Relaunching securitisation in the EU

EXECUTIVE SUMMARY

- Securitisation is a financial technique which allows lenders to refinance their loans in the capital markets by turning them into securities.[1]
- Securitisation, well executed, has a number of advantages:
  - Allowing non-bank capital market investors (eg insurance companies and pension funds) to invest directly in sectors of the economy otherwise closed to them;
  - Creating very safe bonds in which risk averse capital market investors can invest their money for the benefit of their stakeholders;
  - Allowing banks and other financial institutions to manage risk and capital on their balance sheet thus contributing to financial resilience.
- In 2019, the STS Securitisation reforms came into force in Europe. They were designed to implement the lessons of the crisis of 2007/2008 in penalising opaque and badly structured securitisations whilst recognising safe one.
- To recognise safe and socially useful securitisations, the STS Regulation created the most detailed and comprehensive securitisation standard in the world – the STS standard.
- Despite the STS Reforms, the European securitisation market (€106bn in 2019) is stagnating at a minimal level.
- A strong and large European securitisation market is vital for the future of the continent. It is needed:
  - To prevent the new Basel rules from contracting available finance for the economy.
  - To power the Capital Markets Union and reduce Europe's dependence on banks.
  - To assist in funding Europe's green ambitions.
- For these to occur, an increase of €235bn in annual issuance would be the smallest meaningful amount.
- A number of key measures need to be taken to make this a reality. These measures are no more, in most cases, than the completion of the STS reforms. They involve drawing the logical conclusions from the creation of such a comprehensive standard into attendant legislation (i.e. incorporate in capital requirement's formulae e.g. floors, p factor, etc., the removal by the STS framework of all the former causes of non-neutrality, the elimination of agency risks and eventually acknowledge the actual performance through the crisis, of EU securitisations, which would have met the STS standards had it then been in existence, that have were never), as well as the equally logical extension of this standard to similar financial tools (synthetic securitisations).
- In practice this would mean
  - Rectifying the CRR and Solvency II capital calibrations.
  - Amending appropriately the LCR eligibility criteria.
  - Extending the STS standard and its benefits to synthetic securitisations.
  - Introducing a simple, streamlined and workable regime for significant credit risk transfer.

Introduction

Securitisation is a financial tool whereby a lender (usually a bank but sometimes an non-bank finance house or a non-financial corporation) is able to refinance a pool of loans by turning them into securities and placing these with capital market investors.

There are a number of advantages to securitisation One is that the investors can take the risk of the assets themselves (e.g, residential mortgages, consumer loans) without taking the risk of the financial institution which originated them. It is a way for capital market investors to invest into direct lending to the economy which would not otherwise be open to them.

Another advantage is that securitisation includes "tranching" where the risk of the securitised assets is bundled into tranches of risk which are more or less risky. Any losses on the securitised assets are first taken by the most junior tranches whereas the investors in the senior tranches are only at risk if losses are greater than a pre-set amount. Properly executed, this enables the creation of very safe bonds and the allocation of different risks to different types of capital market investors depending on their risk appetite.

A further advantage of securitisation is turning illiquid bank type assets into liquid capital market instruments, thereby providing attractive investment opportunities to pension funds, insurance companies and other funds.

Finally, if the securitisation meets certain rules, it allows banks to rebalance their balance sheet by removing risk and freeing up their capital for new lending to the economy.

However, despite the positive potential of securitisation, one of the clearest triggers of the financial crisis of 2007/2008 was the devastation inflicted on the world's financial system by opaque and badly structured securitisation products coming out of the United States. During the first phase of crisis management, the reaction of most European public institutions towards securitisation generally was extremely negative and the regulatory measures proposed for dealing with this finance tool were punitive.

However, as the management of the crisis progressed, data emerged that began to inflect policy makers' views.

First, European securitisations in the basic and simplest asset classes displayed spectacularly good credit performance through the severe economic downturn triggered by both GFC and the subsequent Eurozone crisis. To this day, twelve years on, AAA to single-A rated senior tranches of traditional asset class securitisations in Europe have still not suffered a single euro of loss. This includes securitisations in what became at times highly stressed economies such as Spain, Greece and Italy. It became clear that properly structured transparent securitisations, such as Europe had been issuing, were a safe and resilient financing tool.

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[1] For a very basic introduction to securitisation please see PCS' "Basic Overview" (https://pcsmarket.org/wp-content/uploads/publications/5f1b5/Basic_Overview_.pdf) and the European Commission's press release (https://ec.europa.eu/commission/presscorner/detail/en/MEMO_15_5733).

Secondly, institutions such as the European Central Bank, the Bank of England and the European Banking Authority began to point out that well-structured securitisations could play a very positive role in shifting risk in the financial system in systemically positive ways [2]. Good securitisation could play a role in increasing banking resilience.

Thirdly, a key lesson of the crisis was that Europe was too dependent on banks to finance its economy and it was therefore vital, to ensure future stability and protect European citizens from a repeat of the 2011/2012 crisis, to boost the role and size of the capital markets. Hence the Capital Markets Union project.

All this led the Commission in 2014 to seek to create a differentiated regulatory system for securitisations which, grounded in what was learned during the crisis, could define and identify safe, simple and transparent securitisations. This was done with the explicit aim to increase meaningfully the volume of issuance of such instruments. Such increase would allow the reduction of systemic risk in the European banking system whilst, simultaneously increasing the size of the European capital markets – in line with the CMU project – and avoid the reduction in the financing of the economy that could result from additional capital requirements for banks.

The STS Securitisation Regulation[3], incorporating these policy aims, was passed in December 2017 and came into effect on January 1, 2019, even though some key pieces of secondary legislation did not fall into place until the end of the first quarter of that year.

However, it did not result in the hoped-for increase in issuance. This paper will try to analyse why this may be the case, why this matters and what could be done to improve the situation.

(For obvious reasons, most of the figures and analysis in this paper are from the pre-COVID19 lock down period, so as not to allow the impact of events of an exceptional nature to confuse the analysis. It should also be noted that, so far, the securitisation market is weathering the storm no worse than capital market instruments generally and better than some -including covered bonds – a fact that is relevant, for example, in analysing some proposals in this paper on LCR – as to which more later).

State of play

The STS regime

The STS Regulation created a new European framework for securitisation. This regulation was drafted very much with the lessons of the crisis of 2007/2008 in mind and is designed to prevent any repetition of the weaknesses that were displayed in the US securitisation market. In particular, it:

- Banned re-securitisations;
- Mandatorily imposed the most extensive transparency and disclosure requirements in the world
- Codified extensive due diligence requirements which must be complied with by all European investors
- Created new categories capital market actors (data repositories and third party verification agents) designed to increase the robustness of the European securitisation market and subjected them to regulation to ensure their independence and integrity.
- Set up a severe sanctions' regime for any breaches by market participants of the new rules.

Most innovative of all, European policy makers, advised by the European Banking Authority, created a new regulated definition of "simple, transparent and standardised securitisations" ("STS securitisations"). To meet this new and exacting standard, a securitisation must meet each and everyone of 102 separate criteria. These criteria were designed to capture all the aspects of securitisations which had been an issue during the crisis as well as additional elements deemed by regulators and the legislators to be important aspects of safe and transparent securitisations. This standard is the highest, most comprehensive and most demanding regulatory securitisation standard in the world.

All this was designed to restart a strong but also safe and socially useful securitisation market.

STS is successful, but only on its own terms

Despite misgivings by some stakeholders that the definition of STS securitisations was overcomplex and the Regulation's requirements for data disclosure overburdensome, for securitisations that are able to achieve the standard, it has become the norm.

In 2019, 143 securitisations were notified to ESMA as meeting the STS standard[4]. By 8th April 2020 that number reached 234. Effectively, almost all transactions publicly placed with investors since March 2019 and which may achieve the STS standard have elected to do so[5].

The STS standard is being used extensively and is therefore a workable standard.

Securitisation issuance is stagnating

What the STS regulation has not been able to achieve though is to increase the use of securitisation as a financing channel. Even though this was explicitly the purpose of the Regulation, issuance – in fact – decreased in 2019.

In 2019, issuance of European securitisations placed with investors was €108bn. That is a 10% fall on 2018. In the securitisation of residential mortgages – the backbone of any securitisation market – the numbers are even starker. In the EU27, placed issuance in 2019 fell to €7bn. This is the lowest post-crisis issuance.

Part of that fall was the delay in the passing of key legislative provisions leading to almost no STS securitisation issuance in the first quarter. Disturbances in the sterling market due to Brexit also weighed on UK issuance which is always the largest securitisation jurisdiction in Europe.

If you remove these negative factors though, it would be fair to say that 2019 was a repeat of 2018. With a very few exceptions, in 2019 the same issuers came to market issuing the same transactions as they would have issued if the STS Regulation had not passed. Of new investors there were few signs.

Some of that continues to be the impact of the ECB's monetary policy. But not, by far, all of it. For example, retained securitisation issuance (in other words, securitisations issued solely to be used as collateral for the ECB Eurosystem or the Bank of England's equivalent) in 2019 were down to €97 bn. That is the lowest number in a very long time.

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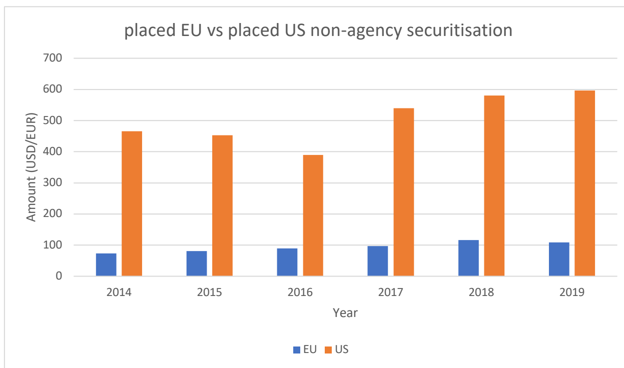
[2] Joint ECB/BoE discussion paper: "the case for a better functioning securitisation in the European Union" (2014) - https://www.bankofengland.co.uk/-/media/boe/files/news/2014/may/case-for-a-better-functioning-securitisation-market-discussion-paper.pdf?la=en&hash=3AC4F391CB45870260134F53BCB67BEE587CC856 and EBA discussion paper: "Simple, standard and transparent securitisations" (2014) - https://eba.europa.eu/sites/default/documents/files/documents/10180/846157/ceefdf3f-58ea-452f-a924-2563410d1705/EBA-DP-2014-02%20Discussion%20Paper%20on%20simple%20standard%20and%20transparent%20securitisations.pdf?retry=1

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=enf.

[4] https://www.esma.europa.eu/policy-activities/securitisation/simple-transparent-and-standardised-sts-securitisation

[5] The one area of exception is UK buy-to-let mortgage transactions for highly technical reasons. The number of transactions retained by banks for use as collateral with ECB which are STS is much lower as a result of the ECB not using the standard in its own rules.

Comparisons with earlier years and with the United States are telling.

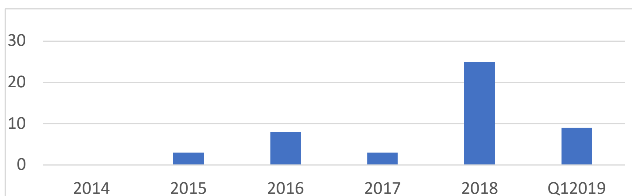


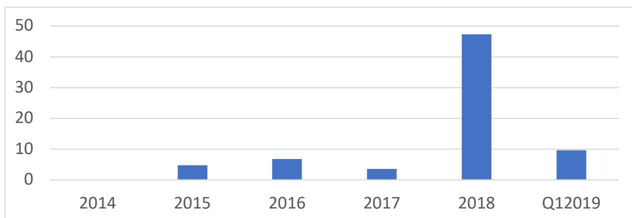
Source: BAML Global Research

Growing importance of SRT

Another key trend in recent years has been the growing importance of securitisations used by European banks to remove risk from their balance sheet and thus free some capital for further lending. Technically, this may be achieved when a bank demonstrates to its prudential regulator that it has met the "significant risk transfer" rules (or "SRT" rules – so that securitisations that meet these rules are called SRT securitisations).

Very rare until a few years ago, recently released EBA data shows a very notable growth in SRT securitisations [6]. This is unsurprising in light of forthcoming changes to the Basel requirements.





SRT Transactions by number (top) and by EUR volume (bottom)

Source: EBA[7]

Growing role of synthetic securitisations

One way to achieve SRT securitisations is to issue "synthetic securitisations". Behind the intimidating name is a fairly simple instrument. Instead of relying on a sale by the financial institution of its assets to a vehicle that issues securitisation bonds, in a synthetic securitisation, the financial institution insures those assets against credit losses. Once properly insured, these assets do not require capital to be held by the financial institution since, in cases of loss, the loss is covered by the insuring investor.

A key aspect of synthetic securitisations though is that they are, legally, "securitisations" and are therefore subject to the European regulations on securitisations, including the rules on Basel capital requirements. As a result, they are also strongly negatively impacted by the newly introduced capital requirements. This has resulted, in some cases, in transactions which can no longer be made to work as capital freeing tools or, in most other cases, in transactions with much reduced benefits in terms of the amount of capital becoming available for additional lending.

Acknowledging the importance of synthetic securitisations, the co-legislators allowed de facto STS status to certain SME synthetic[8] securitisation and requested the Commission to investigate the extension of the STS category to synthetic securitisations generally[9].

Conclusion

Despite the passing of the STS Regulation, European securitisation is stagnating at historically low levels. This is despite the increased use of securitisation for SRT purposes both via traditional securitisation and synthetic securitisation.

We should now examine why this is and why this matters.

There are three main reasons why reviving the European securitisation market is urgent and vital for the well-being of the European economy and the fulfilment of Europe's global ambitions.

Basel implementation

According to the EBA, the coming implementation of the Basel capital requirements will require European banks to raise their capital by 25% on average and 28.5% for systemically important institutions.[10]

Should European banks merely want to maintain the same level of financing to the economy, these rules will require European banks to "find" €100bn of additional capital.[11] Any additional lending – to fund additional growth or ambitious projects such as those envisaged in the Green Deal – will require even more capital to be raised.

Bank capital can be found in one of two ways. A bank can raise additional cash in the form of shares or other instruments meeting the regulatory definition of capital. A bank can also remove risk from its balance sheet so that capital allocated to that risk is now free to be used for new lending. This is what SRT securitisation can do.

Raising new cash for capital in a minimum amount of €100bn – just to stand still – when banks' profitability is stagnating or falling is a challenge containing many uncertainties and risks for the European economy. There are good reasons to doubt that it is even feasible.

Therefore, European banks will either have to sell assets or securitise them. And the sale of assets itself will require the assistance of a healthy securitisation market to succeed as many of the funds that buy assets outright themselves fund these purchases in the securitisation market.

To give a sense of the size of the challenge, if we assume that half of the capital EU-27 bank increase is due to residential mortgages and half of that increase is addressed via securitisation, then we

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[6] See page 22 of the EBA's Discussion Paper.

[7] https://eba.europa.eu/sites/default/documents/files/documents/10180/2963923/67358bc9-921d-49ec-86b6-144e90fa97b3/EBA%20Discussion%20Paper%20on%20STS%20syntehtic%20securitisation.pdf?retry=1

[8] Article 270 of the Capital Requirements Regulation (Regulation (EU) 2017/2401)

[9] Article 45.2 STS Regulation (Regulation (EU) 2017/2402)

[10] These numbers do not take into account the short term measures taken by bank regulators in the face of the COVID19 emergency which have artificially reduced the immediate current "point in time" capital shortfall. However, they remain relevant for any long term planning around banking resilience in the European Union.

[11] Figure provided by BAML Global Research.

estimate a need for €800bn of new RMBS issuance over 5-10 years. As mentioned, RMBS issuance for the whole of 2019 was €7bn.

It is also worth noting that this is not only a challenge for the large international universal banks that operate in Europe but for the whole banking system, including the smaller regional lending institutions that dot the European landscape.

It is sometimes argued that Basel is an international agreement applicable to all nations and therefore designed to create a "level playing field". So, in this context, we should point out that these challenges are nowhere as relevant to the United States. By excluding all their small regional banks from the Basel accords, the US have shielded the small lenders that play such an important role in Europe. By effectively nationalising the mortgage market via institutions such as Fanny Mae and Freddy Mac, the US has provided a state-sponsored and state-backed means for all banks to manage their capital with enormous flexibility. This has allowed the United States the luxury to take very strong positions on Basel in the knowledge that these did not affect their own banking system's lending envelope. Adding to this the much more developed capital market in the US, it becomes clear that Europe's challenges are very different, and Europe's solutions will need to be its own.

Capital Markets Union

Set up under the previous Commission in response to the crisis of 2008/2009, the Capital Markets Union project retains all of its importance and validity today, and even more so in the context of Brexit.

Whereas around 70% of the financing of the economy in the United States is derived from capital markets and 30% from banks, the proportions in the EU are basically reversed.

This creates a number of problems for Europe:

- An over-reliance on banks which makes any crisis in the banking sector almost immediately systemic;
- An over-reliance on banks which creates an artificial ceiling to the amount of financing the European economy may source – namely the amount of capital banks can raise. In other words, if banks find it difficult or expensive to raise capital, necessary lending to the economy may not materialise;
- A hurdle in moving away from Europe's over-reliance on banks as new entrants to the lending business (including fintech houses) rely on capital markets to grow.
- An absence of channels for European savers that provide safe yet decent returns on investments – a problem likely to become ever more acute as the population ages and pensions become a key issue.

There are many causes to the much greater role of capital markets in financing growth in the United States, but one of them is the difference between an EU27 securitisation market that currently stands at US$450bn and a comparable US market that stands at US$2,558bn in 2019. And this comparison excludes all the US state-guaranteed mortgage securitisations which accounts for a staggering US$7,000 bn of additional funding to the US economy. Even if only half of the mortgages currently funded in the US through state sponsored securitisations were to be funded by the private securitisation market, Europe's 450bn market would be set against a US$6,000bn US market.

2018	GDP	Private Securitisation		Agency Securitisation	
	bn	bn	%GDP	bn	%GDP
USA (US$)	20,494	2,558	12.5	7,208	35.2
EU27 (EUR)	12,398	450	3.6	0	0
UK (GBP)	2,110	250	11.8	0	0

Source BAML – Global Research

Finally, to those who argue in respect of the CRR and LCR changes that are advocated later in this paper that the aim of revitalising the European securitisation market is to increase non-bank participation and so we should be indifferent to improving the terms of bank participation, we would argue that this is to ignore the reality of markets. Banks are the most obvious "first mover investors" in the European securitisation market. They have continued to be investors during the crisis. Therefore, they can and probably have to be the locomotive that generates the first wave of volume and liquidity. Only once the volume and liquidity builds up will players who have not been participants in this market for over a decade start to come back.

One should stress also that in addition to capital relief opportunities, securitisation provides banks with a day-to-day tool for diversifying their risk portfolio and optimising their risk profile. Indeed, securitisation enables them to address any excessive concentration within their loan portfolio in certain economic areas (real estate, consumer finance, residential mortgages...) or geographies. This should greatly contribute to improving bank resilience in the EU and dampening the consequences of any future asymmetric shock, notably by facilitating cross border private risk sharing.

Green Finance

In addition to funding "business-as-usual", Europe has also set for itself a very ambitious green project. This project will require funding above and beyond what would be expected from traditional growth.

To find this funding, it is essential that no legitimate and safe financing channels be blocked.

One of the conundrums of green finance is that a substantial part of it will be required to fund innovative solutions often from new companies. Much of it will be in the form of green projects which require upfront finance and produce income streams later. These types of financings are often somewhat or completely speculative. As such, it is not always clear that they would be safe investments into which policy makers would want to direct retail savings. The risk profiles of these investments, in particular, do not make them obvious candidates for the savings backing the pensions of European citizens.

However, the definition of a "securitisation" is a financial investment which is "tranched". This means that securitisation is a financing that is uniquely capable of unbundling risk and segregating it in discrete blocks of higher and lower quality. This would allow risk-averse savers to invest solely in the least risky part of a green financing, letting more speculative funds invest in the riskier parts.

This could attract savings that would not otherwise be capable of investing in such green finance.

For example, a company does solar or geo-thermal projects across Europe. At any point in time, that company owns 5 completed income generating projects and 7 projects in development. The projects in development have a high-risk profile, and so the company's own credit score is middling at best and not suitable for conservative investors.

But if, through a securitisation, the company can segregate away from the speculative projects in development the profitable existing income-generating projects and securitise these, it can provide a much safer investment that might now attract pension or insurance money.

In addition, those securitisations of completed projects can, through tranching, unbundle the risk of those projects and potentially create a large senior tranche of AAA or AA risk. This might be 70-75% of the existing project's financing and be of great interest to risk averse European (and extra-European) funds. The less safe tranches can be funded by the same investors who would have funded the company itself.

Through those securitisations, the company can now raise funding to invest in new ESG projects.

This is why securitisation can provide additional and not substitutional funding to the Green Plan.

We have already seen, globally, securitisations of green mortgages, water processing plants, solar panels, clean energy projects and other ESG asset classes.

Also, as we saw above, by allowing banks to extend more finance to the economy – including green projects – even when raising capital is difficult, securitisation also, in a more general but yet important sense, allows banks to mobilise more resources for green initiatives.

Conclusion

Without a deep and safe securitisation market, Europe could face meaningful constraints on the borrowing capacity of its economic actors, a continued over-reliance on banks, a struggle to create a modern fintech sector and an artificial and unnecessary restriction on its capacity to fund its green ambitions.

Taking as a basis the €800bn over say 7 years for Basel capital (see above) being €115bn a year and a rough but conservative amount of €125bn a year for green projects (€50 for green securitisations and €75bn of bank securitisations reducing capital requirements and allowing an additional equivalent of green lending), we conclude that anything below €240bn of new securitisations in the EU27 would fail to unlock the value of the STS reforms. We stress that this is the floor of our hopes should the proper measures be put in place. In 2006, the last year before the crisis, Europe saw €450bn of securitisation issuance in its traditional asset classes.

What can be done?

To understand what can be done, we need to understand why the STS Regulation has not spurred the market.

For a strong but safe market to arise, one needs to have a larger group of issuers and investors able to agree on a mutually attractive price for safe securitisations taking into account any regulatory capital costs and benefits. Currently, that balance cannot be achieved because the capital costs and benefits are not commensurate with the risks of safe STS securitisations and distort the market to a point where it is not attractive for many players. This is particularly obvious when compared to other asset classes such as covered bonds whose admittedly excellent credit performance during the crisis is not better than that of senior STS securitisations.

CRR calibration for banks

The new CRR calibrations have substantially increased the cost for banks to hold securitisations. Even at the floor for STS of 10%, this is more than a 40% increase over earlier requirements. (For non-STS, the floor has more than doubled.) From this point of view, it is clear that – although STS has been rightly presented as a "gold standard" for securitisations – the introduction of this higher standard has, in fact, resulted in a much more severe treatment regulatory-capital wise.

Although many highly mathematical and data abundant arguments are bandied around in this area, the basic flaw of the current calibrations is simple. After the crisis, regulators agreed that risk weights for securitisations should be (much) greater than the risks of the underlying securitised assets because of "agency risk". This expression covers the idea that the very act of securitising creates additional risks[12]. To counter agency risk, the Basel committee introduced to the formulae setting the capital required to hold a securitisation an added number: the p factor.

It is this p factor (together with the arbitrary floors on senior tranches) that accounts for the non-neutrality of the capital requirements – i.e. that the capital requirements of the same pool of assets in securitised form is a multiple of the capital requirement of those assets before they were securitised. By way of example, for the exact same standard mortgage portfolio, the capital is over two and a half times greater when securitised as when on the bank's balance sheet.

At the same time, learning from the crisis, policy makers – together with the regulators – designed the new extremely detailed and comprehensive STS standard. One of the aims of the STS standard was to identify all agency risks and remove them. We would argue that this has been successfully done.

But largely because of an accident of how these changes were sequenced through time, the achievement of the STS criteria – i.e. the removal of all the causes of non-neutrality – was never incorporated in the final CRR formulae.

We need to remedy this error and see through to its logical conclusion the work of the Commission and the Co-Legislators when they created the STS standard.

The calibration bias in securitisation capital for banks can be corrected through reviewing the CRR calibration of the p factor for the SEC-IRBA (art. 259 of the CRR) and of the p factor for SEC-SA (art. 261 of the CRR). We recommend a p factor of no more than 0.25 for STS deals reflecting the elimination of agency risks brought about by the STS standard.

The risk-weight floor should also be recalibrated: at present, senior tranches attract between c. 25% and c. 50% of the total risk-weight although they cover only a minimal share of the risk. For instance, for a typical transaction on residential mortgages with loan-to-value ratios of 80%, the senior tranche would be attracting c. 50% of total risk weights. We should aim at applying the initial 7% RW floor to STS senior tranches and 15% for non-STS, in order to really provide an incentive for the market to focus on the STS regime and reflect both the actual performance through the crisis of those senior tranches of securitisations which would have met the STS standards had it then been in existence.

LCR Eligibility

With the introduction of the STS standard, on 13 July 2018, the Commission published the final text of revisions to the LCR Delegated Act. This amendment did not provide any recognition of the new standard's strength and thoroughness and simply inserted the new standard (STS) in place of the old.

Yet, the new STS standard is more comprehensive than the old LCR eligibility standard– containing over 100 separate criteria. The new STS standard is backed by a new severe sanctions regime. The new standard is framed by new regulated market participants – third party verification agents and data repositories – to reinforce its integrity and transparency. The new standard is an official designation enhancing its market liquidity. And yet, the new standard was granted no benefits whatsoever in the revised LCR rules.

Considering how strict those rules were at the outset, it is difficult to conclude that either (i) they were in fact too lax – even passed at a time of great diffidence toward securitisation or (ii) the STS standard devised after considerable work by the Commission and Co-Legislators really added nothing to the existing rules.

Again, it is essential to complete the reforms of the securitisation framework begun with the creation of an STS criteria and re-classify STS senior tranches to Level 1 or, at worse, 2A and restore the eligibility at a single-A rating level to recognise the resilience and transparency of the new standard.

[12] The most obvious agency risk was the originate-to-distribute model common in the US sub-prime sector where it was rightly perceived that a finance house originating mortgages which would all be swiftly sold would originate worse quality assets. Similarly, lack of transparency was an agency risk.

Solvency II calibrations

A key target for increased investor involvement in securitisation, are insurance undertakings. Here, again Solvency II calibrations display an unjustifiable non-neutrality. This time, the non-neutrality does not arise from an artificial p factor but as an artificial artefact of the division within the legislation of risk assessment into different «modules" using completely different methodologies.

The result of this artificial distinction is that the capital required by an insurer to be set aside for the purchase of a whole pool of mortgages is less than the capital required to purchase via a securitisation only the senior 80% of the risk of the identical pool and considerably less than purchasing the exact same pool in securitised form. This is even though the securitised pool is considerably more liquid than the un-securitised whole loan pool.

In addition, the data on which the original calculations, were based adversely and idiosyncratically affected securitisations compared to other asset classes. Much of the worse effects of this in the original Solvency II calibrations was ameliorated following the STS Regulation, but – as with CRR – to fulfil the purpose of the new STS standard it is necessary to revisit what we believe to be a no-longer justified non-neutrality. This is particularly, but not only, true of the treatment of junior tranches of STS securitisations.

STS for synthetics

On the introduction of the STS Regulation, the CRR was amended so as to allow benefits equivalent to those afforded by STS to certain synthetic securitisation involving SMEs[13]. Also, the European Parliament specifically requested the Commission to produce a report on how the STS regime could be extended to synthetic securitisations [14].

Currently, this report is the subject of a preliminary EBA discussion paper.[15]

As set out above, synthetic securitisations are no more than a form of credit insurance designed, by passing on the risk to a third actor, to remove the requirement for the originating bank to hold capital to cover the transferred risk.[16]

Sometimes, banks choose synthetic securitisations for ease of transaction, but sometimes they have no choice for legal or commercial reasons but to use a synthetic form of securitisation.

The implementation of the new Basel rules will, however, make synthetic securitisations at best much more costly and, at worst, financially impossible.

Using the most favourable approach for banks, the SEC-IRBA approach, the new rules will – in the case of a synthetic securitisation of corporate loans – provides on average 20% less capital reduction and increases the cost of capital reduction by 26%.

Bearing in mind the issues raised earlier about constrained lending, we have asked a major European bank to provide a practical example. They provided us with the figures from an actual synthetic securitisation which they completed for SRT purposes.

Their figures show that, for the same synthetic securitisation of around €2.4bn, the new rules reduce available finance to the economy by €300m. This is €300m that could otherwise be channelled to SMEs or ESG projects.

How unrealistic the new requirements are under the SEC-SA rules, likely to be used by smaller financial institutions, can easily be demonstrated by another calculation. Capital, under the Basel system, is designed to meet "unexpected losses". ("Expected losses" should be met from operating income, obviously.) Yet, under the new rules, a bank would need to insure via a synthetic securitisation THREE times the entire expected AND unexpected losses merely to reduce its capital requirement to the floor of 15%. In other words, if you remove three times over the entire risk for which Basel requires capital, you still are required to maintain capital against that risk. It is difficult to conclude that such a result is anything but absurd and offends against any logic behind the capital requirements regime.

There is no technical, structural or policy reason why the rules of STS cannot provide – with some adaptations – a robust standard for synthetic securitisations. The EBA itself concluded as much in its discussion paper[17] . This should be accelerated so that this tool may be used in sufficient time and with sufficient deliberation, by European bank before the new Basel implementation cliff-edge. Timing is as important here as is the result[18]. Once this is achieved, the same CRR capital requirement benefits should be provided for synthetic STS securitisations. Not to provide such benefits would negate the policy purpose of extending the STS standard but would also be unexplainable from a logical point of view.

A proper and reasonable SRT infrastructure

As we have noted, achieving SRT and capital reduction is a key to the benefits of securitisation. That key, in turn, can unlock the issuance volume to drive the CMU. But this is dependent on a reasonable process and clear rules through which European banks can be confident that their transactions will, if the rules are followed, result in an improvement of their capital use.

There are currently two stumbling blocks to this.

ECB process

For systemic banks, it is the ECB that determines whether SRT is achieved.

Thanks to intensified dialogue with the ECB, some improvements in the process have been recently observed, however, the process continues to lack transparency.

EU banks are currently required to inform the ECB of their intention to execute a significant risk transfer transaction at least 3 months in advance, the ECB has then 3 months to assess the risk transfer before reverting to banks and indicate if it has an objection or not to the recognition of capital relief from the transaction. The ECB can add new conditions to this recognition. However, some of the deal characteristics that the ECB will incorporate in its analysis, such as the thickness of tranches and the market prices of the tranches, typically evolve until closing. As and when the ECB considers that one of the material characteristics of the transaction has changed, it requires a new 3-month period to revise its SRT analysis. Such a requirement is therefore impossible to meet since, for securitisation as for any other type of market transaction, market conditions evolve until the last minute. If they evolve outside of the ECB decreed parameters, the transaction built over many months of negotiations with potential investors has to be cancelled or proceed with no SRT benefit to the bank.

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[13] Art. 270 the Capital Requirements Regulation (Regulation (EU) 2017/2401)

[14] Art. 45.2 STS Regulation (Regulation (EU) 2017/2402)

[15] EBA discussion paper: https://eba.europa.eu/sites/default/documents/files/documents/10180/2963923/67358bc9-921d-49ec-86b6-144e90fa97b3/EBA%20Discussion%20Paper%20on%20STS%20syntehtic%20securitisation.pdf?retry=1

[16] Although banks sometimes complete synthetic securitisations for internal risk management rather than regulatory capital reduction, the great majority are SRT securitisations.

[17] See footnote 15.

[18] We are, of course, aware of the current COVID19 driven discussions around the timing of the Basel revisions. But we were extremely late in moving towards a more appropriate securitisation regime and so, notwithstanding any delay in implementation of the Basel changes, it is important to proceed with all necessary speed with the required amendments.

Admittedly, banks have recently observed some improvements in the SRT process. Notably, efforts to provide banks with feedback within a timeframe consistent with their planning and market constraints have been noted. Also, monthly meetings between some banks and their respective Joint Supervisory Teams (JSTs), mainly focused on SRT notifications, have taken place. JSTs have also sometimes provided explicit feedback on modifications to structural features during the structuring phase of transactions. Finally, accelerated processes have been noted on some repeat cash deals by certain banks.

While these improvements are helpful overall, additional steps are necessary to achieve the right balance of predictability and dialogue so that the market can function effectively:

- Transparency of the ECB methodology applied to assess significant risk transfer transactions and the criteria used. Banks should be able to understand and anticipate an objection from the ECB based on public, objective and stable criteria.
- Changes could be made to the ECB public guidance for the simplification of data requirements (notably for simple transactions) and to achieve greater proportionality of information required to ensure information requests are relevant to SRT assessment objectives.

Finally, a "fast track" process should be put in place for "simple and repeat" transactions, i.e. transactions which do not contain any new or non-standard features, are a repeat of previously approved transactions or, for traditional securitisations only, where 95% of the tranches are placed. These transactions should benefit from a faster assessment process: full documentation would not have to be re-submitted pre-closing and permission to recognise SRT would be deemed granted in the absence of objection pre-closing. In addition, more limited / pro-forma information requirements should be envisaged. For transactions with new or non-standard features, of course, the process would be more extensive.

Articles 244(3) and 245(3) of the CRR provide a mandate to national competent authorities (or the ECB for large banks) to assess whether significant credit risk transfer is justified by a commensurate transfer of credit risk to third parties, for both traditional and synthetic securitisations[19]. However, the wording of these articles is too vague, leaving the ECB and the national competent authorities with an insufficiently defined latitude for interpretation with the ensuing risk of the growth of an additional layer of pre-conditions, beyond the intent of the Co-legislators. This problem is even greater in the absence of the still to be finalised EBA guidelines.

The SRT assessment must therefore be better structured, to prevent individual national competent authorities or the ECB from imposing diverse and inconsistent additional non-legislative rules. Such rules undermine one of the key initial aims of the SRT rules, namely to avoid regulatory arbitrage. They prevent the creation of a European level playing field and the emergence of a fairly standardised securitisation market – especially in the synthetic area. Yet, such standardised markets are key to volumes.

Conclusion

The SRT process should be considered to be a normal day-to-day process of insurance and capital allocation rather, as appears to be currently the case, an exceptional measure requiring individual bespoke analysis by the prudential regulator and involving unpredictable yet unchallengeable additional rules. It needs to move to a rules-based supervised regime consistent across European jurisdictions in the same way as the rest of the CRR framework.

EBA rules

The final shape of the SRT landscape will be created by the EBA rules which are still in drafting.

This paper is not the forum to go into a detailed analysis of the prospective rules, but serious concern has been raised by market stakeholders about the regulatory approach to some specific topic. These concerns have been raised in circumstances where the results of the discussed rules are not only highly deleterious to the hopes of a robust and effective market but also deeply puzzling and, at time, seemingly inexplicable to market observers.

Some of the highly technical areas of concern would be:

- The differing treatment of sequential and pro-rata pay
- The definition of tranche maturity
- The zero pre-payment assumptions
- The use of "excess spread"

It should also be noted that many of these proposed rules are currently being applied by the ECB.

Conclusion

It is essential for the whole future of the European securitisation market that the SRT rules to be published by the EBA, whilst conservative, should be realistic and capable of operation. There is a real concern from market participants and market observers that any positive changes of the types outlined elsewhere in this paper could be totally negated by highly technical but deeply damaging and unnecessarily conservative SRT rules.

Additional measures

In addition to these key five measures, a number of additional steps should be considered.

Simplify / better target ESMA disclosure templates

Originators, sponsors and securitisation special purpose entities (SSPEs) must make available to holders of a securitisation position, competent authorities and, upon request, to potential investors, certain information on the transaction and underlying exposures.

The ESMA templates are extremely granular. Although they have been simplified in January 2019 notably for ABCPs, they continue to apply to both public and private transactions, penalising the private market. Securitisation market participants have faced major difficulties in achieving the new standard because of very substantial additional information required to be made available, beyond long-standing market practices and the requirements of investors and rating agencies. This is particularly pressing for less sophisticated issuers, and in particular for corporates who rely upon private securitisation to finance trade receivables – an important source of funding for the real economy. Achieving complete compliance across all market sectors and asset classes is not achievable as a practical matter, nor necessary as a prudential one.

Disclosure templates should be adapted to various asset classes and unrealistic expectations should be eliminated, based on an open dialogue with market practitioners. Reporting should also be simplified as relates to private transactions, which by construction should not require public disclosure. The currently proposed ESMA templates are often impossible to apply especially to synthetic securitisations.

Re-examine CRR and Solvency II calibrations for non-STS

Twelve years on from the crisis we have acquired considerable additional data both on the performance and behaviour of non-STS securitisations and other asset classes. It would be useful to use this

[18] « By way of derogation from paragraph 2, competent authorities may allow originator institutions to recognise significant credit risk transfer in relation to a securitisation where the originator institution demonstrates in each case that the reduction in own funds requirements which the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties. »

data to see whether a re-calibration of non-STS securitisations or some sub-class of non-STS securitisations would be justified, so as to broaden the whole market in a safe way.

Adopting the STS standard in the ECB rules

Currently the ECB makes no space in its rules – whether with regards to outright purchases or repo collateral eligibility via the Eurosystem – for the STS standard.

This is strange considering that the standard, in addition to embodying the best aspects of securitisation as defined by regulators and policy makers, is a key tool in assisting the recovery of the European market. This recovery is in line with the ECB's own obligations to assist in creating a stable European banking system and could be achieved without taking additional risks on the ECB's balance sheet.

Such adoption need not be achieved by excluding non-STS securitisations but by providing differential treatment for STS and non-STS securitisations within the different ECB programs and collateral frameworks.

CONCLUSION

The STS Regulation and, in particular, the creation of the STS standard, the most detailed and comprehensive securitisation standard in the world, was a necessary and laudable reform introduced by European policy makers. Yet, it has failed in its aim to revive the European securitisation markets.

Those securitisation markets though are vital to avoid a shrinkage of European bank lending in the face of the new Basel capital requirements. It is vital to any successful development of the CMU. It is vital to help in funding the European Green Project.

Revitalising the European securitisation market requires no new initiatives. It requires that the European Union completes the unfinished business that is the STS reforms.

This can be done in practical ways by modifying the CRR and Solvency II capital calibrations to reflect the work on European institutions in creating the STS standard.

It can be done by seeing through the value of this standard in the LCR eligibility rules and the ECB collateral rules.

It can be done by extending logically the STS standard and its capital benefits to synthetic securitisations.

It can be done by creating a streamlined, safe but sensible SRT framework which allows European banks predictably and swiftly to incorporate risk adjustments in their normal business.

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