

RISK CONTROL

Issuer Perspectives: Regulatory Impact on Issuance

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Regulatory rules should be consistent with the relative riskiness and liquidity of different financial instruments. Deviating from this principle leads either to partial or complete elimination of financial activities or to regulatory arbitrage by the industry unacceptable to regulators.

- *Partial elimination:* the SRT market and the Securitisation market share a common set of regulations, so to find an example of partial elimination, one only needs to look at the collapse in total outstanding of traditional European securitisations. At the end of 2021, this amount (just below €1 trn) had dropped to 64% of its 2012 value (€1.6 trn). In the case of the Dutch market, securitisation's economic importance (defined as ratio of total outstanding to GDP) was 44% in 2012 and this has dropped to below 19% last year. This is a direct result of penalising securitisation in both capital and liquidity regulation.
- *Complete elimination:* to find an example of complete elimination, one can look at securitisation or SRT in Sweden. To discourage the use of the technique, regulators, there, have gone "creative". They invented a new notion, the 'flowback' risk. This prevents Swedish banks from issuing securitisation. 'Flowback' risk amounts to saying that even if you sell an asset, you still need to hold capital against it, because in a crisis, the bank will be forced to lend to the customer. Swedish banks are not forbidden from securitising to achieve capital relief, but the recognition is very limited and does not apply if amounts are large. No SRT trades have occurred as far as we know and there are zero STS transactions. Among Nordic banks, only Nordea has done SRT trades having moved its headquarters to Helsinki 2018, where its supervisor, the ECB, is much more supportive of SRT deals.
- *Regulatory arbitrage:* when there is a disconnect between risk and regulatory capital as prescribed by the regulation, this can lead to regulatory arbitrage, as with the use of the old SFA formula. To stop this, some regulators gold-plate poorly thought-through regulations, which leads to further inconsistencies. 'Commensurate' and 'Synthetic Excess Spread' are examples of such gold-plating.

So, why have rules developed that are inconsistent with relative risk and liquidity? We need to understand both the way rules are created and the historical context in which they are created. At the highest level, decisions by the G20 affect in turn the views of the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO). Basel deals with banks and IOSCO with capital markets. To simplify, Basel deals with capital regulation and IOSCO with liquidity regulation.

After the Global Financial Crisis, regulators had several objectives for securitisation and its use by banks as a means of transferring risk, i.e., SRT. First, almost all policy makers wanted to put an end to the use of CDOs of ABS, and specifically, to the 'crisis amplifier' of Synthetic CDOs of Subprime RMBS. Second, policy makers, particularly in Europe, wished to prevent European entities from investing in US subprime activities. Third, some regulators, most notably the Bank of England, wished to stop its banks using the old SFA formula to do SRT trades leading to capital instability.

The buzzword among regulators was to hinder securitisation. In December 2012, BCBS delivered by publishing a proposed new approach for IRB banks, the Modified Supervisory Formula Approach (MSFA), which would multiply post-securitisation capital by a factor of 3. For SA banks, an old formula conceived before Basel II, the Simplified Supervisory Formula Approach (SSFA) was recycled. It smoothed exponentially the capital requirement, multiplying post-securitisation capital by a factor

of 2.5 (equivalent to a 'p' of 1.5). These approaches, if adopted, would have led to the elimination of the securitisation technique, at least in Europe.

With a group of 80 quants and regulatory specialists from banks across the World, and with Risk Control, we developed alternative models and suggestions which we presented to the Basel Committee. They listened, partially. They scrapped in December 2013 the MSFA and replaced it by the SSFA for IRB banks. They also recalibrated the capital multiplier post-securitisation, and reduced it to a range of 1.3-2.5 for IRB banks and to 2.0 (equivalent to a 'p' of 1.0) for SA banks. Of course, the US had no intention to apply those values, and are still using a 'p' of 0.5.

Meanwhile policy makers in Europe became increasingly concerned that the Basel calibration was going to reduce greatly the securitisation activity in Europe. This led to the joint statement between the Bank of England and the ECB in April 2014 to develop a framework adapted to European needs. The ECB wanted regulation to support the securitisation activity, not just to hinder it. The ECB wanted securitisation of a certain type, consuming less capital than the December 2013 calibration, and wanted the instrument to be liquid, in support of an effective Capital Markets Union. In order to be Basel compliant, the lessening of capital requirements had to be first adopted by the BCBS. And IOSCO was dealing with liquidity regulation. Therefore, a joint taskforce was created BCBS and IOSCO, which produced the framework for STC regulation, which became STS regulation. Initially intended for traditional securitisations, it was extended with a Synthetic STS framework, in the post-Brexit EU.

In parallel, the Bank of England was trying to 'repair' the SFA formula, or at least to control its usage. SRT did not produce stable levels of capital requirement on retained tranches, which led the Bank to ask the question as "Is the transfer commensurate?" The Bank was attempting to ask risk questions which that formula is ill-equipped to answer. If the formula reflected risk accurately, the question of 'commensurate' would not have arisen, as the significant risk calculations would have been risk-based.

Over the years, the notion of 'commensurate' has evolved in a way that (i) is not well thought-through, (ii) is uniquely European and very unlikely ever to be accepted by Basel and (iii) will, for sure, never be adopted by the US Congress. The concept of 'commensurate' was formulated with good intentions but is fundamentally flawed. It exemplifies regulation aimed at supporting securitisation but could in fact hinder it. The best pragmatic approach to this issue is that of ECB bank supervisors who just ignore it, as the commensurate guidelines have not yet passed into law.

Looking at the regulatory landscape, I have two main comments:

- First, regulation is evolving, and there is always time to adopt technical changes. For example, European regulators are reviewing the securitisation and capital rules, and the SRT environment could potentially benefit from such changes. In July this year, we published a Risk Control research note showing how the inputs to the capital formula could be amended to reduce the capital surcharge, while ensuring that the smoothing of the capital requirements between mezzanine tranches stay at a level appropriate for the underlying pool correlation. In publishing this note, we aim to assist regulators in designing effective and appropriate rules. Some regulators perceive the same issues. At the September Eurofi conference, the French regulator talked about addressing the problems that we identified in the formula.
- Second, one must not miss the big picture. Other threats remain, the biggest being the application of the SA Output Floor. We have examined the implications of SA floors for the securitisation market in a study for AFME. Floors create a 'horse race' between increases in capital (i) for underlying assets and (ii) for retained tranches of securitisations. The effect of the floors in Europe will be to eliminate corporate securitisations (both large corporates and SME). This could significantly reduce bank funding to European firms. Existing transactions, especially corporate ones, are likely to fail the SRT test applied by European supervisors and, hence, will have to be terminated. The negative effects of the SA Output Floors on existing transactions would be mitigated if IRBA banks were evaluated SRT tests only at an IRBA level, even if the SA Output Floor is binding.

Disclaimer: The comments in this document are not a literal transcription of the panel's live discussion.