I am sending you the following letter and enclosed material as an answer to your call for comments.

1. I highly appreciate your paper - which up to now – is the best ever published in terms of depth of analysis, openness in approaching the benefits of securitisation and completeness of the range of issues involved.
2. My point is related to the actual possibility of success in promoting a substantial development of the securitisation market. Europe needs a very large and deep market for ABS, being securitisation the only financial technique which can by pass the bottleneck of the lack of new capital which will impede a substantial recovery of the lending activity to families, SME's and corporations.
3. To reach such goal, in terms of amounts of funds, we should develop a market for ABS of a magnitude not comparable to that of corporate bonds but large at least as 1/3 of the government securities market. In terms of size we need have a market able to absorb at least 100 billion per year.
4. We cannot dream to reach such size of primary market if we do not have a really developed, stable, transparent and LIQUID SECONDARY MARKET.
5. The market experience shows that for having a liquid secondary market of DEBT SECURITIES you need to guarantee large amount and continuity of flow of securities on primary market.
6. Spontaneous ABSs' primary market will be made of "small issues" and erratic timing, therefore it will not develop up to a relevant – in macro terms – size because of lack of interest of institutional investors.

   The government securities markets are the only one which are well developed and established because of the amount and continuity of their issues.
7. To give SIZE to the ABS market you have to allow and promote a COLLECTOR or AGGREGATOR which puts together many small ABS'issues and, using then as underlying assets, RE-issue new ABS in a large and continuous flow, thereby providing market participants with an incentive to organize an efficient secondary market.
8. All this will be made impossible by the definition of "SIMPLE" securitisation contained in Pillar 1, criterion 1 of your paper (pag 39) which recalls the definition of RE-securitisation of CRR art 4 par 63, according to which you have RE-securitisation when "at least one of underlying exposures is a securitisation position".

9. My proposal is:

   To make an exemption to the ban of Resecuritisation when the underlying exposure is a QUALIFYING STANDARD, SIMPLE and transparent securitisation according to the new regulation that defined it as QUALIFYING RESECUTISATION.

   Such qualifying resecuritisation will be subject to the same regulation of the qualified securitisation.

   Enclosure

   To better support my argument I enclosed a paper which exposes in better terms the problem of LIQUIDITY OF secondary markets as a precondition for the development of a securitisation market which will effectively compensate the CAPITAL bottleneck of the banking industry in financing the growth of the European Economy.

   Sincerely

Giuseppe Zadra
(Istituto Einaudi- IstEin)

RESECURITISATION TO FINANCE THE RECOVERY

Summary

1. It is widely believed that it is necessary to provide businesses, especially Italian and European SMEs, direct access to financial markets through securitisation and mini-bonds.

   This belief is shared by the European Commission, the ECB, Bankitalia, as well as the Italian government and was confirmed by the Council of Europe on the 26th of June 2014. The success of this operation would also enable businesses to be financed with private capital from the international financial market. The ideal solution would be to operate on a wider European level and not just within the Italian market.

2. Several initiatives have already been adopted and/or put into practice, but have yet to generate any significant results: from the ECB and its requirement on loan securitisation to use them as a guarantee of its funding, to the association of major banks (PCS), to the Italian government with its two acts favouring mini-bonds and securitisations, by the EIB, etc.
3. This document explains why these initiatives have not been effective and offers a possible solution:
   - The cause for this ineffectiveness is because these are structurally illiquid instruments.

The liquidity problem arises from the size and timing of ABS' and minibonds' issuing. Individual issues are too small and erratic to attract institutional investors.

A secondary market for debt securities develops into an organized market and becomes liquid only if there is a continuous, large and predictable flow of new issues as it is for Government EIB and other International Institution securities.

Nowadays, private savings are flowing into institutional investors, which asset managers have to use to market valuation and to adjust their portfolio to volatile interest and exchange rates, thus to continuously trade on the markets. It is no longer true that debt securities are buy and hold securities that do not need liquid secondary markets.

- The proposed solution is based on techniques for the promotion of liquidity, which has been extensively tested by the Italian Treasury.

If liquidity is associated to the size and continuity of issuing flows, the only solution is to aggregate/consolidate individual, small issues into new securities which are issued in a large and continuous flow by a new vehicle. The market perceives this as the stable issuer of these new kinds of securities. This vehicle has to be managed by a new entity, who should be considered by the market as a guarantor of the quality of the underlying securities and of the transparency of the consolidation / resecuritisation process. As a first step, it would be prudent to arrange such a new entity as a combined entity of public institutions and top ranking intermediaries.

4. The real obstacle lies in the regulation that would qualify this consolidation as a resecuritisation, hence making it impossible. It is urgent to intervene in the current regulatory process to prevent this obstacle from blocking European corporates access to the financial markets.

The main difficulty, even though it was not analysed in the initiatives stated above, is that the use of resecuritisation is excluded. THIS IS WHAT SHOULD BE CHANGED AT THE LEVEL OF EUROPEAN REGULATIONS

- The issue of illiquidity and its solution is illustrated in Part I, pages 7-26
- The operational procedures for the solution are illustrated in Part II, pages 27-37

RESECURITISATION TO FINANCE THE RECOVERY

Giuseppe Zadra, July 2014

Preface

This work began from an analysis of the shadow-banking phenomenon in the United States, which brought structured finance techniques (securitisation, tranching, structuring, credit enhancement and derivatives, up to multiple levels such as CDO^3) to extreme levels.

This phenomenon has caused one of the major financial crises of all times and as a result was labelled as evil (bringing down a nearly absolute and generic condemnation upon all of finance). As a result, over time there has been an attempt to understand not only what its weak links were but also its merits. It has become undeniably clear that shadow banking enabled the American real economy to obtain a large flow of loans, far more than what the banking system had done.

Facing an evident funding gap on European loan markets (unknown in the United States) there was an attempt to assess as many positive elements as could be identified in this phenomenon. To date, these positive elements have been mainly found in securitisation, which, if dealt with properly, could bring significant improvements in the credit risk of enterprise whilst financing the recovery through the broad availability of capital found on non-banking financial markets.

The issues concerning credit risk and transparency seem to be heading towards a solution to such an extent that the European Central Bank and the Bank of England recently brought the question of "qualifying securitisation" to the public's attention. The second problem is that the liquidity of securities has yet to be answered. This also includes the ability to continuously find massive amounts of capital in financial markets, which would actually resolve the funding gap.

This document is an initial proposal for resolving the liquidity problem using “second level” securitisation, which, if handled prudently and if restricted only to the second level, will be defined as “qualifying resecuritisation”.

This document is divided into two parts:

1. The first part illustrates the requirements that securities must meet in order to generate a truly liquid market
2. The second part illustrates a technical solution

Note that the financial market referenced is not just the Italian market but the European market as well.

Contents Part I – *The need for (re) securitisation: the liquidity constraint*

Contents Part II – *Overcoming ABS liquidity constraints through transparent "Qualifying Re-Securitisation"*

PART I
The need for (re)securitisation: the liquidity constraint

Introduction

Since the 2008 crisis, the European banking system has gone through a period of extreme difficulty, squeezed between the tightening of regulations, increased credit risk and reduced fund-raising opportunities. The combination of these factors has hindered banks from operating as drivers of the economic system and directing financial resources towards more productive uses.

Faced with ever-growing financial requirements, the banks' ability to extend credit directly to enterprises has been restricted (Sect. 1). Different intermediation systems, which through the financial market would appear to be able to fill this gap, are hardly used even though they would create a virtuous cycle by increasing banks profitability while at the same time assisting the recovery of the real economy.

Mini-bonds and securitisation are two examples of market-based intermediation.

However, unlike the securitisation system, the mini-bond system does not include certain important properties; the first being liquidity of the individual issues (sect. 3). Securitisation, if prudently administered (drawing suggestions and techniques from the shadow banking experience), might be just as attractive to banks, in terms of offered services, as it might be to investors who are capable of exploiting new risk/return combinations (sect. 3).

Note that the focus of this document is based on a European scenario and is not limited just to Italy.

The Funding Gap

The 2008 crisis generated a drastic reduction in banking assets (deleveraging)[1] along with new and more stringent financial regulations. As a result, in terms of capital and liquidity for European banks, weights have grown considerably. This regulatory framework specifically affects three aspects of banking operations: a) the need for new and higher quality capital[2]; b) the limits of using financial leverage;[3] c) the minimum liquidity requirements, understood as the bank's ability to survive for a month without access to external funding.[4] Adding to these new constraints is the economy's need for the banks to recover the volume of loans not just to 2007/8 levels[5] (releveraging) but that they raise that volume to a degree that will sustain a true real recovery, exceeding pre-crisis levels, with the resulting obligation for banks to again increase their capital.

A prudent calculation of the new capital required of European banks must start with the estimate of the new assets, i.e., from the more than €4 trillion (= €4,200 billion) of additional funds required to at least partially finance growth in Europe[6]. It is broken down as follows, according to PCS white paper:

1. €2 trillion for releveraging processes (about 7% of the balance of the banks),[7] that is, to return to 2007 asset levels
2. €1.6 trillion to finance growth in the real economy[8] over and above 2007 levels
3. €600 billion to comply with the new liquidity measures (Liquidity Coverage Ratio, LCR)[9]

[1] In part attenuated by the ECB's expansive and in some cases innovative monetary policy (e.g. LTRO)
[2] More stringent risk-weights in Basel III
[3] Introduction of a leverage ratio
[4] Institution of a Liquidity Coverage Ratio, LCR
[5] Italian banks alone, between 2011 and 2013 showed nearly a €100 billion decrease in loans to enterprise.
[6] (IMF, October 2012), (European Banking Authority, EBA, September 2012) and (PCS Secretariat, March 2013)
[7] (IMF, October 2012)
[8] At 2% per annum over the 2012-2016 period
[9] At 2% per annum over the 2012-2016 period

Applying the Basel III risk coefficients to these estimates, European banks' new capital requirements come out to be around €330 billion[10]. Naturally, the current macroeconomic situation should also be considered: where the vicious spiral of profit contraction (not permitting the use of internal sources) and non-performing loans (which erode capital) continues to put pressure on bank balance sheets (deleveraging).

Under current market conditions, it would appear difficult for banks to come up with such a large amount of their own funds due to these four main reasons:

i. Low profit levels. The traditional business model, based mainly on fund raising and lending, currently results in an average ROE that is practically zero in comparison to a higher cost of capital.

ii. Resistance by shareholders to the dilution of their equity shares. This often requires the need to change ownership structures.

iii. Heightened uncertainty. The slow speed and lack of uniformity of the effect of economic recovery in Europe negatively affects not only the bank's ability to recapitalize, but also their need to resolve their structural problems[11] before they extend new credit.

iv. Reduced institutional support. The increase in public debt, due in some cases to bail out (e.g. Ireland or the United Kingdom), has notably reduced the implicit guarantee of governments to sustain banks in difficulty and in fact discourages intervention linked to the issue of being "too big to fail."

[10] €4100 billion × 8%

[11] High levels of non-performing loans, high operational costs

On the other hand, traditional fund-raising tools - deposits, bonds and covered bonds - do not seem capable of meeting the substantial call for funds, which a full true recovery, would require more than the former levels of 2008. Even assuming the technical feasibility and availability of funding on the market, at the present capital level the Basel III risk coefficients would not permit the extension of credit to the real economy. The same TLTRO operations announced recently by the ECB are not sufficient to resolve this issue: making new loans with the funds provided by the European Central Bank, would, in any event, require new capital.

Theoretically, there are other possible paths toward investments. The public sector, for example, could finance the real economy directly and promote recovery. However, due to obvious public financial constraints (e.g. Stability Pact) this is not a viable option. On the contrary, the "market path" might represent a significant turning point. In this path, funds required by the economy could be raised on the financial markets by way of different intermediation procedures. This would put fund users, banks and investors into contact within a broader, more extended credit system than what was traditionally used.

Recently, Italy has tried two initiatives that move in this direction: mini-bonds and securitisation. Indeed, the US financial system has become the subject of analysis, because in 2007, the securitised credit market (sometimes called shadow banking) brought over 50% more loans into the economy than the traditional banking system.[12]

In short, to finance a real European recovery, about €4,000 billion are needed. That means that just for the banking system, more than €300 billion in hard-to-get capital would be required. In order to keep the possibility of development, it would be necessary to consider an alternative path and turn to the international markets where there is abundant liquidity.

Today, in Italy, it seems that an opposite view prevails. Actually, the common belief is that after the recent capital increases, banks have abundant liquidity and are somewhat unwilling

[12] $12 trillion against $8 trillion (Federal Reserve Bank of New York, 2010)

to lend it out due to credit risk. Actually, recent recapitalisations have been barely sufficient to pass the on-going capital adequacy tests. Any future significant increase in lending would be impossible without additional capital increases.

Market based credit intermediation

To meet the financial needs of banks and of the real economy, a market based credit intermediation system should meet some minimum requirements, for both banks and investors.

First of all, this system must enable banks to meet the Basel III liquidity constraints. Therefore, it must be capable of granting new credit without recourse to additional capital or within the limits of its possibilities. Note, in this regard, that capital increases undertaken recently have not been sufficient to enable the extension of lending (releveraging). Italy, for example, is in the middle of a funding gap situation and is facing a deposit/lending ratio that is already greater than 100%. For the banks to fund new loans and disburse new credit, it is necessary to turn to the market. Note that before the crisis, the ratio was 130% and the banks were raising funds in the international capital market.

From a different perspective, large institutional investors (pension funds, asset managers and large treasuries) that operate on the international financial markets are normally concerned with investment in securities and not in lending activity. Financial products that enable indirect expansion of credit should therefore be attractive to this type of investor. As the 2008 crisis clearly demonstrated, the essential requirements for these investors are transparency and standardisation of the securities.

Lacking transparency and standardisation, institutional investors, which are normally far away from the originators of the credit- both physically and economically - cannot realistically be prepared to appropriately understand, price and compare assets, which, even if part of the same class, originated in different currencies and locations.

In general terms, worldwide standardisation is favoured by the large global audit firms, who certify that a company's economic and financial statements are correct, and by credit rating agencies (CRA), which issue opinions on the credit risk of securities using globally uniform methods.

> The quality of the ratings expressed by CRAs is a sensitive issue and is subject to continuous legislative review. Regardless of the fact that regulators ask that CRA ratings are not given much trust (and banks maintain that they do not use them for credit granting operations), institutional investors working on international markets cannot operate without ratings, without accepting a drastic reduction in the number of opportunities of investment in debt securities.

Moreover, in addition to the standardisation of financial instruments, there is a demand for investors and banks to work within a regulatory framework that is well defined and harmonised among countries.

Finally, it should be noted that investors operating on financial markets are interested in different investment timeframes (from hedge funds to pension funds) and in different risk-return combinations.

Yet, for every investor class, the issue of liquidity of the instrument is fundamental; it is measured using different indicators (from the bid-ask spread to the “depth” of the market in question) and is considered without undergoing losses in value. When working with illiquid instruments, the risk premium required by investors and hence indirectly by borrowers [companies asking for credit], may be so high that it discourages any type of intermediation. A good form of market-based intermediation, should therefore meet all of these requirements.

a) The case for mini-bonds

Mini-bonds, instituted in Italy by Decree Law 83/2012 by the Monti administration, are essentially corporate bonds, issued normally by SMEs, with a usual timeframe of no less than thirty-six months. During November 2012 to December 2013, in Italy, twenty of these operations were performed for a total of nearly €6 billion[13]. These operations represent an interesting initial test for SMEs to access financial markets directly, yet some of their limits have become quite clear.

The current structure of mini-bonds makes them particularly unattractive to most investors on the international financial markets due to the absence of standardisation requirements and more importantly because mini-bonds are not issued in sufficient quantities to be considered worthwhile. In addition, mini-bonds are essentially illiquid[14] for they have no active secondary market (which is developed only in the presence of a significant and systematic issue flow).

Instead, a securitisation system could be organised to be fairly liquid for investors and would therefore generate a secondary market. Furthermore, if banks were to use securitisation methods, their capital requirements could be significantly reduced, because under the new and current regulation, only a 5% retention of the securitised amount is required. In reference to the previously mentioned data[15], if only securitisation methods were used, the new €4 trillion in business financing, would require only € 40 billion (against the previous 330 billion) of new banks' capital (considering a 10% retention).

[13] Nearly all of the issuers are medium to large businesses in Italy. In the first three months of 2014, five new issues for an average amount of €16 million were made by SMEs. (Bankitalia, May 2014)

[14] The preferred instruments used to purchase mini-bonds were Specialised Closed Funds, hence why investors are in for the medium- to long-term.

[15] Cf. sect. 1 "The Funding Gap"

b) The case for securitisation

The securitisation system, in its simplest form,[16] provides a loan originator (normally a bank) and a Special Purpose Vehicle, (SPV) to which the ownership of the loans is transferred. To fund itself, the Special Purpose Vehicle issues debt securities which are guaranteed by its assets (Asset-Backed Securities, ABS), and are sold to investors with varying propensities for risk. There are various ancillary processes that accompany the securitisation of credits, including constant monitoring of the quality of the assets and the relevant cash flow (servicing), and the swap contracts required to convert the cash flows of the underlying assets to the cash flows required by investors.

However, before examining if securitisation might be a good market based credit system, it is essential to consider the role securitisation had in the 2008 global financial crisis.

For example, from July 2007 to the third quarter of 2013, the prudent European securitisation default rate, based on tested consumer credit products (home mortgages, credit cards and various loans), was 0.05%.[17] Instead, the US securitisation default rate, including subprime mortgages was 18.4%.[18]

This profound difference merits an explanation. The pre-crisis US securitisation market–was characterised by very low default rates and during those last few years it was at such a high quality that this enabled it to fund itself on the money market by attracting large funds from large institutional investors.

The initial blame for the crisis was placed on the securitisation of loans which had already been recognized as most likely non-performing (such that they were ex-ante qualified as sub-prime). The fact that the poor quality of the debtors was potentially balanced out by the increased

[16] Cash securitisation

[17] Better, therefore, than the average on the loans

[18] (Bank of England; European Central Bank, May 2014)

property value, which was used for collateral, created the false impression that the loan, albeit of poor quality, was in fact well guaranteed and therefore still capable of easily recovering the amount loaned.[19]

Those who were involved were accused of having relied on the sustainability of this phenomenon: the founding theory of modern finance, which considers risk to be a measurable quantity which can be distributed over many products, the supervisory authorities, the banks, the multiple level securitisations (the well-known synthetic CDO[3] which made the underlying risk unrecognisable) and finally the rating agencies (CRA) on which many final institutional investors relied. To all of this an extreme maturity transformation (mortgages financed with call deposits) abated.

The first crash in the underlying sub-prime mortgages generated such panic that it froze the market for every type of ABS, even the most reliable, including those with well tested underlying loans such as, consumer loans, student loans, and credit cards loans. It was only the Fed's immediate action on these markets that prevented an instantaneous collapse of the entire international financial market. It did so by providing itself the liquidity which was withdrawn by investors (i.e. buying the securities they were fire selling).

Second, the crisis was, at least initially, a liquidity crisis caused by an out-of-control financial system. Apart from excessive financial leverage, (which gave only a bare minimum of structural stability to all of the entities involved including intermediaries and vehicles), it also used extreme maturity transformation methods, through which portfolios of long-term securities were financed by extremely short-term securities (in some cases on overnight markets).[20]

[19] High probability of default (PD) and minimum loss given default (LGD)

[20] For example the case of the Structured Investment Vehicles, (SIVs), which were financed by selling extremely short-term securities (e.g. Asset-Backed Commercial Paper, ABCP) and which then purchased long-term securities(e.g. RMBS)

Finally, another cause of the crisis was from the change in the business model used by banks: switching from an originate-to-hold (OTH) model to an originate-to-distribute (OTD) model, caused a misalignment of interest between the originator of the loans and the final investor, subscriber of the bonds guaranteed by those same loans. Using the OTH model, the originator bank maintained economic interest in the loans it disbursed (those of which are stated on its balance sheet) therefore maintaining an incentive to conduct a regular and in-depth analysis of the credit risk. Using the OTD model, the originator, in just a few months, transferred all of the risk onto the final investor, who was not always capable of suitably assessing a product with unclear tendencies. To overcome this problem, new legislation has introduced what is referred to as the "skin-in-the-game". This forces the originator to maintain a 5% retention of the assigned ABS loans on its balance sheet, thereby reintroducing an incentive to perform a prudent risk analysis and to continue monitoring functions.

With the new proposed regulation, the securitisation process would most likely be aligned toward a "self-liquidating" horizon, that is, the asset's interest and principal would roughly correspond to the ABS's interest and principal.[21]

However, the question of whether or not it would be possible to once again propose a credit intermediation system based on proper securitisation remains open. In this regard, the recent document from the Bank of England and the European Central Bank[22] seems to mark a turning point, justly breaking, in my opinion, the taboos represented by the expressions, "structured finance," "shadow banking" and "paper economy" the press have used for the past several years. This document outlines all of the elements that a "qualifying securitisation" should comply with

[21] (Bank of England; European Central Bank, May 2014)

[22] (Bank of England; European Central Bank, May 2014)

in order to be attractive to the market. It also aims to identify proposals for changes in the regulations that no other proposal presents with equal strength.

In terms of capital, the new regulation (when the qualifying securitization should be considered) clearly states that the bank that securitises the loans must definitively transfer the title to the SPV, freeing up capital which can be allocated to new business/manufacturing lending. The new regulations should also introduce significant improvements in regards to transparency and standardisation in comparison to previous regulations. In particular, originators will be required to comply with the minimum standards for credit risk analysis. This involves, stating granular information on the loans underlying the ABS in the ABSs' prospectus, receiving a rating from accredited rating agencies, and being qualified to continue performing service activities.

Investors, as opposed to what happens in the mini-bond market, could potentially find a market where standardised, structured products are traded and could obtain ratings from accredited rating agencies (yet the history of the underlying loans should be traced). For an investor operating on global financial markets, standardisation and transparency certainly represent two fundamental requirements.[23] Instead of setting up the equivalent of an internal loan department (which would probably incur excessive costs) to analyse and continuously monitor the risk on the ABS,[24] investors would rely directly on those banks that provide servicing and which already have the experience and the necessary infrastructure. It is evident how this process could create substantial and advantageous economies for both the banks and investors.

In addition, due to the procedures that create the ABS (the combination of different assets), it naturally exploits the benefits of risk diversification. These procedures are also easily subject

[23] Cf. sect. 2

[24] For example, an ABS could comprise the securitisation of loans provided to SMEs that are geographically distant from the investor, causing an obvious difficulty in obtaining information on the businesses in question.

to tranching, which allows the portfolio to be "cut up" into credit risk classes (mainly through privilege classes in case of default),[25] based on duration (grouping cash flows by diversified due date maturities) or by currency. Finally, by using a combination of tranching and structuring (i.e., the transformation of cash flows from the portfolio by risk classes and duration), completely new securities can be created[26] and adapted to investors' different propensities for risk.

Regardless of the simple and transparent securitisation, which was clearly stated in the joint ECB and BoE paper, there are still certain obstacles that are currently hindering the (re)birth of a European securitisation market.

1. From a legislative standpoint, the Basel III risk-weights for securitisation were created during the most acute phase of the crisis. Therefore, they are overly disciplinary towards high quality loan securitisations and resecuritisations.[27]
2. The new proposed regulations are too focused on simplifying the securitisation mechanism, and this actually inhibits any type of resecuritisation. Consequently, this significantly reduces the possibilities of increasing the size and frequency of issues (and therefore, access to a broader market for investors).

Finally, in my opinion, the path to "qualifying securitisation" does not take into sufficient consideration the main obstacle of developing a market for these instruments: liquidity. Indeed, as with the mini-bonds, ABS issues from only one vehicle do not reach any significant dimensions and do not guarantee sufficient flows by size or continuity. Therefore, the key issue is the lack of liquidity of the securities, which creates a lack of a secondary market for ABS.

** *

[25] Whereby losses are first covered by the most junior classes and then gradually allocated to the higher classes in case the losses exceed the absorption capacity of the former.

[26] Synthetic securities

[27] The ECB and BoE document is the sponsor of the required changes

Proposal for resolving the liquidity constraint: a "qualifying resecuritisation"

In my opinion, there are three main documents that deal with the issues of securitisation: the 2010 IOSCO document, ["Transparency of Structured Finance Products"]; the March 2013 PCS White Paper, ["Europe in Transition - Bridging the Funding Gap,"], which gives significant evidence that securitisation may be a solution to the Funding Gap and the paper, which certainly has the greatest potential impact, by the ECB and BoE (May 2014), as it examines nearly all of the issues concerning securitisation and points out regulatory solutions as well.

Nevertheless, none of these documents provide an in-depth analysis of the issue of market liquidity of debt securities and hence of securitised assets (ABS and CDO), which are in any event, "non-equity" or "debt securities."

* * *

In the past, in Italy, this issue was first introduced in detail during the development of the MTS [Italian Online Government Bond Market] and later in the discussions promoted by CONSOB for the preparation of the MiFID I, for the TUF [Consolidated Finance Law] and more recently of the MiFID II, under the name of "transparency in secondary non-equity markets," an issue which is still debated within the IOSCO Groups and in the consultation process with the EBA.

The debate hinges on the microstructure of the secondary market for debt securities and specifically on the issue of whether the transparency of the market (in terms of information on prices during the pre-trade and post-trade phases) is, in fact, in contrast with its liquidity. The argument rests on the nature of the secondary market, characterised by the presence of major independent dealers, who claim that pre-trade transparency (competitive firm offers) and post-trade transparency (immediate disclosure) would reveal their individual strategies to

competitors. This would enable their competitors to infer their financial position from the trade transparency, exploit that knowledge aggressively, and adopt competitive behaviours against them.

This problem got its notoriety from the well-known case of a very large international bank that came into conflict with the MTS [Italian Online Government Bonds Market] and other organised government bond markets. This issue is still more relevant in Italy (where a very strong government bond and corporate bank bond market have developed open to retail) than it is in Europe, where the prevailing presence of wholesale operators makes the protection of small investors far less necessary.

The fact remains that the last 20-25 years (since the creation of the MTS and online markets) have shown how the secondary debt market, being a dealer's market, has its own specific and particular operational requirements in terms of liquidity of its instruments.

Specifically, it is useful to have a group of primary dealers willing to purchase large quantities of bonds to later resell to large institutional investors. These investors are interested in a variance in a return (interest and capital gain) as much as those from listed shares. They are also mostly dependent on the expected changes in interest and currency exchange rates (i.e., on variables that are hardly dependent on the issuer of the securities) and much less dependent on the credit risk variations of an individual security.[28]

Portfolio managers will only risk taking positions if the current trading volumes on the market are consistently substantial. Sooner or later, they will have liquidated those positions to update their portfolios, on the basis of future market conditions.

Therefore, the quantity and the continuity of the issues are key elements. The best evidence for this was the policy for the Italian public debt issuance in the early 1990s, which was

[28] Consider, for example, a bond portfolio manager who has to optimize returns while taking into account the country risk, the issuer risk, the currency risk and in the end, the coupon. Normally, bond assets are divided by duration classes (average life), by ratings (credit risk), by currency and finally by interest rate.

characterised by a reduction and standardisation in the number of issues (to reduce the fragmentation of the issue) as well as by their programming and continuity (to enable the market to predict future flows).[29]

In summary, debt securities create good secondary markets if their bid on the primary market is standardised with consistent and reliable volumes, hence predictable and reliable for the final investors and for the short-term investors which act as intermediaries (dealers or market makers).

As a result, the securitisation of loans could become a valid solution, but only if a consistent and continuous flows of securities was organized; this being the opposite of the current situation with mini-bonds and the few current securitisations.

My proposal is to attempt to develop a sufficiently liquid secondary market by using a standard shadow-banking method, that being Re-securitisation, which is the only method that makes it possible to achieve very large sized issues. This requires a large aggregator that buys ABS on the primary market and is self-financed by Re-securitisation operations, whereby such ABSs' are in turn recombined into new debt securities ("second level" ABS) which are to be consistently sold in large quantities within European and international markets. Since these second-level ABSs' must be based on a carefully diversified but completely transparent pool of ABS (being based on a diversified pool of good quality loans), they would be radically different from the pre-crisis CDO, which in a non-transparent manner, combined good loans with bad loans.

Specifically, the most common errors that occurred in the creation of pre-crisis CDOs were caused by imprecise estimates of the parameters for the reference models, the substitution of systemic risk with idiosyncratic risk (capable of being diversified) and by false assumptions of

[29] The Italian Treasury has learned to manage these variables with internationally recognised professionalism.

low correlations between different assets (e.g. subprime mortgages). In our case, a centralised and regulated issuer (the Aggregator) ought to avoid these mistakes.

Ideally, at least in the initial phase, the Aggregator should be a single party that issues debt securities (ABS) of varying durations and with different characteristics which are backed by loans made by local enterprises (e.g. Italian businesses). By using similar methods, this would mirror the Treasury, which issues debt securities guaranteed by the nation's general assets. In addition, by using tranching and structuring, the risk can be managed to concentrate on junior securities, which could be purchased either from a group of involved banks (eventually with tax incentives such as those used for the bad banks) or by public parties in the interest of the nation, as is the case in Germany (KWF), France (Caisse des Dépôts et Consignations) and the US (Fannie Mae).

Conclusions

It is necessary to accept that, in modern financial markets, pure and traditional bank intermediation is no longer sufficient since global fund raising is heavily concentrated among large international institutional investors who operate under the rationale of those markets. The liquidity of the securities traded on those markets comes from the existence of efficient secondary markets. The "quality" of those securities should be certified by major ratings and audit agencies.

Financial development over the past twenty years has demonstrated the power of intermediation as it exists on international capital markets as well as the risk of not managing it appropriately. However, the difficulty in controlling this phenomenon is no different than that of natural energy exploitation, which cannot be given up merely because it is difficult to manage until it has been put into a usable form. In the United States, it was openly admitted that shadow-banking phenomena (tranching, multilevel structuring and unregulated dealers) had slipped under the regulatory system's radar. Therefore, there is currently an attempt to fix these problems rather than to avoid them.

It must not be forgotten though, that undoubtedly many ABSs' defaulted during the crisis, while many others performed well. We need to convince ourselves that we can no longer rely exclusively on the noble model of "family deposits \business loans" to finance EU development (and hence our country as well), potentially leaving the most important part of the financial market in the shadows. We must also study and be prudent in pushing ourselves beyond the traditional limits of intermediation.

In regards to costs/benefits, it seems only reasonable to think that the research investments in finance are probably only a small fraction of investments in scientific research (physics, chemistry, pharmaceuticals, etc.) and that the public participates in a very limited way. A famous economist (Shiller) recently stated, "We know too little." Therefore, can we truly say

that sufficient resources have been allocated to studying the correlation of risks in the field of finance?

Until now, studies have concentrated mainly on credit and market risks that are typical of banks, resulting in systems concerning risk-weights and capital ratios found in Basel III. Now is the time to expand research on the phenomena of correlation / de-correlation in the portfolios of debt securities to better support the use of market financing instruments.

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July 2014

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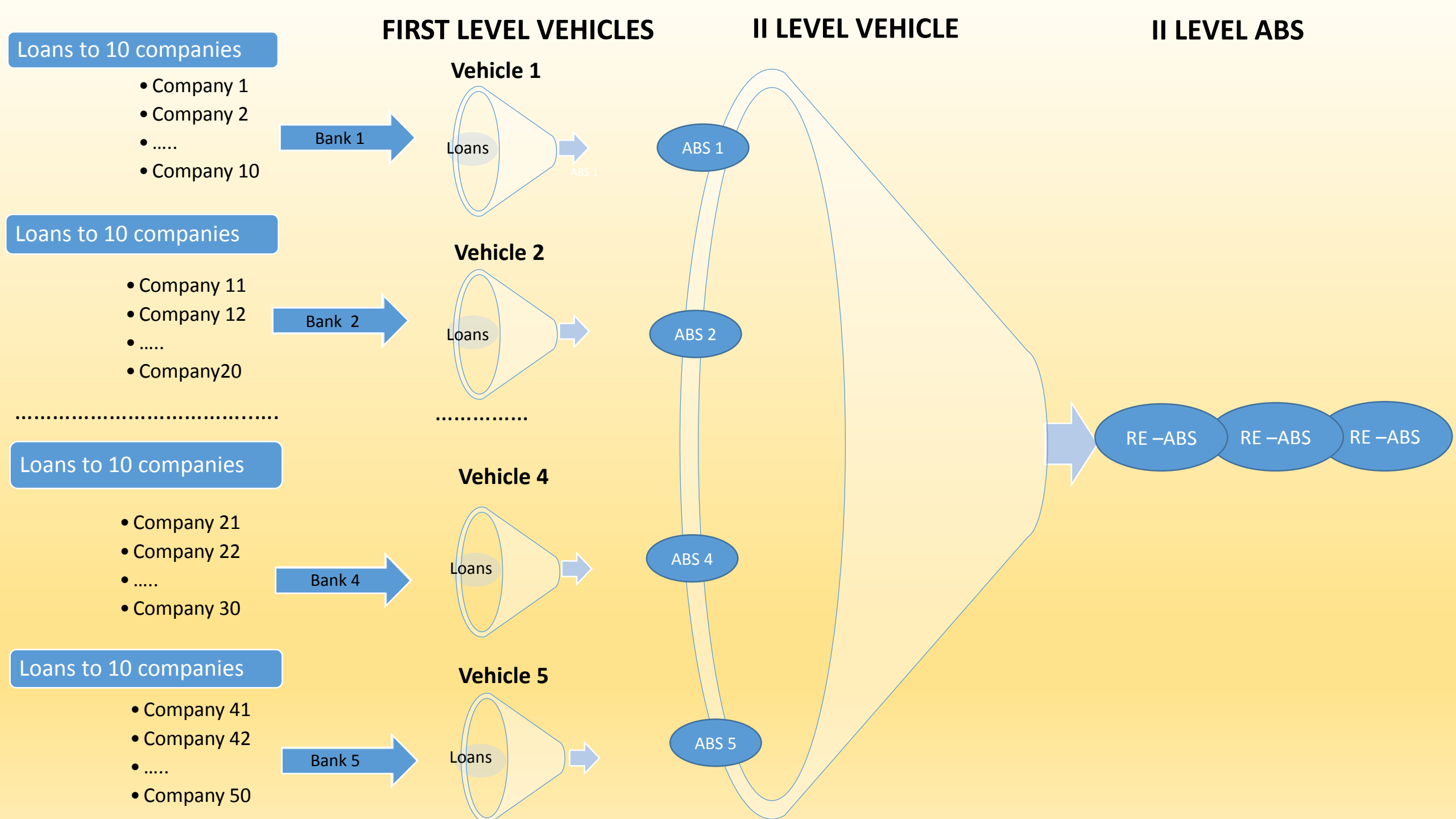
FIRST LEVEL VEHICLES
II LEVEL VEHICLE
II LEVEL ABS
Loans to 10 companies
• Company 1
• Company 2
• …..
• Company 10
Bank 1
Vehicle 1
Loans
ABS 1
Loans to 10 companies
• Company 11
• Company 12
• …..
• Company20
Bank 2
Vehicle 2
Loans
……
……
Loans to 10 companies
• Company 21
• Company 22
• …..
• Company 30
Bank 4
Vehicle 4
Loans
Loans to 10 companies
• Company 41
• Company 42
• …..
• Company 50
Bank 5
Vehicle 5
Loans
ABS 1
ABS 2
ABS 4
ABS 5
RE –ABS
RE –ABS
RE –ABS

PART II

OVERCOMING ABS LIQUIDITY CONSTRAINTS THROUGH TRANSPARENT "QUALIFYING RE-SECURITISATION"

Introduction

The objective of this document is to illustrate how a two-level securitisation system might increase liquidity of ABS instruments in Europe.

A two-level securitisation system initially provides a first cycle of the transformation of loans with the creation of "first level" securitisations (guaranteed by loans) and afterwards, a second cycle with the creation of "second level" securitisations (guaranteed by "first level" ABS).

In the first phase, the loans disbursed by banks to businesses are transferred to "first-level special vehicles," which issue "first level" ABS, backed by assigned loans. These ABS's will then be sold to the "second-level special vehicle" (set up by a possible public sponsor) allowing the second cycle of the mechanism to begin. Borrower businesses would remain extraneous to the process, even though they are partially involved by the change in the creditor (from the bank to the "first-level" special vehicle).[30]

In the second phase, the "second-level special vehicle" buys the "first level ABS" (from the "first-level special vehicles") and issues "second-level ABS" which would later be sold on the financial markets.

[30] The "first phase" essentially represents a transparent and regulated securitisation process. See, for the "first phase" (Bank of England; European Central Bank, May 2014) and (PCS Secretariat, March 2013)

The following provides a brief description of how the "qualifying securitisation" method (for the "first level ABS" as proposed by the ECB and BoE) could be combined with the need for liquidity, which will be provided by consistent and continuous volumes. The mechanism consists of grouping "first level ABS" into "second-level ABS" by using the Re-securitisation method, which, like a magnifying glass, should increase the transparency of the underlying ABS rather than reducing it. This did not happen with the CDO, which made it synonymous with opacity and the impossibility of measuring underlying risk factors (and is considered among the main causes of the crisis in these markets).

The proposal is to use Re-securitisation as a lens. If the lens is out of focus, the observed object cannot be seen, whereas if it is in focus, the object is magnified allowing specific details to be seen.

In our case, an ABS that represents a portfolio of ABS may be useful if it points out the characteristics of the underlying ABS. This is only possible if it provides the best information on the common and uniform underlying characteristics. Transparency should became the key function of the promoter of the second level vehicle, which should "impose" on the promoters of the first level vehicle those features which stimulate market interest.

If the "second level vehicle" invests only in simple ABS and if the entire system (the different first-level vehicles and the second-level vehicle) uses the same legal/fiscal infrastructure, then the second level ABS will not be considered to have substantially different terms of transparency than those in the first level. In this sense, it will function as an aggregator (and/or lens) and will only be used to give an issue both the characteristics and volumes required by the market.

Operational scheme for a two-level securitisation system

Level I

1.1 Origination of the loans and subsequent assignment to the "special vehicle"

In this first phase, the bank assigns medium-sized loans to customer businesses to a specifically created "special vehicle". The bank will ensure that servicing is performed and that 5-10% of the issue is held on the balance sheet (retention).

> For the securitised loans or for the loans kept on the balance sheet, the servicer must ensure the same high standards of monitoring. The combination of servicing and retention should reduce misalignment of the incentives between banks and the investors, which was typical of the OTD (originate-to-distribute) model. In the OTD model, the banks did not maintain economic interest in securitised loans (which were entirely sold on the market). Therefore, the banks had no incentive to conduct continuous and prudent risk analyses, which resulted in lower quality loans.

The loans sold to the "first level special vehicle" must include detailed information on the credit and economic history of the individual borrower businesses. They must also have an external rating that certifies the quality of the individual corporations in the pool of assigned loans. Lastly, they must comply with the "product" transparency requirements which have already been stated in the ECB and BoE document.

1.2. Characteristics of the "special vehicle"

During the first phase, each bank uses a specific special vehicle that is based on a standard model of legal and fiscal infrastructure and is defined by the promoter of the second-level vehicle as stated below. Legal and tax standardisation would favour large scale economies, hence enabling the distribution of the fixed costs onto the various vehicles created by interested banks. It might be that each special vehicle purchases a standard amount of customer business loans from the bank (e.g. fifty), which could be replicated for subsequent modular operations.

The balance sheet of a "special vehicle" will place the loans purchased by the bank (originator)[31] on the asset side, and the liabilities payable to the ABS subscribers (guaranteed by the securitised loans) on the liabilities side. These "first level" ABS will then be sold to the second level special vehicle. The financial flows produced by the assigned assets will be used to pay the first type of "first level special vehicles".

1.3. Characteristics of "first level" ABS

To resolve the credit risk transparency problem and the reliability of the product, the "first level" ABS must meet certain minimum requirements:[32]

1. Structure. The securitisation that creates the "first level" ABS should represent a "true sale." Meaning, it should transfer the loans from the (originator) bank to the special vehicle while respecting the following terms: the transfer (i) must be enforceable against third parties, (ii) must not be undertaken synthetically using derivatives, and (iii) must be "beyond the reach of the seller, its creditors or liquidators".
    a. The securitised loans must be based on commonly used market interest rates and must not use complex formulas or derivative products.

[31] For a standardised number of loans (fifty in the previous example)
[32] (Bank of England; European Central Bank, May 2014)

b. Non-performing loans must not be transferred to the special vehicle. The loans should also be "self liquidating," that is, not subject to refinancing through future loans or sales to repay interest and principal.

c. In addition, one should be able to predict the possibility of using bridge loans to connect the needs of the bank that assigned the loans against "real" deposit, with the possibility that the special vehicle will make this payment only when payment is received from sold ABS.

2. Transparency. The information regarding the economic and credit history of the businesses[33] (updated monthly/quarterly)[34] should guarantee the transparency of the product.[35] For a prudent analysis of the risk, the documents should bear the nominal value, the principal and the interest rate maturity, commissions and miscellaneous expenses. For further details, refer to the essential information provided in the "Prospectus Directive".

3. Standardisation. Standardisation of the "special vehicle"[36] and of the securitisation process should make it relatively easy to compare ABSs that are issued by different vehicles.

4. Reliability and predictability of returns. Diversification of underlying loans (with a maximum concentration in either industry or geography) together with the uniformity of the duration of the loans should generate sufficiently reliable and predictable cash flows for the holders of the securities. Therefore, there should not be any restrictions on swap contracts required to harmonise cash flows.

[33] Some hope for the possibility of accessing historical data from the different types of credit bureau (including the Risk central)

[34] Taken care of by the assigning bank in its function as a servicer

[35] To complete the picture, particular agreements with the external CRA should be provided for and what methodology was used

[36] To which eventual standardisation of usable credit enhancement mechanisms should be added.

5. Tranching, improvement of the credit quality. The "first level" ABS should be able to easily divide risk classes into clear distinctions between junior, mezzanine and senior segments, making them easily identifiable by the second level vehicle purchaser.
6. Credit enhancement. As the Shadow Banking system has shown, credit enhancement (which is an essential part of the securitisation process) can be performed using two main procedures: through either direct or indirect guarantees.
    a. Direct guarantee. A direct guarantee may come from an explicit guarantee (such as the Central Guarantee Fund or SACE) or through an insurance guarantee.[37]
    b. Indirect guarantee. An indirect guarantee may come from i) segmentation (tranching) of the ABS by subordinated default classes (junior, mezzanine and senior) or ii) hedging by way of CDS.

Level II

In the second phase, a promoter, which is essentially the manager of the entire project (a joint group of public banks and public institutions) creates a "second level" special vehicle which will be specialised in the purchasing of first level senior ABS (and not loans directly from the originator bank)[38]. This new vehicle, just like the "special vehicle" from the first phase, transforms the cash flows from the assets purchased, into cash flows matching the "second level" ABS maturities, which will be sold on the market.

We are not dealing with the "nature" of the promoter. Theoretically, the market participants would organize it (as it is in US). Actually, in the present European situation, it would be better to bring together some possible private and public institutions.

[37] See the case of monoliner Insurance

[38] A promoter, which will be de facto the manager of the entities

2.1 Function of the second-level "special vehicle"

The second-level special vehicle, created by the promoter party, buys the "first level" senior ABS from the "first level" special vehicle and issues, new ABS ("second level" ABS) in a standardized feature to fund itself. Unlike first level "special vehicles," the main objective of the second-level "special vehicle" is to ensure a constant and continuous issue of securities, so that the creation of a "fluid" primary market is facilitated. Therefore, it might be useful if the cooperation of a group of "primary dealers" is ensured. A prime model to emulate would be the issuing behaviours of the Italian Treasury in the early 1990s.

As is the case for the "first type" of special vehicle, the "second type" of special vehicle should also use a standardised legal/fiscal infrastructure, which will contribute to providing transparency to its issues and will be completely consistent with the structure of the first level operations.

2.2 Role of the promoter

The promoter of the second level vehicle should systematically and continually issue a flow of "second level ABS" so that they are considered by the market to be a steady series of issues from the same party (which are uniform in their legal and fiscal structure and in their main financial characteristics).

For example, a mechanism of this type could be used to systematically finance legally subsidised loans (therefore, standardised at their origin): including all subsidised loans (L. sabatini) or those guaranteed by Fondo Centrale di Garanzia or from export financing hedged by SACE guarantees, and so on. In these cases, the banks that sell these types of loans will already have the underlying financing operations organised, based on the requirements set by law and will thereby have less administrative complexities linked to their selection. In addition, those same

banks will have already been culturally prepared to consider the assignment of this type of loan to a special vehicle as being normal and will not consider it as the "loss" of a customer or of an interest bearing asset, which loss would not be appreciated. These are fears that seem to be fairly widespread within the business structure of the banks.

Another example of loans that are easily securitised and then aggregated are retail real estate loans.

At this point, it is fairly clear that the true function of the "second level special vehicle" promoter is the key role of the director of the system and that its objective is twofold. First, it must guarantee that the market has a continuous and constant flow of standardized securities, which are accepted as fungible on the secondary market[39] (hence resolving the liquidity problem). The second objective is to ensure that the banking system continuously provides ABS by using the proposed legal/fiscal infrastructure along with the financial characteristics that the promoter suggests (hence resolving the product reliability problem). For example:

- Duration
- Risk level
- Rate type
- Tranching type
- Credit history
- Type of guarantee
- Servicer commitments
- Concentration by sector and geographic area

The legal/fiscal issue is continually quoted because it is one of the highest costs (and is a major complication) for each ABS issue, and involves the attorneys for the issuer, the buyer, the banks, etc. Unifying and standardising everything would save a significant amount.

[39] To best perform this function a group of primary dealers for consultation could be organised

2.3. Characteristics of "second level" ABS

Within a two-level securitisation system, the "second level" ABS has a dual function. It guarantees a consistent and continuous flow of issues and also makes the characteristics of the underlying "first level" ABS very clear and evident.

- In terms of structure (just like the "first level" ABS), the "second level" ABS must avoid complex formulas and derivative instruments that are difficult to understand. They should also not provide subsequent levels of resecuritisation.
- Regarding transparency, the resecuritisation that generates "second level" ABS, should bear the nominal value, the principal and the interest rate maturity, commissions and miscellaneous expenses. In this regard, as for the "first level" ABS, this would mean drawing from the "*Prospectus Directive*."
- Even more than the "first level" ABS, the "second level" ABS must guarantee a certain level of reliability and predictability of their returns through diversification of the underlying assets[40] by way of credit enhancement methods.

Apart from the credit risk guarantees, shadow banking has used guarantees against liquidity risk (liquidity enhancement), which mainly consist of lines of credit and foreign currency swap operations to access different markets.

Another significant point to consider is the correlation among the assets that underlie the "second level" ABS.

Initially, it would be useful to make a parallel comparison to the CDO issued in the United States prior to the crisis, which like the proposed "second level" ABS is an example of resecuritisation. One of the most fragile features of the CDOs was actually the high level of asset correlation because they were mostly dealing with subprime mortgages that

[40] The loans to businesses in the case of "first level" ABS and the "first level" ABS in the case of "second level" ABS

were similar and were distributed in the same geographic area. For this reason, many experts in the United States considered CDO, with underlying assets, highly correlated to the economic cycle.

"Second level" ABS must have a low correlation among the underlying assets as its main characteristic. In this way, true diversification could reduce the overall risk of the operation. In fact, a recent document issued by ABI[41] showed that the risk of small firms is lower than that of large businesses. Indeed, default cases of large businesses are more correlated to each other than they are among small businesses, which instead have a strong idiosyncratic component. Therefore, this evidence supports the idea that second level ABS may be constructed using loans to SMEs as guarantees.

[41] Morelli P., (2012), "*Toward Basel 3. Asset Correlation and SMEs: Estimates from Macro Data"*, TEF No.6 Associazione Bancaria Italiana

Nominalistic problem

It might be said that (i) "second level" ABS are actually CDO (collateralized debt obligations); that is to say, securities that were the critical issues in shadow banking; and that (ii) all of the regulations enacted to date (including the ECB and BoE document from May 2014) state that resecuritisation should be excluded from "qualifying securitisation."

It should be clarified that resecuritisation is being considered in this proposal only when it is limited to the second level. This is fundamental in enabling its aggregation function and in overcoming the illiquidity of individual issues and limited amounts found in "first level" ABS.

This is not a proposal for multiple level resecuritisation (e.g. CDO^3), which actually impedes the transparency function (lens), which is attributed here instead.

Nevertheless, to go beyond the limits of traditional securitisation, a joint commitment is needed from both the "regulated" and the "regulators". Regarding transparency and standardisation for both "first-level" and "second-level" ABS, the regulatory framework should not be excessively demanding and cautious at the expense of (re)securitisation, at least until it is limited to the second level. In fact, these standardised resecuritisations of standardised and transparent ABS should be equally transparent, understandable, and measurable in terms of risk for the "first-level" ABS.

The key point is that, only with this mechanism can plurality of ABS from different origins and sizes (hence illiquid) be transformed into a continuous, regular, predictable, and manageable flow of issues. These are therefore appropriate for the generation of a continuous, fluid and liquid secondary market.

To conclude, while the "qualifying securitisation" tends to solve the problem of credit risk (and seems to have already gone in that direction, especially after indications from the ECB and the BoE), the "qualifying resecuritisation" proposed here is considered suitable to solve the equally important problem, the liquidity of this market.

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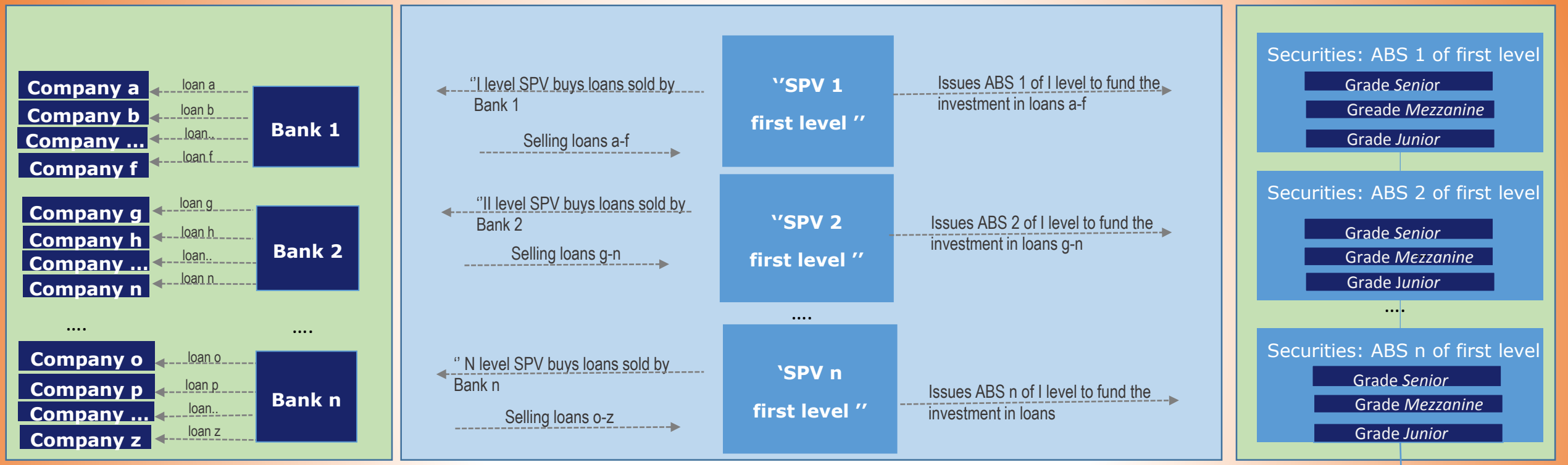
July 2014

2 Levels Securitisation Scheme

I LEVEL SPV



To be sold to the II level SPV

II LEVEL SPV

'Institutional II level SPV''

Buys ''ABS (1; 2; ...; n) of I level''

Asset	Liabilities
ABS 1 (I L) ABS 2 (I L) ... ABS n (I L)	Institutional ABS II L

Grade *Senior*
Grade *Mezzanine*
Grade *Junior*

Issues institutional ABS's of II level to fund the investment

'' Institutional ABS of II Level''

Grade *Senior*
Grade *Mezzanine*
Grade *Junior*

Sale to the market of institutional II level ABS (with *primary dealers*)

Market

II level ABS investors

II level ABS investors

K req. = 8%
Standardised Approach

Originator

SPV

Originator

Investor (if bank)

Asset	RW	Capital absorption
100	100%	8
		Tot. **8**

Seniority	Value	Rating
Senior	60	**AAA**
Mezz.	30	**BBB**
Junior	10	**NR**
	Tot. **100**	

Retained (5%)	RW	Capital Absorption
3	20%	0,048
1,5	50%	0,06
0,5	1250%	0,5
Tot. 5		Tot. **0,61**

Sold (95%)	RW95	Capital Absorption
57	20%	0,912
28,5	50%	1,14
9,5	1250%	9,5
Tot. 95		Tot. **11,55**

Re-securitizator (x10)

Purchased ABS	New tranching	Seniority	Rating
1000	600	Senior	**AAA**
	300	Mezz.	**BBB**
	100	Junior	**NR**

Investor (if bank)

RW resecuritisation	Capital absorption
40%	**19,2**
100%	**24**
1250%	**100**
	Tot. **143,2**

Original capital absorption = **80**

Unregulated investor

Capital absorption
0
0
0