Institute of Global Financial Integrity

Luxembourg

Speech of Francesco Papadia

The role of ABS in Capital Market Union

Introduction

Let me first thank David Clark for having invited me to share some thoughts with you about the role of ABS in Capital Market Union.

Let me also preface my speech with a warning, which is most appropriate when talking at the Institute of Global Financial Integrity: in some EU document I must be qualified as a lobbyist, because of my Chairmanship of the Prime Collateralized Securities (PCS) initiative.

I believe, however, that I can easily defend my choice to take as first post-ECB engagement, the chairmanship of PCS, as I strongly believe in the contrivance of Asset Backed Securities (ABS), even if it was nearly terminally destroyed by faulty (and sometime illegal) implementation. In a way the potential of this financial innovation together with its dismal implementation offered and still offers very interesting growth opportunities.

In today´s speech, I will combine my experience with PCS with my participation as Chair of the Task Force for Capital Market Union at the Centre for European Policy Studies (CEPS).

On Capital Market Union (CMU).

I am positive on ABS, but not to the point that I believe CMU can be reduced to ABS and the prospectus directive, as the Commission in its report seems to think. There is more to CMU than ABS, as it is demonstrated by the thorough CMU report that Diego Valiante prepared for CEPS.

Europe limped along, before the crisis, on one financial leg (banks) and a, so to say, leglet (capital market). When, with the crisis, also the leg became a leglet, then intermediation became scarce and very costly and the real economy suffered, and it is still suffering 8 years after Lehman. In a way the EU had made the capital sin of investment: putting a disproportionate amount of intermediation eggs in a single basket.

In addition, the amount of financial integration that had been achieved before the crisis was, in hindsight, insufficient and lopsided as it consisted mostly of short-term flows. The limits of financial integration severely affected the ability of cross-border financial transactions to mutualize the shocks that, in particular in the euro-area, eventually caused a persistent split between the "core" and the "periphery". One way to assess the situation prevailing before the crisis is that one critical component of an Optimal Currency Area, financial integration, was insufficiently developed.

And that amount of integration that was achieved before the crisis was ruined by it: the ECB has been publishing for some time an indicator of financial integration (Fintec), this indicator, both in its price and in its quantity version showed substantial losses during the crisis and is now only partially recovering.

Given this situation, I think the EU Commission appropriately identified CMU as one of its most important projects, even if, so far, the implementation has been on the timid side.

Before saying something more specific about the CEPS CMU report, let me put forward a fundamental view of it: what it basically proposes is to unleash the force of the market to achieve capital market integration. Once again, the idea is to put Adam Smith at work. Indeed, removing barriers rather than adding regulation is, in my view, the motto of the CEPS CMU report.

The Report, however, goes well beyond a motto: 33 barriers are identified in different phases of the financial transactions (Price discovery, Execution, Enforcement) and the argument is convincingly made that eliminating them with appropriate priority and sequencing will lead to integration. The report also usefully distinguishes between artificial and natural barriers: an example of the former is different accounting practices and conventions; an example of the latter is different languages. The elimination of artificial barriers is both less difficult and more effective than eliminating natural ones. Another important categorization proposed in the report is between barriers that increase costs, vs. barriers that make cost analysis impossible, with the latter constituting a more formidable obstacle to capital market integration.

The report, however, does not shy away from proposing, when needed, a degree of institutional innovation, even if this less obviously needed to achieve Capital Market Union than it was to achieve banking union, in which institution building was the dominant factor in the Single Supervisory Mechanism, in the Single Resolution Board and would be needed to achieve the European Deposit Insurance Scheme. Basically, in the CMU the needed institutional innovation would be to grant more responsibilities and more power to the European Securities and Markets Authority.

On ABS

Why is it that I think that ABS have a great potential? Basically I think they constitute a bridge between capital market and bank intermediation. Banks originate, and will do it well if they keep "skin in the game", and the capital market invests. At the same time, with the help of tranching, risk can be redistributed to those better able and willing to bear it, at least potentially.

But, as any financial innovation, ABS are open to abuse, as demonstrated during the crisis. Indeed I think that the comparison between the European and the US experience shows that ABS can be used as well as abused: in the US they led to large losses for investors, in Europe the losses were minimal.

In a way the US experience followed closely the recurrent sequence identified by Kindleberger and Aliber: a financial innovation leads to a boom, but then the financial innovation is misused, also because of faulty or even inexistent regulation, and the bust and crisis follow.

But the crisis had a silver lining: we have learned from it, we are no longer where we were. We have understood that there are four NOs for ABS to fulfil their potential:

No Pure Originate to Distribute

When the originators, banks or other institutions, have no skin in the game the quality of lending dramatically worsens. Sub-prime lending was the egregious example of this.

No re-securitization

The alchemist dream of transforming lead into gold seemed to have come true thanks to the magic of securitization: pooling and tranching left overs from securitizations, with poor credit quality, the gold of AAA securities was created. The reliance on the illusion of a precise modelling and calibration showed its intrinsic limit with the crisis.

No Embedded maturity transformation

Some securitisations (especially in the Commercial Building segment) had, as underlying, assets with a much longer maturity than the securities. This created an unmanageable liquidity risk: when the security matured, the only option was to refinance it, but liquidity is an intrinsically volatile variable and there was no way to foresee, leave alone guarantee, refinancing at maturity of the securitized asset.

No Opacity

Some securitizations provided insufficient information, some others, just because of their über complicated structure, provided such an overwhelming amount of information that even the most sophisticated and largest investors could not manage it.

Avoiding these lethal characteristics was the basis on which PCS was created by the financial industry to relaunch the ABS. The basic idea was to provide a label to ABS that would avoid the characteristics that caused the problem in the crisis. Let me note, en passant, that in launching PCS I received a confirmation that investors are the innovating constituency in the financial markets, while issuers and brokers tend to be on the more conservative side.

Let me hasten to clarify, however, that having learned the lessons of the crisis, not only we can build prime ABS but we can also find a useful role for bespoke ABS matching specialized uses and investors.

The first task of PCS was the intellectual salvage of ABS from the ruins of the crisis. Of course, PCS could not do this on its own. A critical role was played by the ECB and the Bank of England that powerfully contributing to the rehabilitation. The ECB also contributed with its purchases: if an asset is good enough for the central bank than it must be a legitimate investment more generally.

It is important to recall the basic concept behind PCS and now behind the Simple, Transparent and Standardized (STS) ABS that the Commission is proposing to regulate: the four criteria mentioned above define structural characteristics and the PCS label that we attribute to those ABS that respect them does not say anything about credit quality.

The PCS experience so far is characterized by 3 positive developments, in which we feel we have had some positive role, and a negative one, which we think we do not have the capacity to change. The three positive developments are:

- The advance in rehabilitating the concept of ABS has been good, though not perfect, as some components, also in the European Parliament, maintain a negative attitude towards ABS.
- Thanks to the work of the EU Commission and the Ecofin good, though incomplete, progress has been made in reflecting the lessons of the crisis in the regulation of STS.
- ABS with the PCS label have a large share, between two thirds and three quarters, of the relevant market.

The negative development is that the market is, adopting the term used by the ECB, moribund and unfortunately this negative development more than offsets the three positive developments mentioned above.

The reason we say there is not much PCS can do for the revitalization of the market is that this basically depends on exogenous factors: the subdued macroeconomic conditions, which depress the demand for credit, and the fact that banks surely do not have a dearth of liquidity given what central banks are doing.

Of course, there is a necessary sequence: regulation must precede market rehabilitation. But like a person, a market cannot remain moribund for very long. There is a risk of structural damage to the market, if the depressed turnover does not even cover the cost of the needed infrastructure, there is a risk of structural damage to the market, which it may prove very difficult to repair.

On the progress on regulation, there is a lot to be said in favour of the Commission proposal, in particular because it offered a single definition of STS ABS, to be used in all possible regulatory instances, and because it properly defined structural integrity and transparency. The Ecofin Council improved the proposal. From the point of view of PCS an important improvement is that it recognized the limitations of self-attestation of STS characteristic and the possible use of a third party helping the attestation process. Now the process is with the EP and we had the first report by the rapporteur, which is very preliminary but not prejudicially unfavourable.

One issue that at PCS we find critical is that there should be a single point of interpretation of complex rules. This cannot be assured by a plethora of regulators from different countries for different market sectors (banks, insurance companies, capital markets, pension funds……) each giving its interpretation. Personally I think ESA should have a clear responsibility in interpreting the rules.

Of course PCS sees its potential role in providing third party certification in attesting STS.

Overall, the prospects for a regulation of ABS that would allow a rehabilitation of the market are generically favourable but there still remains an area of uncertainty and the long horizon over which the process is likely to be completed is a source of concern, given the difficulty of keeping the market for much longer in its "moribund" conditions.

Let me mention lastly that PCS has started working on Synthetic (risk transfer) securitization as an extension of the general idea of an STS, or prime, ABS market. But the process cannot be very short because there are important differences between true sale and synthetic ABS that require a significant adaptation of the rules defining prime securities.

Conclusion: how happy am I?

ON CMU: the importance of the topic is now clearly focussed upon and the long-term process needed to complete it has started. First steps are quite timid, though, comparing the 33 barriers whose abolition is necessary, according to the CEPS CMU report, and what is currently in the Commission program.

On ABS: the intellectual rehabilitation has been nearly completed, good progress has been achieved on regulation but the market is moribund and it is not clear how much longer it can resist in this state.