Changing Perceptions Among Regulators and Investors Toward European Securitised Investments

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"When the facts change, I change my mind. What do you do, sir?"

The above quotation is usually ascribed to John Maynard Keynes, commonly regarded as one of the leading economic thinkers of the 20th century.

Even though the first securitisation transactions were yet to be issued during Keynes' lifetime, the idea behind the quotation certainly has relevance when looking at developments in the market for securitised investments in Europe over recent years.

Boom period

Looking back to the late 1990s and early 2000s, the global market for securitised investments saw strong growth as portfolios of residential or commercial mortgage loans, auto loans, credit card receivables, loans to small and medium-sized companies (so-called "SMEs") etc. were packaged into transactions with a variety of acronyms – ABS, RMBS, CMBS, CLO, CDO etc.

At the same time, underlying borrowers were increasingly being classified as "prime" or "sub-prime". Prime borrowers are considered good credit risks and are perceived to have ample income and/or assets in order to be able to service and repay the relevant debts. Sub-prime (or "near prime" / "non-prime" / "non-conforming") is the term used to describe borrowers that are perceived to pose a higher risk as they may not have significant assets or even a regular salary.

"Toxic waste"

When the U.S. housing market bubble burst in 2007/2008, such structures were caught up in the resulting credit crisis that swept global markets. The financial press was awash in dramatic headlines referring to "toxic waste" and "financial weapons of mass destruction". Regulators and investors struggling to cope with the consequences of the fallout from the U.S. housing crisis, especially in relation to sub-prime borrowers, looked increasingly to such transactions as a convenient scapegoat for their frustrations. For a time, it looked as though the market for securitised investments might actually disappear altogether, as investors almost came to perceive it as a "dead asset class".

After the credit crisis

However, in the 5 years or so that have passed since the height of the credit crisis, a more nuanced picture has materialized and a more stable market has emerged. Levered participants, such as structured investment vehicles (SIVs) that dominated the investor base in the run-up to the credit crisis have disappeared. "Real money" investors such as pension funds and insurance companies are now the key buy-side participants. Issuance of new securitised transactions has recovered strongly in the U.S. and, although not to anything like its pre-crisis peak, partially in Europe. Market liquidity has also improved since the dark days of 2008 as confidence has returned.

In addition, when looking at loss performance, the reality has turned out to be somewhat different to the alarmist headlines of 2007/2008. Sufficient time has now passed for in-depth analysis and research on what has actually happened with regard to loss performance over the last few years.

Loss experience: U.S. v.s. Europe

Fitch Ratings has produced a series of reports tracking global structured finance losses and looked at developments in the aftermath of the credit crisis. From these reports a distinction emerges between the levels of realised and expected losses in the U.S., especially in relation to the U.S. housing market, and the picture in Europe. For example, in a report from October 2013, Fitch estimated that 9.5% (representing in excess of US$250bn) of the original balance of U.S. RMBS transactions that they provide a rating for either had been lost or were expected to be lost. In contrast, Fitch's overall loss expectation for RMBS in the European market was only 0.3%. Fitch expected no losses whatsoever in UK or Dutch prime RMBS transactions that they rate.

Similarly, in a report from June 2013, Standard & Poor's indicated that the overall cumulative default rate since mid-2007 for European structured finance was 1.43%, vs. the 17.4% seen in the equivalent measure for U.S. structured finance. Indeed, within the overall number for Europe, the cumulative default rate seen for consumer-related securitisations in Europe over the relevant period was very low at 0.04%.

This significant divergence in performance between the United States and Europe is explained by a number of factors:

- One is cultural – the stigma attached to debt default and personal bankruptcy is often much greater in European jurisdictions than in the U.S.
- Another is legal – residential mortgage loans in Europe typically involve full recourse to the borrower. Full recourse means that the lender can pursue the borrower for any outstanding amounts that remain after the house has been repossessed and sold. The

borrower cannot simply return the house keys to the lender and then walk away.

- European jurisdictions, with the exception of certain hot spots – Spain, Ireland and, to an extent, the Netherlands – did not typically witness the same levels of aggressive pre-crisis mortgage loan underwriting seen in the U.S., especially in relation to the sub-prime mortgage market in America.
- Sub-prime lending has never really emerged as a major focus in Europe; the market has typically been focused on better quality prime borrowers.

Market initiatives

In addition, a number of steps have been taken to improve the process and product in Europe:

- Sponsors must retains some of the risk: Changes within the CRD IV regulation were implemented in 2011 to ensure that the sponsors behind the transactions (typically large banks or other financial institutions) maintain so-called "skin in the game" through the requirement that they retain 5% of the net economic risk in the transaction for their own book, thus creating an alignment of interests with the investors.
- Transparency: A European data warehouse has been created under the auspices of the ECB to provide transparent information (subject to all relevant data protection legislation) on the individual loans with the portfolios.
- Quality mark: The prime collateralised securities (PCS) initiative was launched in 2013. This market initiative provides a PCS quality mark to transactions which meet the relevant criteria in respect of transparency, quality and performance reporting.

Regulatory perceptions

European regulators and central banks have typically taken some time to review what had previously been perceived as a negative stance toward the securitisation market. However, there has been a distinct thawing in attitudes over the last year or so as securitisation has increasingly been seen as an efficient method of transferring funding and liquidity from natural collectors such as insurance companies and pension funds through the commercial banking sector and across into the real economy across Europe. This is particularly relevant given that the European economy is perceived as having been over-reliant on the banking sector for funding in the past, and that there is a strong drive to force European banks to delever and rationalise their balance sheets. The result has been a number of changes in the regulatory environment that have sought to address the previously adverse treatment of securitised investments and to emphasise the important role of good quality transactions. The distinction that is increasingly being drawn is between "good" securitisations involving transparent structures based on prime-quality exposures to real economy assets such as residential mortgage loans and consumer credit (such as auto loans) and "bad" securitisations involving poor quality sub-prime collateral or the more exotic structures (such as CDOs of CDOs) that were being dreamt up by the more aggressive investment banks in the run-up to the credit crisis.

This change in perception is very much a work-in-progress, and certain regulatory regimes continue to be comparatively punitive in their treatment of securitised investments (notably the current draft capital charge requirements within Solvency II; the revised regulatory framework for European insurers, which is due to be introduced from 2016). Nonetheless, the direction is clear and evidenced by the following recent quotations:

"Let me specifically point to two measures which arguably may have the most influence on the future of the ABS market: the revisions to the Basel securitisation capital framework for banks and the Solvency II regime for insurers (...) All ABS were perceived as too risky due to the U.S. experience in the sub-prime mortgage markets. But this regulation is like calibrating the price of flood insurance on the experience of New Orleans for a city like Madrid." (Yves Mersch, Member of the Executive Board of the ECB, 13 November 2013)

"We think that there are good securitisations and bad securitisations, good products and bad products (...) By and large, many of the products that were being traded and priced and rated in Europe were transparent products (...) We need to see whether we can have regulation in place that is less discriminatory toward "good" ABS." Mario Draghi, President of the ECB, 8 July 2013)

Investor reactions

Recent months have seen an enhanced level of interest in securitised investments from investors such as pension funds, wealth managers, money managers, private banks and family offices across Europe. Not only are investors attracted by the comparatively strong credit performance seen in good quality European ABS/RMBS, but increasing concerns regarding a possible medium-term "normalisation" of interest rates are also encouraging them to seek out opportunities in floating-rate asset classes. Securitised investments represent one of the few avenues available for investors to access floating-rate investments in a highly rated format, with good protection versus an early call/refinancing by the relevant issuer.

While it appears that this renewed investor interest has yet to play out in terms of large-scale inflows into related fund products, it is clear that a significant number of European investors are re-assessing their view on the asset class. In doing so, they are also attracted by the opportunity to access the diversification benefits afforded through such direct exposure to residential real estate and consumer credit exposures in Europe, albeit within the context of the "good" ABS structures that the regulators are currently focused on.

Changes in the perceptions of both regulators and investors are gradually taking place as more information emerges as to the true picture regarding the performance on good quality European securitised investments over recent years. It remains, however, a gradual process. All of which brings us neatly back to another quotation often ascribed to John Maynard Keynes:

"The difficulty lies not so much in developing new ideas, as in escaping from the old ones."

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