France introduces securitisation

By François Henrot

SECURITISATION consists of transforming bank loans into negotiable securities. This technique, which appeared in the United States and then in Great Britain and Canada two years ago, has now been introduced in France. It marks a new stage in the transformation of the financing structures of the French economy. That is why the authorities have provided it with a legal framework by creating the concept of a common claims fund (fond commun de créances). The impulse given by the authorities will not, however, be sufficient to ensure its success. The market in securitised loans will not develop unless banks and investors find it to their advantage to meet in it.

Securitisation and financing of the economy

The financing circuits of the French economy have been characterised by three periods over the past 40 years. During the post-war period liquidity for credit-granting was provided by the machinery of rediscounting at the Banque de France.

The reform of the banking system in 1966-67 opened a second phase, that of the transformation of liquid savings into medium- and long-term lending by the branch banks.

The third phase began with the reform of the financial markets started in 1984, which is continuing today with securitisation; it consists of resorting to the money markets in order to provide liquidity for credit and for financing the economy.

Securitisation will make it possible to strengthen the financial markets. The securities issued to represent claims will constitute a new financial product adding to the existing range, already enriched by the negotiable instruments of claim created since 1985.

This product may involve very large amounts of money; the outstanding amount of lending to households was nearly 2,000 billion francs at the end of 1988. Securitisation of part of this outstanding amount will help to stimulate the French financial market by giving it greater weight at European and world level.

Monetary policy will also benefit by the growth in securitisation. This technique will in fact facilitate control of the creation of money, because the transfer of a claim to a non-bank investor destroys the money of which this claim is the counterpart.

The effectiveness of monetary policy operating through the controlling of interest rates will be enhanced: by linking the credit market to the capital market, securitisation reinforces the action of interest rates in the regulation of lending activity.

The monetary authorities appear, however, to fear that the use of securitisation may create, in the banks, a rapidly renewed capacity for short-term lending which is liable to increase the indebtedness of households. That is the explanation of the prohibition, for the time being, against securitising claims whose initial term is less than two years.

The framework of securitisation

The advantages expected from securitisation will materialise only if it develops under conditions of security and economic stability conducive to its permanence. That is the purpose of the legal framework established by the law of 23 December, 1988, creating common claims funds (CCF) and of the implementing decrees.

Securitisation is based on the transfer of ownership to the CCF of the claims held by the transferring institution; these are, therefore, removed from the institution's balance sheet. The CCF itself is defined as a co-ownership, without corporate personality, which issues, in a single operation, units representing the claims acquired.

The CCF units are securities of a new type, similar in some ways to bonds and in other ways to shares. The CCF may, for instance, issue several categories of securities comprising different proportions of principal and interest; such securities are similar to bonds offering several types of coupons.

Investment in CCF units is, however, risky in the same way as investment in shares, because the guarantee still leaves a risk of non-payment and a risk of anticipated redemption. Lastly, certain prerogatives of the shareholders of joint-stock companies are granted to the bearers of CCF units: for instance, the possibility of challenging the auditors.

The minimum amount of the Common Claims Fund unit has been fixed at F10,000. The units cannot be repurchased by the Fund. The claims acquired by the Fund must represent credits of the same nature. A Fund, therefore, chooses either real estate claims or consumer credit claims. The units may not represent either frozen claims or doubtful or disputed claims.

The law also regulates the relations and duties of the "ménage à trois" represented by the transferring institution, the initial debtor and the bearer of units, represented by the Fund's management company.

The transfer of the claims takes place by the mere issuing of a receipt note to the transferor. This contains the name of the Common Claims Fund and the details of the claims transferred.

The transferor remains responsible for the guarantees attaching to the claim. The law expresses concern for protecting the borrower because, while the lender can transfer its claims to a CCF, merely notifying the debtors by an ordinary letter, on the other hand it cannot transfer the collection of the claims to another institution without the express consent of the borrowers to this transfer. The borrowers should, therefore, usually keep the same partner throughout the period of their credit.

Conflicts of interest may arise between the transferor and the Fund's management company; the management company will endeavour to avoid delays in payments, while the transferring institution, being concerned with its corporate image in its customers' eyes, may be tempted to accept rescheduling of the claims all the more readily because it does not bear the cost of this.

Demarcation of the powers of each party is therefore essential and will be provided for by the CCF rules. A real separation between the producer of loans and the investor is considered to be necessary in order to ensure that securitisation shall develop in a proper market and not be confined to a mere merry-go-round operation in which banks remove the claims from their balance sheets in order to place them in the UCITS which they control. That is why the permissions given to buy CCF units are confined by decree to 5% of the UCITS of the issuing institution.

The Commission des Opérations de Bourse (Stock Exchange Operations Commission) (COB), after consulting the Banque de France, gives its prior consent to the establishment or winding-up of a CCF. With regard to the quality of the CCF, COB gives its consent after examining a document drawn up by an authorised body.

These bodies, credit rating agencies, are entrusted with the assessment of the Funds and, together with the auditors, have the duty of watching the operation of the CCFs. Their role is crucial, both in order to ensure the quality of the proposed transactions and to set the valuation standards.

They check, in particular, that the guarantee offered is sufficient to cover the risk of default. Three types of guarantees are accepted: the guaranteeing of the fund by an external body, an insurance company or credit institution, overdimensioning and subordination, consisting of creating specific units which bear the greater part of the risk.

A new tool in the service of the banks

Securitisation ought, first of all, to make it possible to diversify the means of financing of the credit institutions and thus to remedy the lack of liquidity observable on the mortgage market. Securitisation of mortgage loans appears, however, to be difficult at the moment.

In the present state of the money markets a portfolio of mortgage loans to individuals, at a fixed-interest rate and for a long term, would have to produce, in order to be able to be securitised, a yield equal to or greater than 11%. However, the rates applied for the financing of housing are at present between 9 and 10%.

But what seems difficult today may be easier tomorrow, because market conditions evolve. New participants with lower infrastructure costs may also present themselves; in particular, the introduction of freedom of rendering of services on a European scale will enable financial institutions to operate directly from abroad without the expense of setting up local establishments.

Securitisation will allow these participants to concentrate on the selling of credit and to benefit, for securitised lendings, from a good signature quality which will depend only on the quality of their claims and not on their own financial structure. For traditional institutions, securitisation nevertheless already offers opportunities now.

As regards the longest maturities, applying to loans to local authorities, and also medium-term maturities (one to seven years), the refinancing market is too narrow at present. The rates applied to these two types of maturities are high enough to make securitisation attractive.

Securitisation can also be seen to be a very useful balance sheet management tool, first because it makes it possible to obtain a gain in own funds. This is because the removal of claims from the balance sheet is a way of meeting the requirements of the prudential regulations concerning the ratio of own funds.

Here again it would seem that mortgage loans will not be the most attractive candidates for securitisation because the Cooke ratio and the planned European solvency ratio take them into account only to the extent of 50%, unlike short- and medium-term credits, the weighting of which is 100%. But the gain in own funds is not the only benefit to be expected for balance sheet management.

Securitisation will make it possible, when the market has reached a certain size, permanently to adjust interest rate and liquidity matchings by operating on both sides of the balance sheet and not only the liabilities side.

This being so, the question of the cost-benefit balance no longer arises in the same terms: an institution will accept an immediate loss on the transfer of a portfolio of claims if this transfer enables it either to eliminate an interest rate risk or a liquidity risk, whether this risk be latent or actually materialising, or to replenish its capital and speed up the expansion of its activities in a market sector

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which it considers to be more promising or more profitable than the average of its present activities.

Substantial short-term costs coupled with medium-term benefits

A securitisation operation first of all entails entry costs: costs in human resources, acquisition of know-how, costs of adaptation of data processing systems in order to produce the data necessary for the valuation of claims and their automated processing, administrative and accounting costs for the establishment of the information circuits and for meeting the requirements of the checks imposed by law, legal costs, and lastly the costs of working out the various contracts between the parties. Altogether, the costs which will have to be met by each institution in order to enter the securitisation market may be estimated at about ten million francs.

On top of these entry costs there are recurrent costs of five types: the cost of guaranteeing and placing the securities, plus the remuneration of the classification agencies; a possible additional cost of risk cover compared with the cost as recorded or valued in the balance sheet of the credit institution; the additional cost of management of the claims made up into portfolios, which corresponds to the managing body's margin; the extra administrative cost entailed by the operation of the Common Claims Fund (CCF); and, lastly, a novelty premium for the purpose of interesting investors in the product.

In the short term there is every possibility of, at best, the balance of costs and gains breaking even, except for institutions which are in a special situation as regards interest rate risks or which have difficulty in gaining access to the capital market. In the medium term, however, securitisation will lead to rationalisation of the operation of banking activities, because it necessarily involves a precise analysis of the costs of and profits on each operation carried out by the banks.

Risks of default will have to be the subject of a more detailed analysis in order to meet the information requirements of the classification agencies and of investors. It will also be necessary to identify all the interest rate risks. This step is necessary for each institution in order to enable it to determine whether securitisation presents any advantage for it and, if so, in order to ensure that it possesses everything necessary for the utilisation of this technique.

The improvement of its knowledge of costs should reveal the productivity gains to be obtained; it will show, for each institution, the advantage of specialising in the functions in which it has the best capability and of subcontracting the other functions; it will thus lead to an improvement in profitability.

The investors' expectations

The securitisation market will offer a supply (that from the credit institutions) to meet a demand (that from investors). It can operate effectively only if it is to the advantage of the latter to acquire what it is to the advantage of the others to transfer.

Like any new product, the securities issued by the CCFs must assume a position in relation to existing products and offer a comparative advantage which will attract the purchase-investor. The profitability offered by the securities issued by the CCFs must be established not only in relation to production costs but also in relation to market expectations in order to ensure a rapid take-off of securitisation. It has been seen, for instance, how the weakness of the interest rates applied in lending for housing makes a price calculated on the basis of a production cost incompatible with the hierarchy of market rates.

The offerers will furthermore have the advantage of offering products which are sufficiently original to attract investors. The CCFs will be able to offer securities with very long or medium terms, of which there are still only a few on the market. Pension funds, for instance, are interested in long-term products. The flexibility allowed by the legal framework and the various forms of guarantees which can be used give scope for the expression of financial creativity. It does, however, seem necessary that the products offered should be sufficiently simple and easy to analyse, during an initial period, so as to attract the largest possible number of investors.

The market could start its operations by private placement, but there must subsequently be real prospects of subsequent development of a secondary market. That calls for organisation efforts: the creation of stocks of securities ought to increase market liquidity; the appearance of market-makers will also be welcome, especially as securitisation is a new technique; lastly stock exchange listing of certain products might be envisaged.

During an initial period the CCFs' market will probably in fact be confined to institutional investors. This is because the complexity of the product makes access to it by the public difficult. Even if French institutional investors continue to take a wait-and-see attitude, one should not overlook the advantage which securitisation may offer for new categories of investors: foreign banks which wish to include securities representing French claims in their portfolios, firms with structural liquidity surpluses and desirous of benefiting by the yield on these securities.

The investments involved in order to gain entry to the securitisation process are expensive. They are nevertheless essential, because European financial integration demands improvement of the competitiveness of the French financial system. ■

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