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On the replenishment of securitised portfolios and the role of reputation and transparency in the securitisation market

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In a securitisation, a clearly defined and immutable loan portfolio is removed from a bank's balance sheet and converted into marketable securities – that is the general understanding of how securitisation works. However, contrary to this view, the composition of securitised loan portfolios may change during the life of the securities. A new study explains why this is the case and examines the impact of replenishment on the quality of securitised portfolios. Originators' reputation and transparency in the securitisation market are identified as key determinants in the selection of loans used to replenish securitised portfolios.

Securitisation allows banks to bundle illiquid loans and sell them to investors as marketable securities. For banks, this has the advantage to generate new liquidity and, at the same time, free up capital by selling their loans. Investors make their decisions based on the information available on the originator at the time of issuance, the securitisation structure and terms and conditions, and the quality of the securitised loans. However, the latter may change over the life of the securities, for example if the macroeconomic situation changes or the loans used as collateral mature and need to be replaced. In addition, the securitisation market is often perceived by investors as being intransparent.

Securitisation tranches have longer maturities than the underlying loans

Securitisation tranches secured by loans to small and medium-sized enterprises generally have significantly longer maturities than the underlying loans. Accordingly, banks must transfer additional loans to the securitised portfolios after the transaction's closing in order to reinvest borrowers' principal and interest payments. This is referred to as portfolio replenishment. The volume of the loans added after the transaction's closing is sufficiently high to potentially affect the composition and quality of the loan portfolio.

In Fenner et al. (2021) we examine whether banks select loans of lower quality for portfolio replenishment than for the initial securitisation and what role reputation and transparency play in this context. For investors, it is particularly important to understand how banks replenish their securitised portfolios. Although there are contractual arrangements regarding the selection of loans, these still allow banks some leeway. In addition, investors have already made their decision and rating agencies have assigned their security ratings, which can both result in less strict monitoring.

Prerequisites for analysing the replenishment of securitised portfolios

The data used for the analysis are unique in Europe so far, as they provide information on the individual loans contained in the securitised portfolios over the entire life of the securities. This makes the analysis of how banks behave when replenishing securitised portfolios in Europe possible in the first place. The analysis focuses on securitised portfolios which are accepted by the European Central Bank as collateral in credit operations and are secured by loans to small and medium-sized enterprises. Banks often maintain a close relationship with these customers, which allows them to generate information advantages. At the same time, small and medium-sized enterprises do not, for the most part, have external ratings or access to the capital market. Therefore, these enterprises appear intransparent and it is more difficult for securitisation investors to assess their creditworthiness.

Higher defaults on loans used to replenish securitised portfolios

In a first step, various regression analyses are used to compare actual defaults and delinquencies on the loans included in the initial securitised portfolio with those on loans that were subsequently added to replenish the portfolios. The results show that the probability of an actual default is 0.42 percentage points higher and the probability of delinquency is 1.04 percentage points higher for loans added later. There is also evidence to suggest that this is due to banks consciously exploiting their information advantage over securitisation investors and not to other factors, such as a deteriorating business cycle. Loans with a higher estimated probability of default prior to their securitisation are more likely not to have been part of the initial securitised portfolio, but to have been added to the portfolio at a later date.

The impact of reputation and transparency on banks' securitisation behaviour

However, banks for whom establishing a good reputation is worthwhile on account of their regular securitisation activities behave differently. Another factor that has a positive effect on banks' behaviour is the availability of more public information on the securitised portfolios. Under stricter transparency requirements, banks appear to select higher-quality loans to replenish their portfolios, as market participants such as rating agencies or investors may exert a greater disciplining effect. This underscores the high relevance of transparency in the securitisation market and confirms existing results in the literature (Ertan et al., 2017; Klein et al., 2021). Finally, it should be noted that the results are robust based on the underlying European dataset and different model specifications. However, this does not mean that all banks exploit their information advantages when replenishing their portfolios. Nor do the results show a clear picture for German banks alone.

Conclusion

Loans used to replenish securitised portfolios have higher defaults and delinquencies than those that are part of the initial portfolios. There is some evidence to suggest that this could be due to banks consciously exploiting their information advantage over investors. However, banks' reputation and greater transparency in the securitisation market can mitigate this behaviour. Given the numerous advantages of having a functioning and sustainable securitisation market, the results of the analysis suggest the need for mandatory disclosure requirements that have already been implemented for certain portfolios in the securitisation framework published in December 2017.

References

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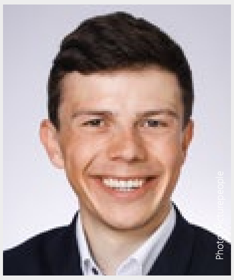

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Publications

"A Structural Investigation of Quantitative Easing" by Felix Strobel (Deutsche Bundesbank), Gregor Boehl (Universität Bonn) and Gavin Goy (De Nederlandsche Bank) will be published in the *Review of Economics and Statistics*.

"Labor adjustment and productivity in the OECD" by Andrea Gazzani (Banca d'Italia), Maarten Dossche (Eurpean Central Bank) and Vivien Lewis (Deutsche Bundesbank) will be published in the *Review of Economic Dynamics.*

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