Securitisation in BRICS: Issues, challenges and prospects

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ABSTRACT

While there is no doubt that securitisation contributed to the 2007-9 global financial crisis (GFC), it remains a very viable and flexible financing tool especially for developing and emerging markets. Focusing on the BRICS (Brazil, Russia, India, China and South Africa), this paper examines the issues, challenges and prospects of securitisation in these economies. Although the challenges such as the need for more robust and effective regulation, limited size and development of their financial markets remain, we argue that securitisation should be properly explored and utilised to address the funding gaps in developing and emerging markets. Possibly learning from the experiences of the Developed economies (for instance USA and UK) during the GFC, the BRICS seem to be developing a more prudential and stringent regulation of their securitisation markets. If this is properly applied, such as the increased Minimum Risk Requirement (MMR), securitisation might turn to be a tool not only for financing but also a key one for the development and expansion of their financial markets.

1. Introduction

Since the global financial crisis (GFC) 2007–09, the global securitisation markets have experienced a downturn not only in developed economies such as USA and UK but also in emerging markets that were witnessing an evolving trend in securitisation practice (IOSCO, 2012). Although securitisation has been identified as a key trigger of the GFC (Turner, 2009), it is still a valuable financing technique if properly regulated and utilised. It started in the BRICS countries (Brazil, Russia, India, China and South Africa) from about 2004 but was largely stopped or temporarily halted during to the GFC. With the perceived end of the GFC, securitisation was restarted across the BRICS but has not witnessed a reasonable growth or utilisation as was the case in developed economies before the GFC. Nevertheless, given their high development financing needs, securitisation provides a huge financing opportunity yet to be properly utilised. As securitisation has remained limitedly utilised in these emerging economies (with the exception of China) despite their inherent financing needs, a critical examination of the issues, challenges and prospects of securitisation in these economies is pertinent. It needs to be clarified that even outside BRICS, securitisation has remained moribund in many developed financial markets. Much of the post-2008 securitisation activity in the US for instance is due to public subsidies and the situation is even more alarming in the EU. Restarting the securitisation market (and more broadly capital market-based funding channels) is in fact at the heart of recent EU policy initiatives (EU Commission, 2015). The stagnation is said to depend on a number of reasons chiefly identified with investors’ stigma, and with the perceived stiffness of post-crisis regulation (in particular the regulatory capital regime in force since January 2014, which brought changes to the risk retention rules, see Directive 2013/36/EU CRDIV).

This paper has two aims. First is to draw from the securitisation experience in developed economies to critically evaluate the
challenges of using securitisation in BRICS countries. Second is to provide suggestions on how a better securitisation market can be created in the BRICS and other developing economies through effective regulation. The remaining parts of the paper will proceed as follows: In addition to providing an overview of the rationale and development of securitisation, section two will examine the benefits and drawbacks of securitisation. In section three, the development and state of the securitisation market in each of the BRICS countries is examined. Section four analyses the challenges of creating and sustaining a well-functioning securitisation market in the BRICS countries. It will mainly focus on the problem of how the regulators determine a proper percentage or approach for the minimum risk retention (MRR) requirement and how the limited size and development of the financial sector of the BRICS might constrain their securitisation market. Section five examines the prospects of the securitisation in BRICS countries by drawing on the experiences in USA and UK. With a critical examination of the risks and benefits, it will analyse the possibilities for securitisation market to succeed notwithstanding the challenges emerged in the aftermath of the GFC. Section six is the conclusion.

2. Overview of securitisation

In the years preceding the GFC, securitisation activities grew enormously, both among corporations and government entities which had traditionally sought ways to minimise funding and liquidity problems, and more topically among financial institutions. For these entities, securitisation became an essential tool to optimise the outlook of their balance sheet and in particular to manage their regulatory capital. This was largely a consequence of the capital adequacy regulation under the Basel Accords (I and II) which prompted banks to manage the process of risk accumulation by inter alia engaging in the originate-and-distribute model (Arner 2009). By moving assets off-balance sheet, banks could originate more loans while at the same time comply with the Basel requirement to hold capital against risk. This model proved to be particularly successful because the securitised bonds marketed and sold by financial institutions were considered highly safe investments (due also to triple-A ratings provided by credit rating agencies) and attracted therefore the appetite of different types of institutional investors. These included other banks and financial institutions active in the wholesale market for funding purposes.

Securitisation traditionally also encompassed the function of turning illiquid assets (such as loans or mortgages) into liquid securities (tradeable bonds). This in turns contributes to deeper, more liquid and diversified financial markets (Criado and Van Rixtel, 2008). From originators’ perspective, securitisation has represented a cheaper and more direct financing channel than traditional bank lending (due to the direct access to the ultimate source of finance, the capital markets, without the intermediation of banks). It has also been more efficient than corporate bonds, because securitised bonds tend to be secured over a pool of specific assets and therefore receive a higher credit rating.

The accounting advantages associated with off-balance sheet techniques came to prominence in unsuspected times, with the wave of corporate scandals between 2001 and 2003. Thanks to securitisation, originators improve their balance sheet because they can originate more assets and move the relating liabilities off-balance sheet, optimising therefore their gearing ratio (at least its appearance) and, as already explained, the regulatory capital.

In the pre-crisis years the securitisation of mortgages, car loans, credit card receivables and other forms of consumer credit allowed a greater access to finance to a number of social groups. On the face of it, this seemed to represent a means to reduce inequality and to increase social mobility, a function that is particularly important in the context of emerging economies. Generally speaking, financial development and financial innovation were considered before 2008 by most mainstream economists to be conducive to economic growth. This was so because Anglo-American-type deep and liquid financial markets were seen as the benchmark of economic development and a diversified financial system was thought to be vital for successful infrastructure projects. This paradigm however has been strongly revisited after 2008 and already as early as 2005 IMF economist Raghuram Rajan raised red flags on the possible dangers of the global financial system, increasingly characterised by long and opaque chains of intermediations and by intermediaries with high-risk appetite (Rajan 2005). It has also been observed by Turner that securitisation, as a process of credit creation, can be the cause of asset bubbles, because it creates – especially in conjunction with low interest rate policies – an elastic supply of money. This however is countered by an inelastic supply of goods, which is particularly true with respect to real estate and housing (Turner 2015). This line of critique is consistent with recent studies that have demonstrated that credit creation and increasing levels of debt in the financial system are not always conducive to financial development and economic growth. This is so because there is little feedback from credit growth to real economy expenditures, which in other words implies a situation of growth-less credit boom (BIS, 2015). Hence the development of asset bubbles, which lead in turn to more inequality and restricted access to some essential goods, most prominently housing (see Picketty, 2014, ch.2).

When discussing the possible advantages of a well-functioning securitisation market, it is worth looking at the functions identified by the EU Commission in its recent proposal for the regulation of Simple Transparent and Standardised Securitisation (EU Commission Proposal, 2015). The Commission in particular identified four functions of the transaction, namely 1) the investment function that allows investing in long-term maturity assets without having to hold them on the books; 2) the funding tool that supports real economy activities by alleviating the maturity mismatch of assets and liabilities; 3) the market-based risk transfer mechanism that disenfranchises banks from the business cycle; 4) the process that generates high-quality collateral that is necessary to support other transactions (EU Commission Proposal, 2015).

As already announced earlier in the article, the market-based intermediation chain based on securitisation has been singled out as one of the major causes of the GFC. In particular, Turner highlighted the problems associated with financial innovation (Turner, 2009) and the resulting transformation of simple securitisation structures into much more complex and opaque transactions, such as synthetic CDOs or CDO squared, which combined the traditional features of securitisation with the application of derivatives (Bavoso, 2013).
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