There is nothing "simple" about the European Commission's securitisation proposal

Eight years after what was arguably the biggest financial crisis since the 1930s, the European Commission is on the verge of giving up some of the regulatory gains made since. We are referring to that part of the Commission's Capital Markets Union (CMU) that purports to set up a European market for so-called "simple", "transparent" and "standardised" (STS) securitisations. While years of recession and sluggish recovery do of course warrant an urgent search for policies that promise jobs and growth, we are concerned that a new market for STS securitisations is not going to do the trick and may instead run counter to some of the most important lessons of the crisis. For that reason we call upon the honourable Members of European Parliament who are currently preparing their response, to carefully consider the future ramifications of these plans and to launch a more thorough future impact analysis than is now provided.

Our concerns are fourfold.

First, regarding its objectives, it is not clear that reviving securitisation would help SMEs as the European Commission maintains. Even before the crisis the market of securitised SME-loans in Europe was marginal due the opaqueness of these loans. What instead can be expected to receive a boost from the European Commission's proposals are securitised mortgage loans. Sizeable before the crisis, especially in The Netherlands, Spain and the UK, it allowed European banks to tap into international credit markets to allocate credit towards the buying and selling of already existing assets, resulting in real estate bubbles and economic dislocations, as research of the Bank of International Settlements has shown. The current plan portents a post-crisis replay of that pre-crisis scenario. More "financialised" growth, instead of real growth.

We were surprised to see that the Commission does not even concede the possibility of new real estate bubbles. Instead, readers are given data that intend to show that European securitisations performed better during the crisis than US ones and hence should be treated differently in terms of capital requirements. The proposal talks about a "significant reduction" of capital charges, for both buyers and sellers of STS securitisations. That will immediately improve the bottom line of banks but does nothing for growth and jobs.

Second, it is unclear how reviving securitisation would help to diversify risk and make the financial system more stable, as the Commission maintains. The buyers of these securitisations are already heavily interconnected with banks through repo markets and will be even more so through the securitisation channel. The promotion of non-bank credit intermediation, which is the official goal of Capital Markets Union, in fact boils down to a regulatory subsidy for market-based banking and will increase interconnectedness, procyclicality and leverage. This proposal is hence not a break with the pre-crisis world of finance but a re-enactment of it, despite the language it employs.

Which brings us to our third concern. The legal description of the kind of securitisations that would be eligible to receive the STS stamp suggests that these would be anything but "simple", "transparent" or "standardised". Tranching is fully allowed, as are credit enhancements such as credit default swaps, while interest rate swaps are even obliged. All three suggest not simplicity but the same kind of complexity that caught investors as well as regulators off guard before the crisis. No wonder that industry insiders have expressed their bemusement over the level of complexity allowed by a proposal whose headline aim is simplicity, transparency and standardisation.

Our fourth concern deals with one of the main lessons of the crisis, namely that in order to overcome endemic conflicts of interest, originators should be forced to have more skin in the game. The current risk retention paragraph is both too lax and too arbitrage prone. The Commission wants banks to keep five percent of every batch on their balance sheets. This is not enough to meaningfully address conflicts of interest. For that reason, sophisticated buyers demand at least 20 percent skin in the game. The Commission has failed to follow this best practice using the industry argument that it would make transactions too costly, since it would give banks insufficient regulatory capital relief. Given the size of the crisis, we would have expected the Commission to align itself with citizens and their interest in financial stability, not with banks and their preference for higher profits. Similarly, under the current proposal banks can pick the tranches they want to fulfil their risk retention requirements. Again, this smacks of letting profitability concerns prevail over stability considerations.

The European Parliament faces a momentous decision on a highly technical and hence hard to politicise issue that, we fear, is going to be a first step in a longer journey of financial deregulation in which banks will use the leverage they have over policy makers eager for jobs and growth to again get their way. The details of the proposal contain insufficient guarantees to the contrary. Hence our urgent call on the Members of European Parliament to initiate a thorough, independent impact assessment that addresses the sort of concerns we have raised here.

What is at stake is nothing less than the future of Europe. Will it be a future of financial stability, albeit at the cost of some bank profitability? Or will it instead be a future of highly profitable banks again, at the cost of sizeable risks to the taxpayer?

Members of European Parliament, the choice is yours.

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