

Transparency in the European Loan Markets: from words to facts

The ECB is at the forefront of bringing transparency to the European loan markets. First, with the introduction of its loan level initiative for the Asset Backed Securities (ABS) markets and second with its latest project to create a pan-European database for the collection of granular credit and credit risk data.

The path to transparency is an arduous one requiring great efforts for all those involved. In the lines below I will try to describe this path, first by recalling the key steps taken by the ECB in its loan level initiative which is now a reality and second by outlining the future steps that the ECB will take to bring about an European credit register which is currently a work in progress. In both cases, I would emphasise the key benefits that both initiatives bring to better understand risks and opportunities in loan markets.

The ECB ABS loan level initiative: a key breakthrough

In autumn 2008 the financial markets were still reeling from the recent insolvency of Lehman Brothers and the Icelandic Banks. All ABSs were seen as toxic – one of the root causes of the crisis. Even the reputable ABS deals had been tainted and the market was at its low point. One could even say that this perception endured in the collective mind of investors and regulators to a point that even until this day, ABS continue to be a hard sale.

In the ECB, we were well aware of what went wrong with securitisation – excessive lending combined with deterioration in underwriting standards, too much complexity, opaque off balance sheet vehicles, lack of due diligence by investors, and so on. But at the same time we were also convinced that the economic rationale un-

derlying the securitisation technology was sound. If done properly, securitisation should lead to a more efficient allocation of risk, help the provision of credit to the private sector, and ultimately promote economic growth.

It was not the tool itself which was at fault but what the tool was used for. We firmly believed that securitisation had a future even in those more pessimistic times. However, at the same time, the ECB risk management saw with preoccupation how the European ABS market reached almost a complete standstill. Virtually, all primary European ABS issuance was retained by originating banks. A vibrant market with many ABS buyers and sellers gave way to a situation in which the only

absorber of new and old ABS was the ECB through its monetary policy refinancing operations. At its peak, almost 40 per cent of all collateral pledged by Eurosystem counterparties was in the form of ABS. Without doubt the ECB played a very important role as a financial stability shock absorber but at the expense of taking on more risk putting the ECB in a difficult position as a sudden key player in the ABS market.

A clear determination to help the market

It was this very dysfunctional market and the new central role of the ECB in the market that triggered the need to take action. We had a clear determination to help the market to reactivate itself and bring back investor confidence to such important funding channel for credit. There was also a selfish risk management motivation as the Eurosystem needed to have a functional ABS market in case it needed to sell ABS collateral after a default of a counterparty.

Our analysis showed that a key ingredient for bringing back investor confidence was missing. The vast majority of European ABS were opaque, it was not possible to look through the ABS transactions and also to have confidence on the quality of the underlying assets. We pledged to improve the situation by making the case for better and higher transparency standards. However, we recognised then, as we still do today, that better transparency is not the final fix but a necessary element in the restoration of a more normal market. We also recognised early on that the success of the initiative was not only going to depend on setting transparency standards but also on the way the standards would be implemented.

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Es gibt nicht nur das allgemeine Bekenntnis der EZB zur Förderung der Transparenz auf den europäischen Kreditmärkten, sondern es hat in den vergangenen Jahren auch viele konkrete Schritte in diese Richtung gegeben. Ausgehend von dem Zusammenbruch des europäischen ABS-Marktes als Folgewirkung der Finanzkrise schildert der Autor den Erkenntnisprozess und konkrete Maßnahmen der EZB zur Wiederbelebung des ABS-Marktes in den vergangenen Jahren. Als sehr bedeutenden Schritt in diese Richtung wertet er die Schaffung des European Data Warehouse unter Einbeziehung der Branche. Schon dieses Projekt stuft er als strategisch wichtig für das gesamte Eurosystem ein. Die konkreten Überlegungen reichen aber weiter. Schon in Arbeit ist ein pan-europäisches Zentralregister für Kredite, von dem er sich positive Impulse auf viele Bereiche des Finanzmarktes verspricht. (Red.)

Around then an article in the Financial Times from the Executive Board member in charge of risk management at the ECB Jose-Manuel Gonzalez-Paramo was published. This article was significant and had some important repercussions, as it was the first signal from a public body announcing that something had to be done to support this market. It changed the tide. From being touted as toxic market, the trigger of this profound financial crisis, the ABS market was presented as something worth supporting. He pledged that the ECB would do "whatever it can" to support the market and specifically that the ECB would improve disclosure standards in the ABS market working together with market participants.

A public consultation

In early 2009, the ECB began exploratory discussions with rating agencies on the need for loan level data and the possibility of introducing standardised loan level templates and loan information requirements in the ECB collateral eligibility requirements. The information should not only flow to the Eurosystem but also be accessible to the wider market. In that sense, the new eligibility requirements should help rating agencies and market participants to better assess the risk in ABS transactions. The ECB quickly expanded the discussions to investors and originators.

At the end of 2009, we were sufficiently advanced that the ECB's Governing Council gave a green light to the project with the launch of a public consultation. The results of the consultation were beyond expectations revealing strong market support for the project. The ECB Governing Council therefore agreed that the preparatory work should then begin without delay.

During 2010, the templates for RMBS, CMBS and SME were prepared with market participants. From our perspective it was clear very early in the process that this project needed to have a very strong input from the market. A key consideration for us was that the loan level disclosure requirements would need to help market participants in understanding the risks embedded in ABS. So the input of market participants was key and we listened to the wishes and constraints of all sides.

During 2011 we then worked on the other templates, for consumer loans, auto loans and leasing and during 2012 on credit cards. All the ECB templates were shared with the Bank of England who then modified the ECB templates to cater for specific conditions in the UK market. This ensured a fairly high level of harmonisation helping the market to comply with the requirements in both jurisdictions. We are also proud that the pioneering work conducted by the ECB with European market participants is currently used as far away places as Australia where the ECB templates have been also adopted as the basis for local requirements. The US SEC has recently adopted asset or loan level data disclosure requirements looking at the ECB templates as a basis for the introduction of the Dodd-Frank transparency requirements in the US.

Creation of the European Data Warehouse

After going through the motivations for launching the ECB transparency initiative and the creation of the loan level data standards, let me now discuss about the creation of the European Data Warehouse.

Some time midway in the process of creating the loan level data templates, we started to work around the beginning of 2011 on the establishment of a data handling infrastructure to support the transmission and the verification of the loan level data. As I said earlier, we recognised that the success of the initiative was not only going to depend on the introduction of loan level data standards but also on how the transmission and verification of the data was going to be handled. We set a very clear objective: we did not want to have information disclosure for the sake of it but we wanted information that could be trusted, of good quality, data that could help the market conduct a better risk assessment.

This requires a way to conduct some control checks to verify that the required data complies with the standards. Various models were analysed but taking into account the feedback from the technical working groups a unified model was selected as the best solution, acting as a single platform for all various European ABS markets. This would bring harmonisation and equal treatment and more importantly it would

facilitate the submission of the data by the data providers as there would be a single entry point and a single counterparty to control and verify the data.

We also wanted the market to take responsibility in the creation of such a platform, which should also act in the form of a utility, owned by and for the market. With this in mind, the ECB President Trichet published a letter of intent to encourage the broad participation in the Data Warehouse and to raise the fund necessary for its development.

A long-term strategic project for the Eurosystem

Due to the deepening of the financial crisis that started to hit more closely the bottom line of banks and other market participants, it proved more difficult than expected to get sufficient industry participation. But with intensive efforts, also at the highest level, the goal was achieved by the summer of 2012. The shareholders of the European Data Warehouse are some of the most important players in the securitisation industry. Without their leadership and vision the European Data Warehouse would not have been possible.

To finalise let me recall that the whole project – from conception of the idea until the establishment of the Data Warehouse – has been a major effort. Significant time and resources have been dedicated to it by the ECB's Risk Management Office, which has been leading the project since the start. The Eurosystem national central banks have also been playing a very important role both in the technical working groups and in liaising with their counterparties. We were willing to devote resources to this because we saw it as a long-term strategic project for the Eurosystem.

We have faced many obstacles along the way and at times it really looked like the project might fail. But we succeeded against all the odds. Indeed, a rational risk manager back in 2008 might have calculated the future success of the project as a 99 per cent "tail event". Luckily, the realisation of this particular tail event is for once a happy occasion. But I would not put this down to luck, but to the character of all us who directly participated in this project and fought to make this project a reality, to those who believed that the

market had to be put at a higher level to succeed.

Restoring confidence in the ABS market

The go-live of the Data Warehouse and the start of the loan level requirements in January 2013 has been a major benefit in the still arduous quest for the long-term restoration of the ABS market in Europe. Restoring confidence in the ABS market – restoring its reputation – is a precondition for the return of real end-investors to this sector. To do this, it is therefore necessary to create more transparent, and also simpler, instruments.

On the need for more simple transactions, the Eurosystem has already taken some steps to improve the structures of ABS which it accepts as collateral. The requirement for homogenous granular pools which comply with one of the seven loan level templates which come into force next year will be another step in this direction.

There are around 700 ABS deals which are currently eligible as ECB collateral. This is a very large proportion of the whole ABS market in Europe. Issuers report loan level data for all these transactions in order to maintain eligibility. Investors want eligibility as it increases the liquidity and general attractiveness of their ABS investments. ECB eligibility provides an important "carrot" for ABS originators and issuers to submit their data.

Over time, I would expect that the European Data Warehouse will provide the label of data quality to ABS transactions. If the data for your transaction is in the Data Warehouse, you can be sure that it is of high quality and meets the Eurosystem's requirements in terms of completeness. Actually I hope the positive effect of branding combined with market pressure will be so strong that investors will start to demand that even those deals which are not intended to be ECB eligible will gravitate towards the Data Warehouse over time. The technical infrastructure is already here and the marginal costs of including new transactions are practically zero. Eventually there may be 100 per cent transparency for European ABS.

The European Data Warehouse could also be used for other purposes and other markets. Time will tell, but I believe that this

infrastructure fills an important void in the European context as it provides a common platform for information across jurisdictions, new regulatory initiatives and potentially could serve many markets.

Going forward, the interesting question is how will the ABS market change as the market starts reaping its benefits. What new products or services will be provided by data vendors and other intermediaries? How will the scrutiny of the market increase now that standardised information for all transactions is available? How will the investor base change? Will funding opportunities increase? I am sure that the effects of the new transparency concept will surprise us in many ways.

At the ECB we are already making use of the data. For the first time, the Eurosystem is able to carry out its own risk assessment of ABS collateral in its credit operations which can then be fed into its own pricing models. We can also use the data for benchmarking the appropriate risks control measures for similar types of collateral. The loan level data is also an important tool in the design of new non-standard monetary policies in relation to interventions in structured finance markets. Also we are achieving significant efficiency gains and qualitative improvements in the conduct of our risk management activities.

Furthermore, for the central bank, the availability of such information can also be leveraged more widely, not only for risk management purposes, but also for analysing economic and banking developments in the context of the monetary policy transmission mechanism. It can also be used for assessing risks to financial stability and developing early warning indicators of financial fragility.

Pan-European central credit register

The ECB has committed to create a pan-European database for the collection of granular 'credit and credit risk data'. The data will be collected from the central credit registers (CCRs) operated by the National Central Banks or from other data sources and its implementation is foreseen for the beginning of 2017.

The process of building this needed database for understanding risks of real

economy loans will be difficult and costly. Nevertheless, the benefits will be very important for a more integrated European credit market. The project management team responsible for bringing this database to fruition has already conducted a cost assessment and currently all important stakeholders are being consulted on the merits of the concept. Taking into account the costs and the merits assessment, a proposal will be developed by the ECB around the end of 2014 for decision within the Governing Council of the ECB who will ultimately decide on the set up of the harmonised reporting requirements and the establishment of this European central credit register.

In relation to the benefits that this database would bring about let me just list a few. These mainly relate to benefits to an enhanced management of risks. First, it would support a consistent use of a common definition of default, as default data will be available for all euro area countries following a consistent basis as today each national central credit register has its own default trigger thresholds and deadline requirements. Second, the provision of more risk data could increase the effectiveness and performance of credit risk models enabling better and deeper benchmarking exercises. Third, it will provide more transparency on banks' loan portfolios in terms of composition and their risk characteristics. Fourth, it will provide a view on macro risks developing, for example by spotting sectors for which risks are building up and for which no detailed public information was available before.

An up to date view of risk dynamics

There are a number of areas where the European CCR could benefit from the concept built around the ECB ABS loan level data information. The loan level data templates developed for the ECB ABS loan level initiative can be served as a basis for reporting requirements. This will ensure completeness and granularity of the European CCR attributes. For this to happen, we hope that the final concept, after taking into account the merits assessment, will retain the loan level data requirement, as opposed to requirements based on aggregated borrower by borrower information and that the reporting frequency is high enough to enable an up to date view of risk dynamics.