the ECB's monetary policy.

We will see why this is a potentially dangerous illusion. Finalising the reforms begun in 2017 with the passing of the Securitisation Regulation and attendant amendments of the Capital Requirements Regulation and Solvency II is essential to the future of Europe's finances.

The changes that are needed are also well known. They were laid out by the European Commission's High-Level Forum of experts and endorsed by virtually the entire stakeholder universe, including PCS[1]. At the heart of these necessary reforms are more risk sensitive capital requirements for bank and insurance companies holding securitisations, and especially the extremely high-quality securitisations meeting the STS standards.

Yet, both in written and public oral pronouncements, the European Banking Authority and the European Insurance and Occupational Pensions Authority have expressed a great reluctance to revisit these capital calibrations[2]. This paper will contend that this reluctance is largely grounded in the fear of ghosts from the GFC. They are described as "ghosts" because, in truth and certainly for STS securitisations, these factors no longer exist, or – if they still have some existence – they exist in such ghostly attenuated forms that they pose no actual threat. Yet they remain frightening, it seems.

## Importance and urgency

The reasons why a revitalisation of the European securitisation market is essential to the economic future of the continent have been rehearsed extensively and it is not the purpose of this paper to go over this ground once more[3].

These reasons include securitisation being the vector for safe and pro-active capital management by European banks to ensure sufficient lending capacity to meet the needs of the European economy, the role of securitisation in helping fund the immense needs of the European Green Plan, the importance of securitisation to the global competitiveness of European banks faced with US and Chinese banks that benefit from a healthy securitisation market and the need for safe European assets to channel the large savings pools that exist in the EU.

To the importance of a revival of the securitisation market has now been added urgency. Since the GFC, the ECB has provided the banking system with effectively infinite liquidity. Today, the times of endless free central bank money are drawing to a close. Some policy makers have expressed the belief that the lack of revival of the securitisation market was caused primarily by monetary accommodation and that ECB QT would reverse this trend. Although proving counterfactuals is always challenging, there are good reasons to doubt that this is the whole (or even the primary) reason for the anaemic securitisation market. For one, the substantial growth in covered bond issuance – especially from institutions that previously were large securitisation issuers – strongly suggests that regulatory arbitrage played a greater role in the decline of securitisation.

Setting aside the fact that achieving the correct capital requirements for debt instruments is a public good in and of itself and essential to avoid regulatory arbitrage, when taking into account the necessary time to achieve regulatory changes and the immediacy of the sea-change brought about by the ECB's new direction, we believe that waiting to see how things turn out following monetary tightening before addressing known issues with securitisation's regulatory framework runs very serious and unnecessary risks for Europe's capacity to fund a fragilized economy. It would be akin to someone jumping off a diving board in the hope that their belief there is indeed water at the bottom will prove correct, notwithstanding the views of many experts that this is probably not the case. This is especially odd when the diver has the means to ensure the pool is filled.

But then there are the ghosts…

1. https://finance.ec.europa.eu/system/files/2020-06/200610-cmu-high-level-forum-final-report_en.pdf
2. For example, the assertion that the current Solvency II rules were "fit for purpose" in the recent EIOPA consultation (https://www.eiopa.europa.eu/sites/default/files/publications/consultations/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf)
3. See, for example, "Securitisation: the indispensable reform" (p.58 Eurofi Regulatory Update - https://www.eurofi.net/wp-content/uploads/2021/09/regulatory-update_ljubljana_september-2021.pdf)

## Agency risks

Both the EBA and EIOPA, as well as many national competent authorities, when challenged on the fact that the capital requirements for securitisations do not seem consistent with the data on the risk of the securitised assets or with the rules for other similar assets refer to "agency risks" as the explanation.

### What are agency risks?

"Agency risks" play a technical role in what is called the "non-neutrality" issue in the CRR. The investor in a securitisation takes the risk of the assets that have been securitised without recourse to the originator or other third party. At first blush, this would mean that if the assets do not perform, the investor's loss and delinquencies will match the losses and delinquencies on the assets. It would therefore follow that the capital required by a bank investor who invested in every tranche of a securitisation should be the same as the capital that investor would need to hold if he held the securitised assets directly on his books. Same risk, same capital.

However, this is not the case under the CRR. This is because policy makers are worried about additional risks that are not in the securitised assets but are created by the act of securitisation itself. The archetypal such risk is the "originate to distribute" risk where the originator having no "skin in the game" for the assets securitised because it sells all of them, originates assets which are much worst credit risks than the "normal" assets for which capital calibrations have been fixed.

All those additional risks created by the act of securitising are called "agency risks". In the case of the CRR they are captured by the *p* factor in the capital formula. The *p* factor is an arbitrary number that increases the capital requirement above what a "neutral" formula would generate.

Agency risks also play a role in the approach to capital rules for insurance investors and more generally as somewhat of a catch-all explanation of why capital requirements for securitisations in Europe are greater than those of the assets, similar asset backed instruments or than what data would suggest[4].

The advantage of "agency risks" is that most have never been quantified mathematically. For example, how much worse would the credit of assets originated under an "originate to distribute" model be than traditionally originated assets? Twice as bad, three times, ten times…? This allows regulators arbitrarily to fix the surplus capital for "agency risks" at any rate they feel comfortable with without having to justify it. The *p* factor in CRR, as mentioned above, is an entirely arbitrary figure not derived from any data.

A similar problem exists in the Solvency II calibration where the capital for securitisation is multiple times that for its underlying assets. Even though the discrepancy in capital requirements is nowhere near as large in the US, the US insurance regulator (NAIC) made the realignment of the capital after securitisation with that before securitisation for the same type of assets a key objective of the recently proposed solvency capital ratio.

### Problem with relying on agency risks

First, we should be clear that agency risks are real. They are a legitimate category of risks that should be examined and quantified.

Although, in Europe, even before the securitisation reforms of 2017, agency risks appear to be more theoretical than actual. In Italy, research showed when examining the infamous "originate-to-distribute" lack of alignment, that Italian mortgages that had been securitised performed ***better*** than those that had not. This, in PCS' view, is not merely an accident but reflect fundamental differences in the structure of financial services on either side of the Atlantic[5].

The problem is that, in calibrating regulatory requirements – especially post the 2019 reforms – they were usually not examined and even less quantified.

Yet, when they are examined, especially for Simple Transparent Standard (STS) securitisations, they appear not to exist.

When they do exist, for example in non-STS securitisations, they appear to be identical to well-known and banal risks that exist in many other capital market instruments. Yet, they are effectively ignored in the capital fixing for those other instruments.

### Where is the agency-related risks list?

Most regulatory references to agency risks are vague with a few non-exclusive examples given but with little elaboration: additional capital is required "for agency risks (such as servicing risk)" and let us leave it at that. But agency risks are a set of risks capable of enumeration. It is not possible to examine, even less to quantify, agency risks without listing them. Such a list must be generated if stakeholders are to engage in a meaningful debate with policy makers on the correct way to account for them in the regulation. There is no conceptual or technical reason that would impede the collation of such a list.

### Was that not the point of STS?

The process of defining "simple, transparent and standardised (STS)" securitisations involved the EBA, ESMA, EIOPA, the European Commission, the European Council and the European Parliament, over a period of three years and with the assistance of multiple consultations and hearings, examining all the aspects of securitisation with the sole and focused aim to identify each and every specific non-credit risk that could exist and to exclude them from STS designated securitisations. This process resulted in a definition that removed 103 separate non-credit risks (the STS criteria). The vast majority are designed with the explicit aim to remove, one by one, individually identified

4. For example, they are extensively cited by EIOPA in their recent consultation as to why capital requirements for securitisations are as high as they are (https://www.eiopa.europa.eu/sites/default/files/publications/consultations/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf)
5. See "Securitization is not that evil after all" by Ugo Albertazzi et al. (BIS Working Paper 341 – 2011) - https://www.bis.org/publ/work341.pdf

agency risks. For example, the risk that the originator securitises its worse assets is explicitly the subject matter of an STS criteria prohibiting such behaviour. Similarly, originate-to-distribute risk is removed by the mandatory retention requirement (that applies not only to STS but all securitisations).

We would respectfully invite regulatory authorities, if they believe that there exist agency risks that are not catered for in the 103 STS criteria, to identify and list them. Should these, indeed, be identified, PCS would volunteer to advocate in favour of adding them as additional STS criteria in the current review. If, however, and as we strongly suspect, no such risks are identified, then the appropriate conclusions need be drawn and any reference to nebulous and unspecified "agency risks" should no longer be used as a justification for non-neutrality for STS investments.

**Comparisons with other asset classes**

It is also worth noting that, whereas STS securitisations are burdened by additional capital requirements for agency risks that do not exist, other asset classes where the same agency risks do actually exist have absolutely no modifier to their capital requirements to account for them.

For example, the risk that the originator securitises its worst assets is prohibited in STS securitisation. But the same risk exists in mortgage or SME portfolio sales. These are very common, and the purchasers are often insurance companies. Clearly the seller is incentivised to sell its worst assets, yet Solvency II makes no adjustment for this agency risk.

We also note that no such prohibition exists for covered bond where a bank may choose its worst assets to go into a cover pool to retain the option of selling its better assets later if it gets into trouble. Again, this agency risk is unaccounted for.

Many other examples could be provided.

**What about risks that cannot be catered for in STS?**

In their recent consultation, EIOPA also listed as examples a series of agency risks that could not, by their nature, be the subject of an STS criterion. However, upon closer examination, these risks all appear to be fraud or quasi-fraud risks and, although common to many debt instruments, are only used to justify additional requirements when related to securitisation.

We will take some of the examples given by EIOPA and show what we mean.

- The originator may disregard the selection criteria for the assets. Disregard for the defined criteria is a fraud. This is no different than disregard for the selection criteria in a portfolio sale or in the selection criteria over a cover pool for a covered bond or an investment fund. No *p* factor or other modifier applies though in those cases.
- The servicer may fail to report losses. This is outright fraud. Failure to report losses is at the root of almost all corporate bond fraud or asset management fraud (*e.g.*, Wirecard or Madoff). Yet, no capital modifier exists to account for this in any other asset class.
- Lack of motivation to collect receivables. This is breach of contract and makes the servicer liable for damages. It also ignores the fact that, with retention requirements, this would necessarily lead (in almost all cases *i.e.*, where the servicer is the originator) to the servicer suffering losses. This is the alignment of interest sought by and achieved by the retention rules. But equally important it is also a risk that exists in every mortgage or SME portfolio purchased by insurance companies and serviced by the originator without, in those cases, any mitigation from retention requirements. But despite that lack of mitigation, no extra-weight is provided for such pools. In the case of covered bonds, the issue is even more acute since the investor only relies on the pool *after the insolvency of the bank*. Regulators are therefore concerned, in the case of securitisations, about a solvent bank that has a financial and reputational incentive to collect the receivables but are completely comfortable, in the case of covered bonds, with an insolvent one that has pretty much zero incentive to collect money that is of no benefit to its insolvent estate.
- Failure to report losses. Again, this is fraud or quasi fraud. But we fail to see how this is a securitisation agency risk and not equally a corporate bond via published accounts, covered bond or even, sovereign bond risk.

When dealing with general non-securitisation specific "agency risk" , both in CRR and in Solvency II, the approach appears to be that such risks are deemed reflected in the historical data and therefore need no specific adjustments unless they appear in the context of a securitisation where they are used to justify an additional amount of capital on top of what the data requires.

## Modelling risks

The other category of risks mentioned in ushed tones by regulators are "modelling risks". These are deemed to be particular to, or particularly vicious when involved with, securitisations.

Again, as with agency risk, modelling risk is a real risk and needs to be examined. We would argue that together with originate to distribute in sub-prime mortgages in the United States, modelling risk in CDOs was the main cause of the catastrophe that overtook the US securitisation market in 2007-2008.

But, as with agency risks, when examined in the context of European securitisation post reform, modelling risk appears to be no more than a ghostly and unthreatening presence.

In the 2013 White Paper on the causes of the securitisation crisis[6], PCS cited model risk as one of the four aspects of

6. "Europe in transition – Bridging the Funding Gap" (2013) - https://pcsmarket.org/draft//wp-content/uploads/2013/03/Europe-in-Transition-Bridging-the-Funding-Gap1.pdf

the crisis that had caused securitisations to fail. The EBA, in its own 2014 paper on the matter was kind enough to endorse explicitly our analysis[7].

But the modelling risk that we identified was in a very specific context: that of the use of models on models. The risk only emerges as meaningful when a model was seeking to model the output of the combination of other similar models. The contention is that all models of future behaviour have uncertainty. When another model takes the output of a first model and models it, then the uncertainties are factored.

This is a risk that obtained in one specific type of securitisation and only that type of securitisation: re-securitisations.

Re-securitisations were banned in Europe from 2019.

In all other types of securitisations – and even more so in STS securitisations where non-sequential payments are (broadly) not allowed – the models used are simple, straightforward and do not carry the model-on-model risk.

They are not more complex than the models one would need to model asset behaviour in a covered bond pool should the investor need to rely on the collateral. They are simpler than most models in project finance or even corporate finance when an investor needs to figure out if there will be sufficient cash to pay interest and principal. They are much simpler than the models used to model a sovereign's debt service capacity which depend on complex economic and fiscal assumptions.

## Conclusions

When examining the case for better calibrations of the securitisation regulations, policy makers and regulators must not rely on nebulous or barely examined categories such as agency risks and modelling risks as excuses for holding on to indefensible numbers.

Like other frightening phenomena, agency risks and modelling risks should be subjected to a rigorous, scientific and objective analysis. We believe that to do this will allow a realistic assessment of the actual risks involved, especially in STS securitisations. We are confident that this assessment will show that a substantial reduction of capital requirements imposed because of these ghostly risks is warranted.

We also, as with many other aspects of securitisation regulation, urge policy makers and regulators to bring a holistic approach to regulation. This means not imposing burdens on one capital market instrument for perceived risks that exist but are ignored in others. This is the only way to establish a level-playing field and thus avoid regulatory arbitrage.

7. "EBA discussion paper on simple, standard and transparent securitisations" (2014) at page 36 - https://www.eba.europa.eu/sites/default/documents/files/documents/10180/846157/ceefdf3f-58ea-452f-a924-2563410d1705/EBA-DP-2014-02%20Discussion%20Paper%20on%20simple%20standard%20and%20transparent%20securitisations.pdf