

Securitisation: The key to credit reactivation

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Despite the fact that Europe's banks now have greater liquidity, the reactivation of credit to the economy remains slow in Spain and in the rest of Europe. Both the ECB and the Bank of England agree that in order to get credit flowing again, it is vital to revive the European securitisation market.

Issuance of securitized bonds in Spain, as in the rest of Europe, essentially came to a halt with the outbreak of the financial crisis. The reduction in Spain in the outstanding bond balance has become palpable, having dropped from almost 300 billion euros in 2008 to 170 billion euros in June 2014. Nevertheless, funds continued to be set up with a view of amassing collateral for ECB credit operations. Today, despite European banks' increased liquidity, private sector lending remains low. After searching for the right mechanism for alleviating the lingering credit crunch in Europe, the main European central banks seem to agree that securitization, once viewed as part of the problem, may now be part of the solution. This is evidenced by the recent announcement of new ECB measures, such as the ABS buyback programme. Despite the latest shift in policy stance, there are existing obstacles to the successful reactivation of European securitization markets, which need to be overcome with the help of regulatory support from European authorities.

Introduction

After a seven-year drought in the securitisation market, stigmatised by the US subprime crisis and hindered, in part, by the introduction of regulatory measures, global authorities are now focused on its revival. Securitisations have gone from being viewed as part of the problem to being part of a potential solution – now seen as an important channel for getting banks to start lending again to the private sector. This shift in policy stance has been shaped by recognition that securitisations, in and of themselves, are not harmful for the economy. While it is true that widespread and unchecked use of this instrument, using opaque

structures, can be potentially harmful to the economy, controlled and transparent reliance on this instrument, using simple structures and high-quality underlying assets, can generate substantial benefits for the economy overall. In particular: (i) securitisations can help stabilise prices by injecting liquidity into credit and from there into consumption; (ii) they act as a financial stabiliser by sharing a known risk among various financial players, thereby reducing correlation with the financial health of the agents exposed to these risks in times of crisis; and, (iii) they help reduce borrowing costs and channel bank liquidity into the private sector. In Spain, reactivation of the securitisation market is increasingly seen as

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an imperative to ending the recession. However, it appears unlikely that the climate will become favourable so as to make securitisations an efficient financing instrument and/or risk mitigation tool for banks in the absence of unambiguous support from the European authorities. This article examines the state of the securitisation market in Spain today, its performance in the past and the outlook in Spain and Europe.

The idiosyncrasies of Spain´s securitisation market

The idiosyncrasy of the Spanish economy means that the local securitisation market has been traditionally highly dependent on trends in the real estate market. In fact, securitisations were first created in Spain in 1992 with a view to facilitating access to the housing market. Securitisation of mortgage loans brought down the cost of mortgages taken on by Spanish households to finance their home purchases. Subsequent legislation made room for the securitization of other classes of underlying assets, which had the effect of expanding the spectrum of issuers

beyond banks to other entities in possession of cash-flow producing financial assets.

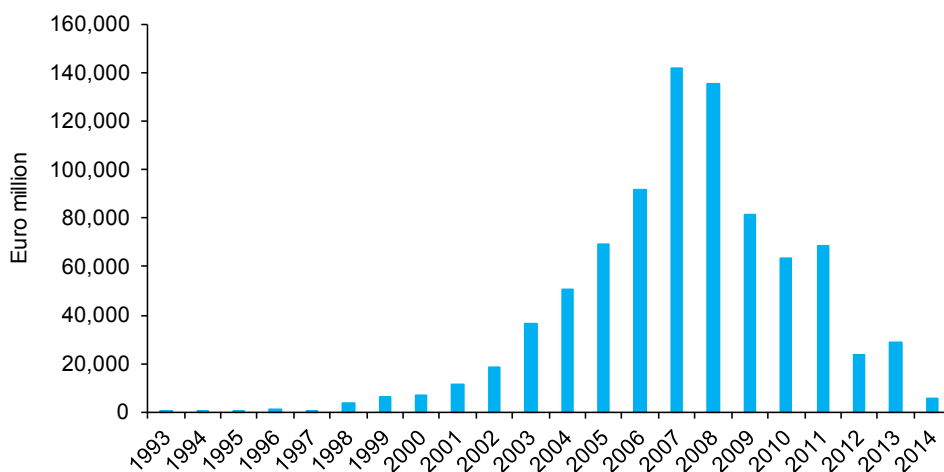
However, it was not until the creation of the euro, and the arrival of potential investors from Europe (funds, banks, insurers, etc.) that Spanish banks began to actively securitise their assets, triggering a boom in issuance in the early years of the 21st century.

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The take-off of the Spanish securitisation market was, accordingly, closely linked to the real estate market and clearly dominated by the banks.² Residential mortgage backed securities (RMBSs) constituted the bulk of the bonds issued and placed in Spain. This situation has not changed dramatically; the role of non-bank issuers has been

Exhibit 1

Trend in securitised bond issuance in Spain

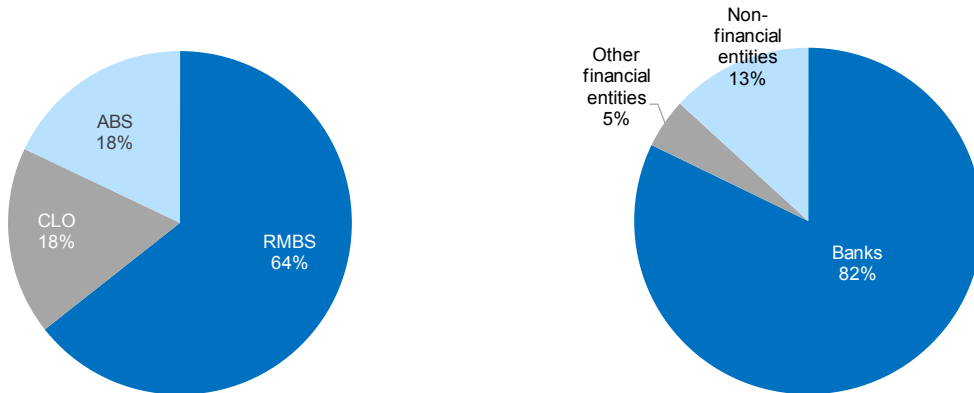


Sources: CNMV, AFI.

² Banks, savings banks (the so-called cajas) and credit cooperatives.

Exhibits 2 & 3

Outstanding securitised bonds in Spain, broken down by asset and issuer classes (as of June 2014)



Sources: CNMV, AFI.

marginal, the banks' grip on the product being nuanced only by the securitisation of the Spanish electricity tariff deficit (accounting for issuance of almost 25 billion euros) and the occasional public sector issuance for example by the Official Credit Institute (ICO in its Spanish initials).

As a result, it is meaningless to analyse the state of the securitisation market in Spain and its development without analysing the state and performance of the Spanish banks and how the crisis has affected these entities and their assets.

Securitisation in Spain during the crisis

In Spain, as was the case in the rest of Europe, the eruption of the financial crisis had the effect of closing down the primary securitised bond market, with the exception of the occasional private placement and the placement of the bonds securitising Spain's electricity tariff deficit (by FADE, the acronym in Spanish for the electricity deficit amortisation fund). The last public placement of Spanish securitised bonds took place in July 2007. Since then, neither the various attempts at issuing public security guarantee

programmes (FTPYME, FTGENCAT and FTVPO, for funds issuing securities backed by SME loans and protected housing mortgages, among others)

In Spain, as was the case in the rest of Europe, the eruption of the financial crisis had the effect of closing down the primary securitised bond market. Despite this, the balance of outstanding bonds available to the Spanish banks remained constant in the early years of the crisis due to the 'pass-through' structure of the bonds, giving them a stable source of collateral for discounting vis-à-vis the ECB.

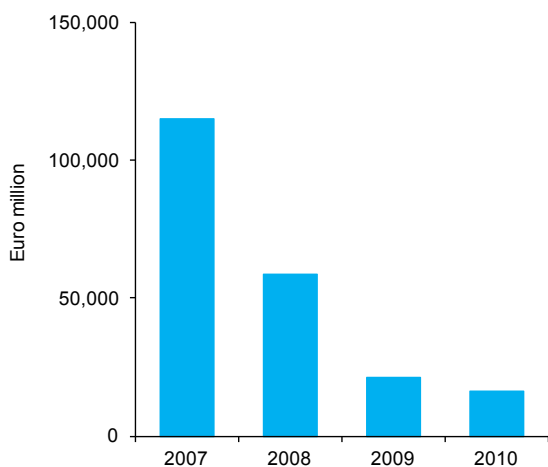
nor the efforts made by the successive securitisation panels set up have found the magic formula for reactivating the securitisation market. Nonetheless, new securitisation funds continued to be created, particularly in the years following the start of the crisis (in 2008 funds created surpassed the 60 billion euro mark) with the sole aim of amassing collateral for Eurosystem credit operations and other facilities designed

to inject liquidity into the banks. In Spain, the FAAF (acronym in Spanish for the financial asset acquisition fund created in 2008) bought a total of 19.34 billion euros of top-rated mortgage-backed and other securitised bonds in a series of auctions held between the end of 2008 and beginning of 2009.

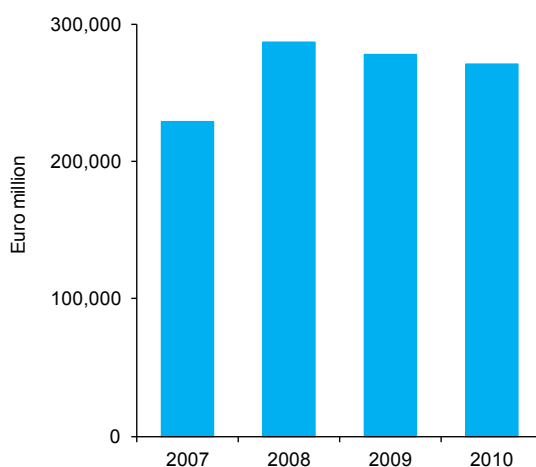
The downward trend in issuance, however, became more and more pronounced year after year, with the balance placed (and retained) in 2010 barely surpassing 16 billion euros (not including securitisation of multiseller covered bonds). Despite this, the balance of outstanding bonds available to the Spanish banks remained constant in the

Exhibits 4 & 5

Securitisation issuance and outstanding amount during the early years of the crisis



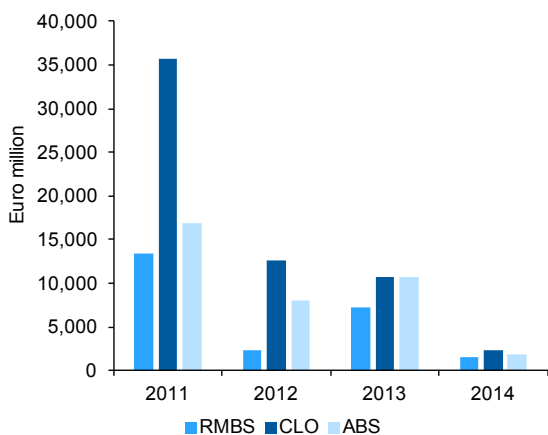
Sources: CNMV, AFI.



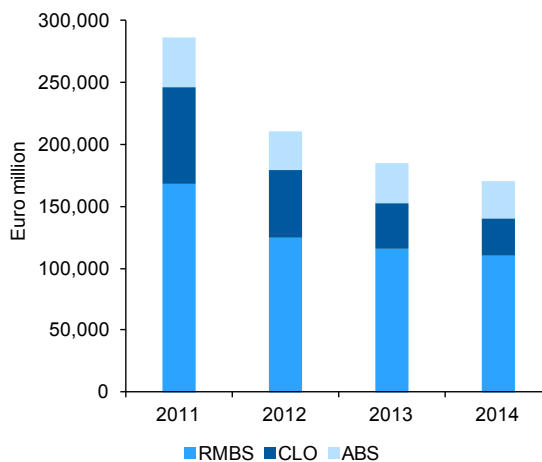
Sources: CNMV, AFI.

Exhibits 6 & 7

Securitisation issuance and outstanding amount from 2011



Sources: CNMV, AFI.



Sources: CNMV, AFI.

early years of the crisis due to the ‘pass-through’ structure of the bonds, giving them a stable source of collateral for discounting vis-à-vis the ECB.

This situation continued throughout the following years. The effective lack of a primary market, coupled with the ECB’s stringent requirements for discounting securitised products (senior tranche discounting, higher and higher ratings thresholds and the application of steep valuation haircuts), as well as the rating agencies’ stricter hurdles (lower allowed senior tranche percentage, higher reserve fund requirement and steep ratings requirement for acting as swap counterparty or accounts provider), drove the costs of originating securitisation funds higher, making them unprofitable for banks. The reduction in the outstanding bond balance has become palpable, having dropped from almost 300 billion euros in 2008 to 170 billion euros in June 2014 (including the bonds issued by the FADE).

Securitisation in other jurisdictions

Spain is not the only country to have seen its securitisation market freeze. The market also

ground to a halt in the rest of the world even though each market’s idiosyncrasies have translated into different uses of securitisations and varying types of collateral in each jurisdiction.

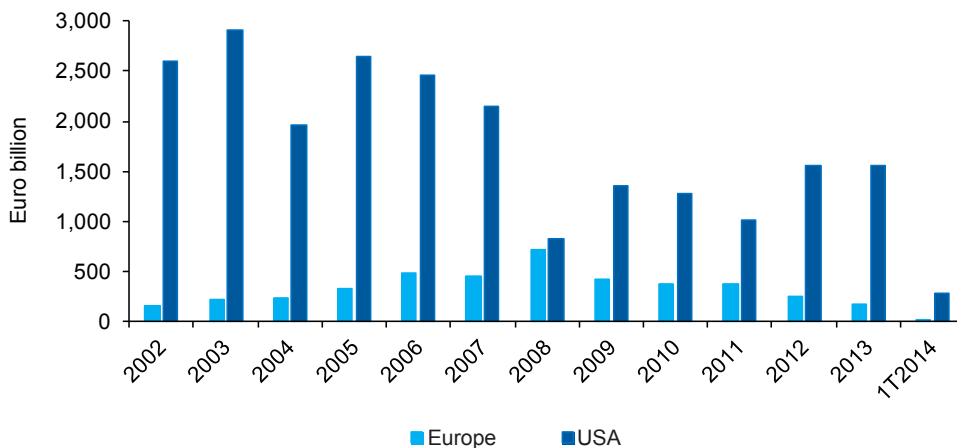
In the US, for example, the ‘home’ of securitisations, the market reeled from the stigma effect of the subprime crisis in 2007 and 2008. However, the market’s recovery, while not total, has been significant in comparison with Europe.

In Europe, although the common denominator is the lack of an efficient primary market in securitisations since the start of the crisis, each country has performed differently depending on home market idiosyncrasies.

- The French securitisation market was traditionally dominated by the issuance of RMBSs and consumer ABSs. However, the crisis has changed the shape of the market. The volume of issuance of mortgage-backed securities has declined as mortgage loans were earmarked for covered bond issuance purposes, a trend echoed in other European markets.
- In Germany, the subprime crisis put an end to new RMBS issues. As was the case in France,

Exhibit 8

Securitisation issuance in the US vs. Europe

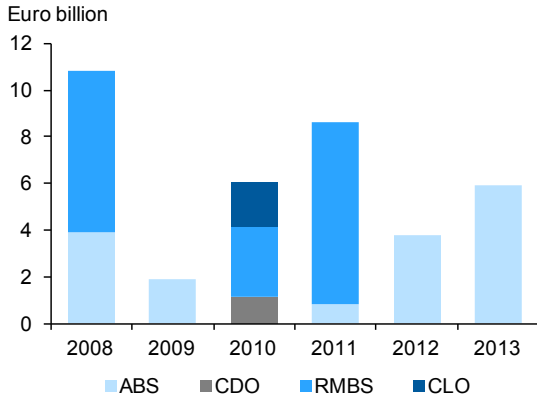


Sources: CNMV, AFI.

Exhibit 9

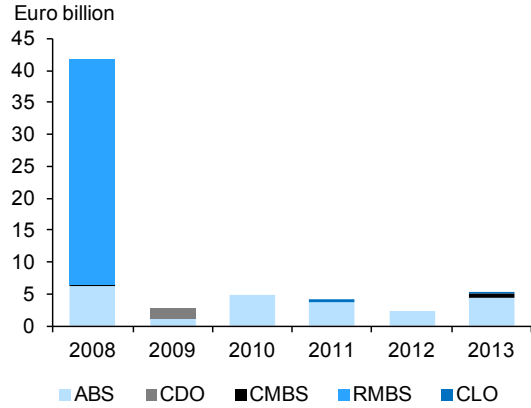
Securitisation issuance in Europe by country

France



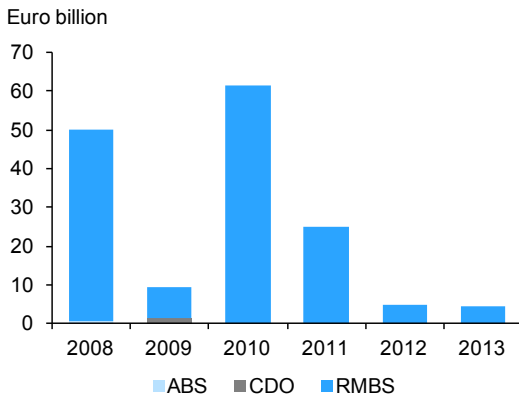
Source: AFME, AFI.

Germany



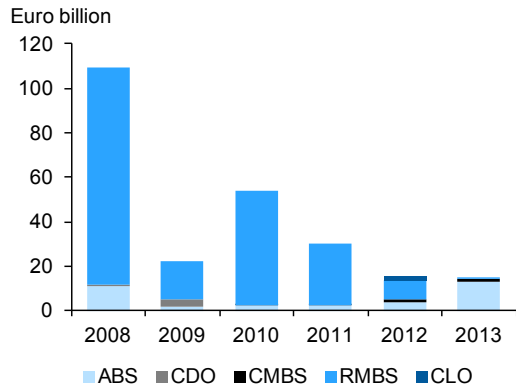
Source: AFME, AFI.

Holland



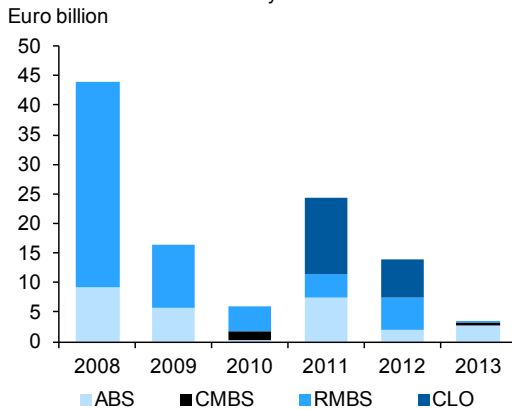
Source: AFME, AFI.

United Kingdom



Source: AFME, AFI.

Italy



Source: AFME, AFI.

there was a sharp shift out of mortgage-backed bond issuance into other lower-risk and lower-cost collateralised products.

- In the Netherlands and the UK, countries with a strong tradition in RMBS issuance, the crisis had a significant impact in 2009. However, these markets managed to stage a partial recovery in 2010 thanks to the securitisation of high-quality loan portfolios. Nevertheless, the market remains far from its peak and the risks lingering in the European housing market may undermine the tentative recovery.
- The patterns in Italy and Portugal are similar to those seen in Spain. These markets were also highly dependent on the real estate sector and dominated by RMBS issuance. The advent of the crisis paralysed the placement of securitised bonds but not the creation of funds, which continued to be set up with a view to retaining collateral for ECB discounting purposes. However, there is one clear difference between the three and that is the incidence of the corporate debt securitisation segment. Italy, like France, has a strong tradition of asset-backed commercial paper (ABCP) conduit programmes, whereas these structures are virtually non-existent in Spain.

Reactivation of credit and the future for securitisation

After months of looking for a mechanism for restarting credit flows in Europe, there seems to be widespread consensus that the very instruments that played a part in creating and spreading the crisis, securitisations, may well be part of the solution. In the wake of the recent announcement by the ECB of an ABS buyback programme, securitisation has regained the attention of the entire financial community and is being increasingly viewed as the most efficient way to get credit flowing once again. The Bank of England, no less, has joined the ECB in emphasising the importance of securitisations in remedying the credit crunch lingering in Europe.

And what is the key to reactivating the securitisation market? The idiosyncratic nature of the various member state securitisation markets in Europe makes it hard to find universal, one-size-fits-all measures for stimulating the market. The downward trend in spreads on securitised bonds in recent months is unquestionably a clear sign of initial market recovery. However, much lost ground still has to be recovered. Originators are not ready to issue securitised bonds to the market for two main reasons: (i) the spread demanded by investors, which is still high compared to the returns generated by the collateralised assets and/or what the banks are willing to pay; and, (ii) the reduced supply of collateral due to the deleveraging phenomenon (particularly among Spanish banks), with issuers still preferring to use their assets as collateral for less expensive and more easy to place products such as covered bonds. Herein lies the securitisation conundrum: in order to securitise, the banks need collateral. However, the banks are not willing to grant more loans without an efficient risk transfer and funding mechanism such as securitisation.

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Reactivation of the European securitisation market

The market needs a trigger to jump start the securitisation circuit in Europe in general and in Spain in particular, with the overriding goal of reactivating credit. This trigger could be the ECB's ABS buyback programme. However, it seems improbable that this programme will achieve its stated aims if it is not bolstered by the buyback of mezzanine tranches in order to facilitate risk transfer and give the banks some capital relief.

Meanwhile, various market players are calling for further measures to unlock potential benefits in the European securitisation market:

- A more flexible regulatory framework, very harsh on securitisations to date. In this respect, the ultimate inclusion of securitisations as a high quality liquid asset for the banks' LCR calculation purposes could prove a step in the right direction, albeit not decisive. Recall that in the US, securitisations will not qualify as high quality assets.
- Inter-country standardisation (to the extent possible) of the information to be provided to investors or of prospectus templates would bring new investors into the market; as would definition of a 'qualifying securitisation' as a form of quality certification for investors.
- More favourable treatment by the credit rating agencies by reducing credit enhancement requirements for high quality securitisation funds or eliminating the rating cap derived from the sovereign rating of the country originating the collateralised assets.

Measures such as these are needed to reactivate the securitisation market in Europe with a view to ultimately getting credit flowing back into the real economy.