‘Securitisation and risk retention in European banking: the importance of collateral and prudential regulation’ – A.D. Scopelliti

Discussion by M. Rimarchi* – 4th EBA Research Workshop – November 2015
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* Opinions expressed here are personal and do not reflect those of the EBA

Scopelliti (2015) exercise in 2 slides (1/2)

The paper addresses the following question: **do capital requirements and the collateral framework affect risk transfer/retention decisions in EU securitisation issuance during 1999-2010?**

Different set of rules affect differently the risk/retention choice over different securitisation products:

- **ECB collateral framework:** accepts minimum rating grades – e.g. 'A' – and tends to accept 'plain vanilla' (e.g. RMBS) asset classes;

2007-2010 focus: banks almost exclusively 'issue to retain' and swap with ECB

- **Prudential (bank capital) risk-weights**: tranches of different rating grade are risk-weighted differently AND the comparison **RWsec vs. RWassets** is different for different asset classes;

2007 - 2010: Basel II is implemented → SRT rules for originators & risk-weights based on external ratings & tighter treatment of off-balance sheet support (LF)

Scopelliti (2015) exercise in 2 slides (2/2)

For 14 European issuers over the samples 2003Q1-2007Q2:

[REG Cap Ratio] = [securitisation by <u>asset class</u>] +[bank controls] + error;

[REG Cap Ratio] = [securitisation by <u>rating</u>] +[bank controls] + error;

Where securitisation impacts REG Cap Ratio in direct and indirect channel

RISK TRANSFER	Indirect ?	RISK RETENTION	Direct ?
Risk-based capital ratio		*Risk-based capital ratio*	
⇧	If the bank keeps cash, invests in less risky assets or repays debt	⇧	If $RWA_{SECURITISATION} < RWA_{ASSETS}$ If bank increases capital
=	If the bank invests in equally risky assets	=	If $RWA_{SECURITISATION} = RWA_{ASSETS}$ If bank keeps capital constant
⇩	If the bank invests cash in more risky assets	⇩	If $RWA_{SECURITISATION} > RWA_{ASSETS}$ If bank provides implicit support

My general comments 1/2

It appears overall difficult to ‘disentangle’ the answers to the original questions e.g. on

1) <u>asset class analysis</u>:

- Pre-crisis: Issuance of Credit Cards <u>lowers</u> CAP-ratio
  - **Is it due to higher RWA requirements on support instruments (denominator) – given the amount of capital?** *[not likely..]*
  - **Is it due to supported ‘exceptional losses’ on those deals (numerator)?** *[EU ABS defaults are close to zero and only materialise from 2007 onwards]*
  - **Is it due to issuers of those products being more aggressive in re-investment (indirect)?** *[does the bank fixed effect control for this?]*
- CMBS and CLOs don’t seem to have a ‘significant’ impact on CAP-ratio
- RMBS do risk transfer only during the crisis period [2007-2010]
  - **The paper says due to ECB eligibility and <u>driven by</u> favourable trade-off RWsec vs. RWpool for the originator.**
  - **Did originator achieve risk SRT on ‘retain-to-repo’ deals? [specific comment will follow]**
  - **Why is the RWsec vs. RWassets favourable to RMBS only?**
  - **What about the indirect channel in the crisis period?**

My general comments 2/2

2) <u>Rating grade analysis</u>:

- 'AAA' tranches increase CAP-ration before the crisis only.
  - **The paper claims this is due to risk transfer** *[why?]*
- 'AA' tranches lower CAP-ratio before the crisis and increase CAP-ratio during the crisis;
  - **The paper claims this is due to 'AA' replacing 'AAA' due to downgrades** *[what about the pre-crisis effect?]*
- 'BBB' always decrease CAP-ratio
  - **The paper claims this is due to implicit support as investors have no interest due to 'BBB' not being ECB-eligible and being subject to cliff-effect capital requirements** *[evidence is that even outside a 'retain-to-swap' environment banks almost exclusively invest in senior tranches, and not BBB. Non-bank investors in the market have risk appetite for mezzanine-junior notes]*

<u>General question:</u> isn't the use of outstanding volumes of X-rated tranches simply transferring on CAP-ratio the capital costs of downgrades?

Specific comment: the retain-to-repo sample (2007-2010)

No-SRT scenario

- **SRT tests (mezzanine or 1250% test) are binding in the regulation;**
- **Tranching changes wrt pre-crisis period: reduced number of mezzanine tranches – towards two-tranche format: senior tranche (e.g. 80%) is ECB-repoed for funding;**
- **Mezzanine (if any) or first-loss are difficult to place on the market (in that environment): no SRT is achieved → originator's RWA follows the credit risk framework NOT the securitisation framework (in the language of the paper equivalent to $RWA_{sec} = RWA_{assets}$)**

The risk transfer/risk retention narrative in the paper is not clear wrt to the post-SRT-regulation sample