SECURITISATION: THE INDISPENSABLE REFORM[1]

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1. Introduction

Securitisation is a financial tool whereby a lender (usually a bank but sometimes a 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 capital for new lending to the economy.

However, despite the positive potential of securitisation, one of the triggers of the financial crisis of 2007/2008 was the devastation inflicted on the world's financial system by opaque and badly structured securitisations 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 led policy makers' views to revise their assessment.

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, thirteen 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.

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 desirable 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 Securitisation Regulation[3], incorporating these policy aims, was passed in December 2017 and came into effect on January 1, 2019. It was then amended in 2021 to extend the new STS status to on-balance-sheet securitisations and effect some necessary changes to the treatment of non-performing loan securitisations.[4]

1. This article is an update of an article written in April 2020.
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://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0557&from=EN.

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.

2. State of play

2.1 The STS regime

The Securitisation Regulation created a new European framework. 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 every one 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.

2.2 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.

Since the regime came into force, 535 securitisations have been notified to ESMA as meeting the STS standard.[5] In 2020 alone that number reached 300. Effectively, almost all transactions publicly placed with investors since March 2019, and which may achieve the STS standard have elected to do so.

The STS standard is being used extensively and is therefore a workable standard. However, in line with what we write below, the trend is concerning. After 300 STS transactions notified in 2020, the number so far in 2021 is less than one hundred and it is very unlikely that the rest of the year will make up the shortfall. Even more concerning, of those, less than 40 are public placed securitisations of the type the new STS standard was designed to promote.

2.3 Securitisation issuance is stagnating

What the STS regime 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 – has continued to decrease.

Between 2018 and 2019, European placed issuance fell 10% from €116bn to €108bn. In 2020 that fall just accelerated with issuance of €81.8 only just three quarter of the previous year[6]. Although 2021 looks marginally better, it is most unlikely that it will return to even the depressed numbers of 2019.

In the securitisation of prime residential mortgages – the backbone of any securitisation market – the numbers are even starker. In the EU27, placed issuance in 2019 fell to €6.8bn, to further fall in 2020 to €6.2bn. This is the lowest post-crisis issuance. This can be contrasted with covered bond issuance in both years of around €300bn.

Moving from a purely quantitative analysis to a qualitative one, the post-STS European securitisation market shows no meaningful difference in the identity of the participants than that of the earlier period. Post-2019 is merely a smaller version of pre-2019: the same issuers issuing the same types of securitisation, just in smaller volumes.

As for attracting a large and more diverse investor base, there is no sign. One investor group in particular on which the STS reforms were counting – through changes to Solvency II – were European insurers. Here the data are nothing short of catastrophic. The Joint Committee of the ESA's report on the functioning of the European securitisation market[7], revealed not only that securitisation represented only 2.3% of the overall investment portfolios of European insurers but that STS securitisation, the asset class policy makers explicitly wished to find its way there, was only 2% of that small number, in other words, ***a staggering 0.046% only of total investment.***

Some of the weakness continues to reflect the impact of the ECB's monetary policy and, for 2020, the effect of COVID on lending volumes but comparisons with earlier years and with the United States are telling. Central bank policy in the US has been no less accommodating, nor the economic impact of COVID meaningfully less.

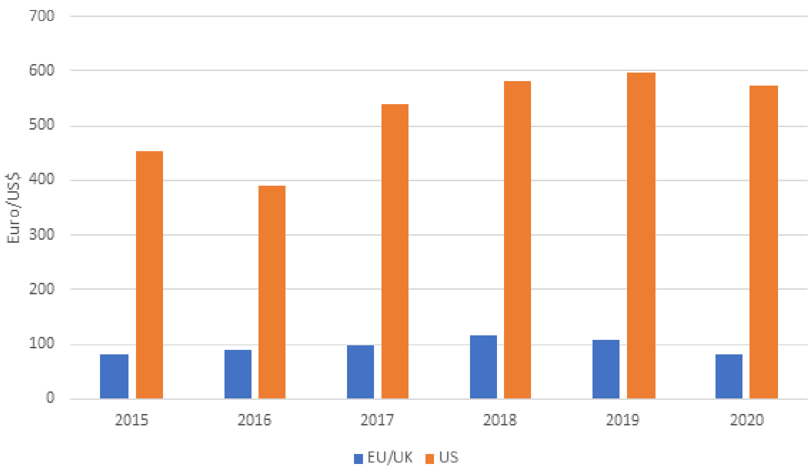
5. As at 24th August 2021, see https://www.esma.europa.eu/policy-activities/securitisation/simple-transparent-and-standardised-sts-securitisation.

6. These numbers include the UK, but the EU only trendline is the same with total 2020 issuance at €62bn.

7. https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1001427/JC%202021%2031%20(JC%20Report%20on%20the%20implementation%20and%20functioning%20of%20the%20Securitisation%20Regulation)%20(1).pdf

CHART 1.

Placed Issuance (Non-Agency)



2.4 Growing importance of SRT

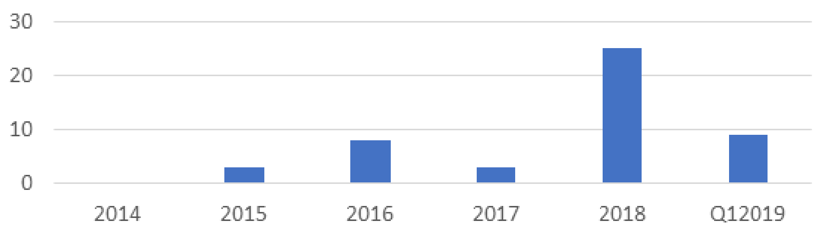
Another key trend in recent years has been the growing importance of securitisations used by European banks to remove risk from their balance sheet and thus free some capital for further lending. Technically, this may be achieved when a bank demonstrates to its prudential regulator that it has met the "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[8]. This is unsurprising in light of forthcoming changes to the Basel requirements.

CHART 2.

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

Source: EBA



2.5 Growing role of synthetic securitisations

One way to achieve SRT securitisations is to issue "synthetic securitisations" (also known as "on-balance-sheet 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 resulted, in some cases, in transactions which could 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 amended both the Securitisation Regulation and the Capital Requirements Regulation to allow synthetic securitisations to achieve STS status and to provide more appropriate capital charges for banks using such securitisations to manage risk and capital.[9]

Conclusion

Despite the passing of the Securitisation 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.

8. See page 22 of the EBA's 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

9. See link in footnote 5

3. 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 as an economy but also as a leader of sustainable development.

3.1 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]

The EBA's figures though only cover the legal bare minimum. In their recent paper[11], the economists at Copenhagen Economics have convincingly analysed the additional capital required by European banks to be in the order of €170bn to €230bn. Put in a different way, this represents €2 to €2.3 trillion in lending.

More concerning yet, these numbers do not take into account any impact of the COVID crisis on losses and the concomitant potential erosion in existing bank capital. A recent IMF paper estimates these could result in the loss of €100bn in bank capital[12].

This would take the capital gap for European banks to €270bn to €330bn.

Banks can confront this capital gap in one or a combination of three ways:

a) Raise capital

A bank can raise additional capital by issuing shares or other capital market instruments meeting the regulatory definition of capital or retaining profits.

Raising new cash for capital in a minimum amount of €170bn to €230bn (or more depending on COVID losses) – just to stand still –is a challenge containing many uncertainties and risks for the European economy. There are good reasons to doubt that it is even feasible.

b) Reduce lending

To the extent a bank cannot raise additional capital – the numerator of the capital formula- it can attack the denominator by reducing the amount of lending it needs to hold that capital against.

Looking at past crisis, Copenhagen Economics in their paper have determined that banks faced with steep capital raising requirements usually meet 30% of that requirement via a reduction in lending.

Based on €170bn to €230bn of capital requirements, this would translate into ***a reduction of €600bn to €700bn in European bank lending.***

Faced with the challenges of keeping the economy on a growth path post-COVID and funding the European Green Plan (of which more later), such a reduction would be catastrophic.

c) Reducing risk

A bank can 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.

This can also be done by selling whole loans. Although sales occur these are, for a number of reasons, unlikely to be sufficient. Additionally, many key potential purchasers of such loans are themselves reliant on securitisation as their financing source. So substantial whole loan sales themselves will depend on a healthy securitisation market.

To give a sense of the size of the challenge, even on the extremely conservative EBA figures, 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 estimate a need for €800bn of new RMBS issuance over 5-10 years. As mentioned, RMBS issuance for the whole of 2020 was €6.2bn.

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.

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..
11. "EU implementation of the final Basel iii standard" (June 2021) https://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/7/567/1623766208/copenhagen-economics_eu-implementation-of-the-final-basel-iii.pdf
12. "COVID-19: How will European Banks Fare?" Aiyar, IMF (March 2021) https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2021/03/24/COVID-19-How-Will-European-Banks-Fare-50214

3.2 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 access – namely the amount of capital banks can raise. In other words, if banks find it difficult or expensive to raise capital, in the absence of a securitisation market, necessary lending to the economy may not materialise (as outlined above);
- A hurdle in moving away from Europe's over-reliance on banks as new entrants to the lending business (including fintech firms) rely on capital markets, especially securitisation, to grow;
- An absence of channels for European savers providing 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 stands at €743bn and a comparable US market that stands at €2420bn in 2020. And this comparison excludes all the US state-guaranteed mortgage securitisations which accounts for a staggering €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 €740bn market would be set against a US$6,000bn US market. Overall securitisation outstandings in the US are ten times those of the EU and represent 45% of GDP compared to 5.7% in the EU.

TABLE 1.

Sources: AFME, World Bank, all amounts in Euros

2021	GDP	Private Securitisation		Agency Securitisation	
	bn	bn	%GDP	bn	%GDP
USA	20,937	2,420	11.5	7,000	33.4
EU27	12,985	743	5.75	0	0
UK	2,307	243	10.5	0	0

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.

3.3 Green Finance

In addition to funding COVID recovery, as well as "business-as-usual", Europe has also set for itself a very ambitious green target. This project will require funding above and beyond what would be expected for traditional growth. The European Commission estimates, in its Sustainable Finance Action Plan[13], that, in addition to public money, there is a yearly €180bn investment gap to achieve EU climate and energy targets by 2030. The Commission also cites the EIB's estimate of an overall yearly investment gap in transport, energy, and resource management infrastructure of €270 bn.

To find this funding, it is essential that no legitimate and safe financing channels be blocked, and that Europe can find ways to mobilise its deep savings pools.

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 those deep savings pools of mainly retail savings. The risk profiles of these investments do not make them obvious candidates for the savings backing the retirements 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. Risk-averse savers could invest solely in the least risky part of a green financing, letting more speculative funds invest in the riskier parts.

13. "Action Plan: Financing Sustainable Growth" (March 2018) https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN

This would enable conservative and risk averse investors (eg insurance companies and pension funds as well as retail funds) to invest in green projects in a safe way.

At the same time, the riskier tranches can be funded by growth funds as well as equity finance houses backing sustainable projects.

Finally, since, the safest tranches of a green securitisation are likely to represent the bulk of the investment, investing in the riskier tranches can provide a multiplier effect for limited public funds. For example, a €500m securitisation of solar panel installations could be split into a €400m senior AAA tranche and a €100m junior tranche. The AAA tranche is attractive to risk averse investors. The €100m tranche could be funded with public money. The entire €500m financing is too risky without tranching for risk averse capital market players, so if it were to be funded by public money, the taxpayer would have to provide the full €500m. By funding only €100m the public purse has created a one to five leverage in its deployable investment. So €500m that would otherwise have funded one solar panel investment can now fund five times that number.

Another key aspect of securitisation is that it bundles together small financings (such as mortgages, auto loans, SME loans, etc…) allowing them to be funded by the capital markets even though each individual loan is too small to attract capital market investors. In turn, many green projects are also very small: the installation of solar panels on a house, the purchase of an electric vehicle, the transformation by an SME of its production cycle. Securitisation is the only financing technique that can mobilise capital market investment pools for such financings by pooling them together.[14]

This is why securitisation can provide additional and not substitutional funding to the Green Plan as well as a leverage effect for limited public funding

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:

- ***€135bn a year representing the very conservative €800bn over say 6 years for Basel capital reduction to help maintain "business as usual" lending (see above);***
- ***€55bn a year for green securitisations representing 20% of the EIB estimated investment gap; and***
- ***an additional €75bn of bank securitisations to further free capital to allow an equivalent level of new and green lending;***

we conclude that anything below €265bn of yearly 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.

4. 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.

4.1 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

14. It has sometimes been argued that covered bonds can also mobilise capital market funding for bundled pools. This, however, is to misunderstand covered bonds. Covered bonds are a direct borrowing by a bank which is cheaper because it is secured. But the investors do not technically become the lenders under the assets nor do they accept the risk of those assets as the bond is a direct obligation of the issuer. In turn the issuer does not remove any of the risks associated with those assets. Covered bonds mobilise capital market funding for banks, not assets.

very act of securitising creates additional risks[15]. 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.

(In conversation with some regulators, we have sometimes heard the contention that maybe not all agency risks had been removed by STS. Although this contention is not always buttressed with examples and often remains vague, the counter remains straightforward: if an agency risk is identified that is not yet addressed in the STS criteria, then the STS criteria should be adapted, so that the p factor can be reduced to an appropriate level rather than maintained, with all the negative consequences this entails, to cover the last minuscule risk factor.).

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). Although we believe that in the absence of identified agency risks, the p factor should logically be set at zero, we acknowledge the conservative approach of regulators and recommend a p factor of no more than 0.25 for STS deals.

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 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.

4.2 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.

Finally, securitisation is the only asset class that has a maturity cap at five years for LCR eligibility. This arbitrary cap does not appear to be backed by any empirical data and fits oddly with the possibility of including a twenty year covered bond in the LCR pools. This maturity cap should be removed.

4.3 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

15. 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.

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.

4.4 STS for synthetics

With the amendments allowing synthetic/on-balance-sheet securitisations to achieve STS, a great step was made towards allowing banks to adjust their risk and capital in a safe, ongoing and pro-active way.

A number of technical standards remain to be published though and it is important that they do not undermine the progress embodied in the new legislation.

This is particularly the case of the technical standard on "synthetic excess spread", where the EBA are required to draft a proposal for its capitalisation under the CRR. Specifically, we encourage the EBA to adopt the approach currently used by the ECB as a prudential regulator when analysing the impact of synthetic excess spread.

4.5 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, very substantial improvements in the process have been implemented, for which the regulator must be given their fair due.

However, the process continues to lack the necessary transparency and ease in key areas.

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.

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.[16] 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,

16. « 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. ».

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 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.

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.

4.6 A level playing field

Issuing a securitisation for a financial institution or purchasing one for an investor is never an absolute decision but a relative one. Both almost always have the option of different instruments and will judge the benefits of choosing one – securitisation – against the other options.

As a result of the GFC and despite vast amounts of data showing the resilience, safety and quality of European STS securitisations, securitisation legislation imposes the heaviest burdens on both securitisation issuers and investors. These burdens fall mainly in two categories. For issuers, disclosure burdens[17] and for investors due diligence burdens[18].

Issuers must disclose an enormous amount of information about the assets and do so on an ongoing basis for as long as the securitisation is outstanding. This information must be disclosed in an extremely prescriptive and granular format mandated by ESMA and must be housed in specific regulated data repositories.

These requirements are costly both in time and IT investment.

Investors must not only perform extensive mandated due diligence but must record this due diligence to be able to demonstrate its execution to their regulators. This due diligence must be performed at regular intervals even when no adverse event has occurred that would justify it.

These requirements are costly in time and IT investment as well as compliance costs.

We are broadly supportive of these requirements but not insofar as they only apply to securitisation and not to other similar assets. In particular, covered bonds, which are asset-based financing instruments are not subject to any such requirements.

The benefits to Europe of a safe and deep securitisation market have been examined in this article. But, so long as it is so much cheaper and easier to issue or buy a covered bond, despite the similar credit performance of senior STS securitisation and covered bonds, securitisation will struggle.

It is therefore crucial that a holistic look at capital market regulation been taken, not with the intention of lowering standards but with the aim of levelling the playing field between instruments of equal risk profiles and complexities.

4.7 Additional measures

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

17. These are broadly found in article 7 of the securitisation regulation.

18. These are broadly found in article 5 of the securitisation regulation.

4.8 Simplify / better target ESMA disclosure templates

Although we are broadly supportive of the securitisation disclosure standards, it remains the case that he ESMA templates are extremely granular. They 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.

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

Thirteen 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 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.

4.10 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.

5. Conclusion

The Securitisation 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 and possible COVID losses. They are vital to any successful development of the CMU. And they are vital to fund 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 thoughtfully levelling the playing field between securitisations and similarly complex instruments with identical risk profiles (especially covered bonds and other asset-based instruments).

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.

We also want to emphasise that these reforms are not only a temporary set of transformations to get Europe over the COVID recovery and Green Plan financing gap. They represent, in our view, the most realistic and indispensable transformation of the European financial architecture to ensure the continent remains economically competitive, mobilises productively the potential locked in its savings pools and achieve a banking system able to adapt its risk and capital profile proactively in a safe manner to be able to finance the economy.

This is what makes it the indispensable reform of Europe's financial architecture.