AFME - Securitisation
Speech by Sharon Bowles MEP

Global Asset backed Securitization

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Thank you for inviting me here today. This conference is about securitisation, on which I will say a few things, but I hope you won't mind me first giving a wider overview of where we are in this legislative mandate and some personal perspectives.

During this mandate the Parliament has stepped up its impact on legislation – I can certainly see that in the work that we have covered in ECON. There are several reasons for this. First under the Lisbon Treaty more areas came under co-decision, making the Parliament a true co-legislator over most areas of policy. This collective confidence has transmitted into areas such as financial services where we had co-decision already. Secondly of course, the huge public impact of the financial crisis, and the role of Parliament being closer to public opinion, has added to determination in my committee.

It should be recalled that the ECON committee covers much more than financial services. We do also what it says on the tin – economic and monetary affairs where the committee gained new co-decision power in the area of multilateral surveillance. That did not look much in terms of Treaty articles but has in fact been the basis of important and highly political legislation on economic governance. We also cover tax where we only have an opinion because Council voting is still unanimous, and competition which is primarily consultation but where a major co-decision proposal on damages and compensation has just been released.

During this mandate the high profile Monetary Dialogue with the President of the ECB has gained partners in the Economic Dialogue with Finance Ministers and the Supervisory Dialogue will be added for holding the ECB to account as the supervisor for the Eurozone banks.

Turning specifically to financial services by the time we get to the European elections next year we will have had 40 pieces of financial services legislation passing through committee, and also some related legislation such as transparency and accounting on which we provide input with respect to financial institutions to the legal affairs committee. It will not all get completed through to agreement with Council and prioritisation planning is going on between the institutions. That which does not get completed can be picked up and continued by the new Parliament if the new committee wishes, which is in fact what ECON has always chosen to do in the past

Of course most recently we have completed CRD4, and as some of you know we are still ironing out wrinkles in so called ‘corrigenda’, one of which was passed by the Parliament last week and another one which is scheduled for October.

So we now have the most complex set of rules ever, which interact with other pretty complex rules such as for derivatives and markets. All these rules have the objective of keeping banking and investment stable for the general good. Rules are complex because modern banking is complex - more complex that it should be - and because we are on a treadmill of trying to draw a precise line between the proper and improper for the sake of 'legal clarity' which all too often means opening the door to legal arbitrage.

My ideal world would have far simpler rules, far harsher penalties for transgression, and would be able to rely on stronger ethical codes not just in banking but in the professions that surround them - the accountants and lawyers - otherwise they drag one another down.

But returning to CRD, in addition to the well-publicised big issues, there are quite a lot of interesting extras inserted by the Parliament particularly in the areas of transparency and governance. A couple of examples are repos and securities lending.

A couple of years ago I started to object to 'originate to repo' relating to a discovered practice of baskets of assets being put together and repoed with a counterparty, with a similar basket of assets being repoed the other way, the cross repo magically meaning the assets had increased their liquidity. You may say what's the problem – but in the past with originate to distribute, things went wrong with excessive drivers for origination, so this is always something that has to be watched and I will return to that later in the context of securitisation.

Anyway, in CRD4 being repo-able is a qualification for liquidity, which given the repo with a friend arrangements I just referred to, has been restricted to being a simple repo, not baskets of assorted assets.

The Parliament's drive for transparency and understanding also turned to securities lending and what this means for balance sheets of banks in the developing legislative environment for bank resolution. When bail-in has to be taken seriously into account, it is all the more important for investors to see how big the cushions and buffers are, or whether assets are pledged in favour of others, and so CRD4 also introduces reporting of unencumbered assets, securities lending and repos.

In themselves these may be small moves but the message should be clear, the Parliament has sought to increase transparency and understanding, which makes it a good time to move on to discussing securitisation.

At the time of the financial crisis securitisation became a dirty word due most especially to two reasons – first excessive complexity, and

indeed secrecy, in some structures making reliance on ratings instead of analysing the product the norm. Concealed leverage, maturity transformation and non-linear behaviour of embedded derivatives were among the problems. And secondly there were large quantities of dubious assets which found their way into these structures, magically gaining undeserved credit enhancement, and the profits to be generated by selling structured products became of themselves a driving force to originate ever more debt. This is the highly fallible 'originate to distribute' model which I have already referenced.

Some in Parliament and elsewhere wanted to ban complex structured products altogether, that did not happen but skin in the game retention was invented.

Of course we also know that the hit on the reputation of securitisation meant that the markets closed almost as effectively as if they had been banned, with many of what one can call the simpler or traditional securitisations also ceasing to exist. Now the need for securitisation to return for long term investment and also as an alternative to pooling in funds for SME loans is high on the agenda of ministers and central banks and has gained traction in Parliament.

Looking at basics it seems a great idea to be able to pool assets and then divide them up again - not into equal units as in a fund, but into differently rated slices so that all kinds of investors can find the slice that matches their particular risk appetite. However, I remain concerned that with a many-tranched securitisation – even without fancy derivatives, there are too many assumptions that have to be made in the grading of the slices in between top and bottom.

I do not think I am alone in this view and the securitisation of SME loans that is being talked about by central banks, in particular for the peripheral Eurozone countries, envisages only three tranches. Although it does seem that the EIB is being lined up as the replacement for monoline insurers.

I am aware that work is being done by PCS on setting standards for high quality securitisations. In principle this is a good idea and I understand the elements which they suggest are required for a high quality securitisation are that the originator retains a meaningful share of the risk, ie skin in the game, the structures are not leveraged, are pass through and appropriate information is given to investors.

That's not a bad start. I would include as well no fancy derivatives, so beyond FX or interest rate swaps questions should be asked, and then I do still worry about the tranching. It would be my preference if our legislation were free from the numerous ties to ratings and did not put us in the situation that investment in a tranche of a securitisation was more allowable than a suitably balanced set of investments in other pooled assets. However, for now we are where we are and so development of a proper set of standards may well have a place.

So this takes us to the debate on skin in the game. When this was first proposed in CRD2, I was not a fan of it, partly because the whole issue was surrounded by the demonising of all securitisations, and partly because it was crude tool. So I fought hard to stop it being increased by Parliament to 10% or even more, which was a real threat both in CRD2 and again more recently in CRD4. I also obtained proportionality in any penalty for non-compliance.

When we enacted 'skin in the game' we had primarily the originate to distribute model in mind, and the target was one the one hand banks who were the perceived source of the origination, and on the other hand a restraint on end investors such as insurers and pension funds that we did not want to hold investments they did not understand and still less pass those, or their effects, through to the retail level.

I am aware that since then guidelines from the EBA have been interpreted and reinterpreted in a way that leads away from those principles, in particular with some CLOs. Through use of SPVs the situation arises where there is disconnect from those profiting from

the fess of the securitisation and the retained slices have been sold on to end investors.

This was not the intention of the legislators and so in CRD4 we have strengthened the role of the EBA so that there are binding technical standards rather than guidelines. The EBA has produced its draft consultation aimed at returning the interpretation of ‘skin in the game’ to where the legislators intended it to be. It was never the intention of the legislation to allow selling on of the retained tranche, nor for us to find it being taken on by asset managers while banks run off with the fees and an incentive to return to excessive origination.

Some argue, with reason, that ‘origination’ may not be a simple matter. That may be true but any assessment of how to deal with that non-simple situation should address the root of concerns, which have not changed – excessive impetus to ‘originate’ without due care about the assets should be discouraged. So should getting rid of all connection with those assets. And if there is any doubt about who is the originator, then my suggestion is to follow the fee. It may be that we have been wrong to think that the retention should always be in one place and one thing that I would be interested to hear about is whether the retained tranche should perhaps be split between, say, the banks and the balance sheet of the asset manager in appropriate circumstances.

And I think I now also have a preference for all tranches to have retention, so as to ensure that there is even handed treatment between them.

So, the latest CRD rules may well make retention work again, but the fact is the arms race of regulator versus regulated is no contest: you only have to look at the numbers of supervisors versus the personnel in regulated entities and the aggressive advice that comes from some lawyers, and as I said earlier if finance and banking is to regain its reputation, then the surrounding professions have a part to play.

Lately we are seeing moves against aggressive tax planning and avoidance, and of course we got country by country reporting into CRD4 before the European Council saw the light. Well, I would outlaw aggressive lawyering and regulatory avoidance too.

Good financial institutions need good lawyers. Moral financial institutions need moral lawyers, and that is not defined solely by words on a page, interpreted purely to yield advantage to an institution against the intended greater good.

So I would put a duty of care for the common regulatory good on to banks, financial institutions and their professional representatives, with penalties for circumvention of the 'pith and marrow' or basic intent of a regulation.

You may be wondering where this might go, well there is the non financial reporting directive. This has already been earmarked in the European Council Conclusions to be expanded to cover country by country reporting, which I take to mean it needs a financial chapter. It also seems to me a good place to start to deal with other types of ‘morality’.