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Securitisation, credit risk and lending standards revisited

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It is commonly argued that in the run-up to the recent financial crisis, banks selected and securitised loans of relatively lower credit quality. This article reviews new evidence from the euro-denominated corporate loan market which suggests that this presumption does not hold for this market segment in Europe. Banks that were more active in securitisation markets are also not found to offer, all else being equal, lower lending rates to borrowers. Our results complement earlier findings from the US securitisation markets.

Many analysts blame the recent financial crisis on the increased use of securitisation, which, they argue, weakened the credit standards of banks, encouraged them to take excessive risks and, subsequently, pass those risks on to other investors. Two recent studies provide evidence about the role of securitisation in European financial markets, employing a detailed dataset from the syndicated loan market (Kara, Marques-Ibanez and Ongena, 2016a and 2016b). The studies conclude that a more nuanced understanding of the impact of securitisation on banks' incentives is required in order to implement the right type of regulations in these markets.

Securitisation and financial stability

In the decade prior to the recent financial crisis, there was an unprecedented expansion in the use of funded securitisation and other methods of transferring credit risk, such as synthetic securitisation and credit derivatives. Funded securitisation can be broadly defined as the process whereby individual bank loans and other financial assets are bundled together into tradable securities, which are then sold on to investors. The most commonly securitised assets were initially mortgage loans, but in the run-up to the recent financial crisis, more sophisticated forms of securitisation were developed and/or used more frequently. As a result, banks and other corporations were able to securitise large portions of their credit book.

In contrast to the United States, where securitisation has been used for over 50 years, in Europe securitisation has been a relatively recent and sudden phenomenon (see Figure below);^[2] it started very slowly in the late 1990s and developed significantly between 2004 and 2007. Following the start of the financial crisis securitisation issuance almost ground to a halt, and the majority of new issuances have been retained by originating banks.^[3]

The expansion of securitisation has been perceived as a major contributing factor to the 2007-09 financial crisis (Financial Crisis Inquiry Commission, 2011). Broadly speaking, there are two arguments for this claim. First, banks might have had an incentive to securitise loans of lower credit quality, as they tended to have more knowledge than investors about the credit quality of the loans they originate. Second, after securitisation, originating banks probably had fewer incentives to monitor the changing risk profile of borrowers whose loans were passed on to outside investors.

But are these two arguments about securitisation necessarily valid?

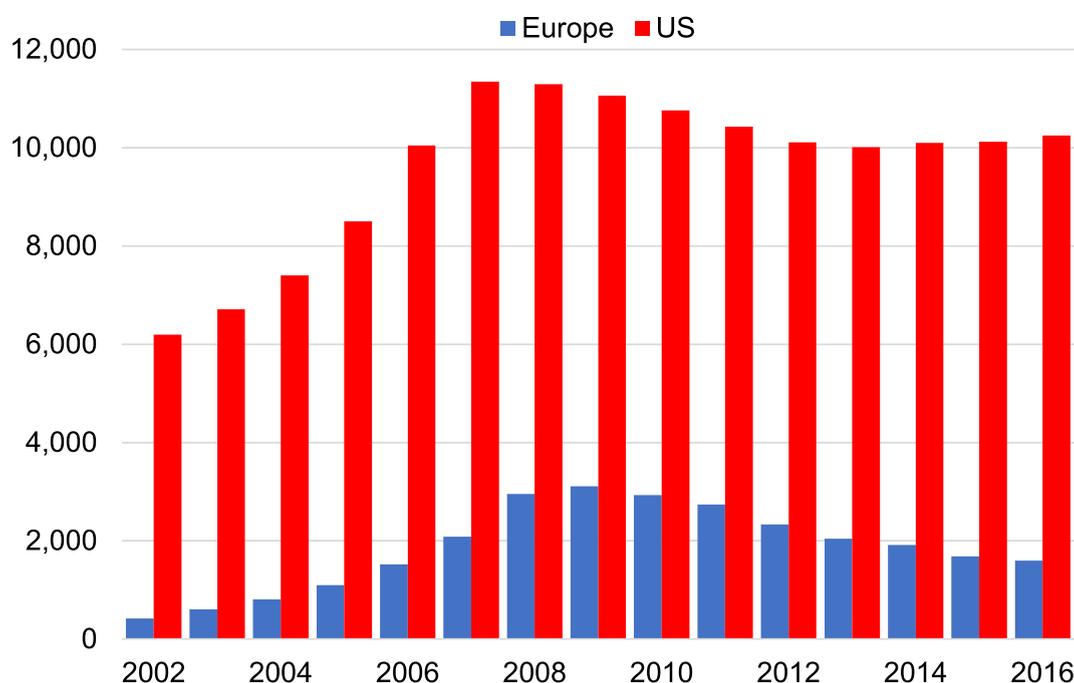
Understanding the validity of these arguments is important as securitisation can produce important benefits: for banks it is an additional tool for effective balance sheet management and there is strong evidence linking securitisation and increases in bank loan supply.^[4] On the other hand, it can lead to moral hazard and adverse selection. This is because banks play a special role in monitoring and screening

borrower risks and this helps mitigating moral hazard between borrowers and lenders. By creating informational “distance” between the loan’s originator and the bearer of the loan’s default risk, securitisation can potentially reduce lenders’ incentives to carefully select, screen, price and monitor borrowers (Gorton and Pennacchi, 1995). In stark contrast, other studies suggest that banks might also have an incentive to securitise those loans of intrinsic better credit risk to signal the quality of the securities (Greenbaum and Thakor, 1987).

In terms of previous research, recent results for the US mortgage market tend to show that banks securitised their ex ante riskiest mortgages and that, following securitisation, delinquency rates were higher for securitised than for non-securitised mortgages. There is also evidence suggesting that banks that resorted more intensively to mortgage securitisation relaxed their lending standards more aggressively (Keys et al., 2011). In contrast, evidence regarding mortgage securitisation for Italy show that for given observable characteristics, securitised mortgages have a lower default probability than non-securitised ones (Albertazzi et al., 2015). For the corporate loan market, evidence from Europe remains scant, and there are contradictory findings for the US (Benmelech et al., 2012; Bord and Santos, 2015).

Figure 1: Securitisation in Europe and the United States

(outstanding figures, USD billions)



Sources: Association for Financial Markets in Europe (AFME) and Securities Industry and Financial Markets Association (SIFMA).

Note: This figure shows developments in amounts outstanding of all funded securitisation issued in Europe and the United States.

Evidence from the euro-denominated syndicated loan market

The euro-denominated corporate loan market provides a good laboratory to complement prior findings on the impact of securitisation on lending standards, as the mentioned sudden emergence of securitisation in Europe may allow for a clear assessment of its effects.^[5] Unlike in the United States, where institutions such as Fannie Mae and Freddie Mac have supported the securitisation market, government-sponsored institutions have not driven the development of the securitisation market in Europe.

Kara, Marques-Ibanez and Ongena (2016a) aim to complement earlier results and test whether, in Europe, banks that were active in the securitisation market priced loans more aggressively through tighter spreads. These authors construct a uniquely detailed dataset in which they manually match individual bank balance sheet information with deal-by-deal securitisation issuance originated by each bank, as well as individual syndicated loans granted by those banks. They then identify the syndicated loans that were eventually

securitised. Overall, the dataset covers 10,911 euro-denominated loan tranches lent by 406 European banks in the period between 2000 and 2009.

The results show that in the run-up to the 2007-09 crisis banks that were more active in originating asset-backed securities did not price their loans more aggressively (i.e. with narrower lending spreads to similar borrowers) than non-active banks. Furthermore, within the set of loans that were previously securitised, the relative level of securitisation activity by the originating bank is not related to narrower lending spreads. The findings therefore suggest that the effect of securitisation on the cost of corporate funding appears to be quite limited *across banks*.

It is important to note that these authors focus on pricing differences of syndicated loans associated with banks' securitisation activity and, their paper does not provide evidence on a "level effect", i.e. a decrease in the overall cost of funding for *all* syndicated loans or other forms of credit. This level effect could be very significant. During credit booms, banks increasingly resorted to additional sources of funding via financial markets – including securitisation, covered bonds or repo deals – which probably led to credit supply increases, higher leverage and declines in lending rates. However, a significant amount of the additional risks created remained within the financial system, either directly or indirectly. In other words, the increase in market funding by banks was possibly making the system more unstable (Hahm, Shin and Shin 2013).

In a subsequent study - also focusing on the European syndicated loan market -, Kara, Marques-Ibanez and Ongena (2016b) compare the future credit performance of securitised loans with that of non-securitised loans which, prior to securitisation, were very similar in terms of their observable characteristics (such as risk, price, maturity, size, etc.). To make this comparison, the probability of loan securitisation is linked to a set of loan, borrower and lender-specific characteristics. They then track changes in the credit quality of loans by using a forward-looking measure of credit risk. The results show that, at the time of issuance of the security and based on observable characteristics, originating banks do not seem to select and securitise corporate loans of lower credit quality. Following securitisation, however, the credit quality of borrowers whose loans are securitised deteriorated by somewhat more than those whose loans were not securitised. While this underperformance could be due to a number of causes, the authors provide some evidence that suggests that the poorer performance of securitised loans might be linked to banks' reduced incentives to monitor securitised loans.

Possible policy implications

It is often argued that banks used securitisation to sell loans of lower credit quality to unsuspecting investors and that the increased use of securitisation was a major factor contributing to the financial crisis, owing to looser credit standards by banks that were more active in securitisation markets.

A complementary picture emerges from the above evidence relating to the European market for securitised corporate loans: banks did not initially securitise their riskier loans, nor did banks that were more active in these securitisation markets loosen their overall credit standards more aggressively than other institutions. There is, however, some evidence of slightly less careful monitoring once the credit risk was passed on to third parties.

From these findings it cannot be concluded that securitisation did not have an impact on financial stability; rather, this evidence calls for a more nuanced understanding of how securitisation affected the incentives of banks. For instance it might well be that during lending booms all types of market funding by banks – including securitisation – exacerbated the credit cycle.

More broadly, understanding the impact of securitisation is also important from a monetary policy perspective as a more vibrant securitisation market, may have contributed to support loan supply in countries with very subdued loan growth. In fact, given this potential for securitisation to positively affect loan supply^[6] and to diversify banks' funding sources, European policymakers have taken steps to revitalise this market (European Central Bank, 2014). These policy initiatives have been buttressed by the positive credit performance of euro-denominated securitisation products in recent years.^[7]

In terms of specific proposals, the above evidence on weaker monitoring from originators for the loans they securitised supports the regulatory move towards increased information regarding loan-by-loan data. Another obvious example would be to standardise the definition of basic variables, such as adopting a common definition of delinquencies in securitisation markets, which can vary significantly across countries. ^[8] Also the new proposed securitisation regulation and simple, transparent and standardised (STS) securitisation would contribute to achieve the right balance between the need to revive the European securitisation markets and the need to avoid financial stability risks.

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^[2]This is partly also due to the wider use of covered bonds in some jurisdictions such as Germany, Spain or France, which often use a similar pool of assets such as mortgages.

^[3]In recent years in Europe there have been asset-backed securities (ABS) created only to be pledged as a collateral at the central bank.

^[4]Loutskina and Strahan (2009) and Altunbas, Gambacorta and Marques-Ibanez (2009).

^[5]Corporate loans are securitized via cash collateralized debt obligations (CDOs). The size of the CDO market is around 10 percent of the outstanding European securitization market which also includes other forms of corporate debt. Net issuance of CLO collateralized loan obligations (CDO using corporate loans as a collateral) was around 35 billion of Europe at its peak in 2006.

^[6]Particularly for some asset classes that cannot be financed via covered bonds, such as SME loans.

^[7]Delinquencies, and eventually losses, in most euro-denominated securitisation instruments have been very low in absolute terms – one exception being commercial real estate – and tend to be significantly lower than in the United States.

^[8]Delinquent loans are those that are more than a certain number of days past due on their regular payments.

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