SECURITISATION: CALIBRATION ISSUES AND FUTURE STEPS

1. After the many legislative and regulatory initiatives in relation to the regulatory framework for securitisation in the European Union, a new impetus is expected in the coming months from the Commission

A regulator noted that many of the risks that were noted before 2006 and 2007 materialised. Efforts have been made in recent years to resurrect the market, which have been successful, so the market is now at a crossroads.

A regulator noted that a new regime has been applicable since 2019. Two legislative changes were adopted in April 2021, one on Simple, Transparent and Standardised (STS) for synthetic securitisations, and one on securitisations for non-performing loans (NPLs). A European Banking Authority (EBA) paper on significant risk transfer was issued in November 2020. The Commission recently launched a 69-question questionnaire. A report to the Council and Parliament is scheduled for the beginning of 2022, with a potential legislative proposal following this. There is a call for advice to the joint committee of the three ESAs. However, market participants are somewhat gloomy or disappointed.

2. Securitisation market participants express a deep disappointment about the number of operations and their size

A regulator noted that disappointment is often expressed when securitisation is discussed, because perhaps the number of operations and the size of operations are not where they were expected to be. However, a lot of progress has been made and the situation may have been worse without these measures.

A regulator noted that there was a significant drop in the issuance of securitisation after the current financial crisis, and an even worse drop after 2011/2012. There was a pickup in issuance in the years 2013 to 2017/2018, but this dropped again and reverted to the mean in 2019 and 2020.

An industry representative stated that a commentary published by the European Stability Mechanism (ESM) indicated that the European securitisation market was 75% of the US securitisation market in 2008, while in 2020, it was only 6%. The new placed issuance in Europe in 2020 was about a ninth of what it was in 2008. For the industry representative's organisation, what goes to investors is what matters when considering the market size: at present, about half of the total issuance tends to go to the investor, with the other half retained by the originator to use in operations with the central bank. STS is a great initiative that has removed some of the stigma. However, there were only around 400 issuers in the last two and a half to three years, of which only a quarter issued STS, and of that only about a seventh or an eighth were first time issuers. And many of the issuers retained the securitisation themselves. In 2010 the European insurers held about 10% of securitisation as part of their assets under management; this number is down to 3% in 2020. This is not surprising, given the complex regulatory framework and the collapse of issuance.

An industry representative stated that the private market has declined as well, especially due to capital constraints and COVID. There is an artificial inflation of STS notifications in asset-backed commercial paper (ABCP) because ABCP have to notify for each part of the transaction. If this is corrected for, instead of 172 notifications for ABCP last year, there were 69 private transactions, versus 86 public deals. The private market is well below the public market and has reduced. Practitioners must decline many good transactions, which have very little risk, because the capital formulas are too harsh.

2.1 The STS regime intended to remove the securitisation stigma has proved to be workable

A regulator stated that the new STS concept represented 30% of the market in its first year and 40% at the end of 2020, which is impressive. The joint committee and the EBA have been reviewing its operation. Most challenges faced by the industry are due to limitations that were either intentionally prescribed by the regulation or could be solved when providing further guidance to interpret the STS criteria. The STS helps to reduce the stigma of securitisation amongst investors. Issuance is picking up and continued to do so even in COVID times, which may indicate resilience. The STS criteria for ABCP appears to be functioning as expected. There is no crowding out of non-STS by STS currently.

2.2 The reasons for a limited success of the STS regime are manifold: a very recent framework, cost and complexity of the STS rules, harsh prudential treatment of securitisation, and cheap liquidity provided by the ECB to EU banks

A policymaker stated that securitisation is a key measure from the first Capital Markets Union (CMU) action plan and remains an important part of the tools needed to make CMU a success. The new framework has not so far reinvigorated the EU securitisation markets in the way the European Commission intended.

A regulator stated that the expected increase in the investor base for the entire EU securitisation market has not been seen. This is most likely related to the density and the complexity of the STS rules, the due diligence and transparency requirements, and the limited benefit in terms of pricing and prudential treatment. The STS level has not been used in practice for ABCP programmes. There is limited experience of supervision of securitisation. The EBA advocates for an extension of the STS level to synthetic securitisation. This has been agreed by the co-legislators. Significant

response for recognition is still very difficult and the rules should be clarified. There are some regulatory constraints that could be removed for the securitisation of NPLs.

An industry representative stated that, although the authorities expected that the STS regulation and the cash reserve ratio (CRR) capital charges would result in a growth of the market, this was an illusion. The decline in the market should have been expected due to the increase in the capital charges. The public market has declined since January 2019 when the new rules came into force. The significant risk transfer (SRT) market is a key market for banks currently to reduce their risk-weighted assets (RWAs) and manage new capital burdens, but the new rules have discouraged and made it more difficult for banks to do SRTs. An SRT is also a key tool to reduce systemic risk, so discouraging this market increases systemic risk.

A policymaker commented that it is difficult to assess fully the impact of the new framework since it has only been in place for a little over two years, including the COVID period. The ECB is still providing a lot of liquidity, so there is a great deal of cheap funding available, which might lead to a reduced incentive to use securitisations.

2.3 The detrimental divergence between the regulatory framework for securitisation in the EU versus the regulatory framework for other comparable asset classes is not justified

An industry representative noted the discrepancy between the established regulatory framework for securitisation and the regulatory framework for other comparable asset classes. This is not justified by data. The impairment rate of European securitisation investment rate is close to zero. The European structured finance downgrade rate is smaller and lower than the downgrade of European covered bonds. The liquidity of European residential mortgage-backed securities (RMBS) is equivalent, and in some cases better, especially for auto asset-backed securities (ABS), than the liquidity of covered bonds. The large discrepancy in regulatory treatment of comparable exposures is one reason why investors and issuers are not coming back to the securitisation market.

2.4 The STS regime does not address the specificities of private-placed issuances where investors were already appropriately protected

An industry representative commented that the regulation has achieved its purpose in the public market. There were excesses in the public market in the past where investors were loading ABS on their balance sheet with little due diligence and relying on the rating agencies. This has been corrected by the regulation. However, the regulation is not fit for purpose in the private market. Full due diligence is carried out when clients in the private markets are financed through ABCP or through warehousing. Private market actors have access to all the data they need, can talk to the company, do their own credit analysis, do not rely on rating agencies and do their own stress testing. The regulation has not provided added protection but instead created new obstacles, such as harsher capital rules and reporting requirements.

3. To review the current framework, the Commission has launched a consultation on the whole spectrum of issues: size of the market, due diligence burden, jurisdictional scope and supervision, possible equivalence regime, contribution of the framework to financing sustainability transition and the post covid EU recovery (NPLs securitisations)

A policymaker indicated that the consultation considers whether the regulation is fit for purpose and if it has improved access to credit, widened the issuer space and revived the European securitisation market. Questions are also asked around due diligence, jurisdictional scope, supervisory issues and the third country dimension. The consultation also touches on disclosure, sustainability issues and environmental performance. There is also a mandate from the Capital Market Recovery Package to consider sustainable securitisation. In that context, the green bond framework that the Commission proposed a few weeks ago is also quite relevant.

A policymaker stated that publication of the report on the consultation is expected at the end of 2021 or the beginning of 2022. In parallel, input from the three ESAs, in particular on capital requirements, is being sought, through a call for advice. Whether legislative changes are needed will be considered subsequently. The previous legislative process around this issue in the Council and Parliament was lengthy and complicated, partly due to the legacy issues from the financial crisis, connected with securitisation. Opening the framework could be a complex process. She confirmed that a holistic approach and level playing field issues should be borne in mind when considering the treatment of different financial products.

3.1 Related capital requirements will also be reconsidered and a call for advice is being issued to the joint committee of the European Supervisory Authorities (ESAs)

A policymaker noted that the capital requirements were a focus area when the current framework was being discussed and negotiated. There is often a focus on banks, but insurance companies are also important players in this area. Capital requirements of securitisation is not at the centre of the Solvency II review. However, if the capital requirements in the banking sector were to be reviewed in the future, the insurance sector should also be considered. In this context, we need to be mindful of the Basel framework. In future, there may be a reason to deviate on this issue, but the justification would need to be carefully considered. In any event, no decision had yet been taken on this matter.

3.2 Making capital charges on insurance companies, liquidity treatment and due diligence obligations proportionate is essential to bring back EU investors to the market

An industry representative stated that the investor base has not expanded. In comparable markets around the world, insurance companies are key participants. Participation of insurance companies is very limited in Europe, partly due to the capital requirements, so a first aspect to consider could be Solvency II recalibration. In many cases, investors' money allocated to securitisation is being managed by asset managers indirectly, because

meeting all the due diligence requirements by direct investors is very complex. It is often not proportionate to the risk involved. The liquidity treatment (lack of comparability) is another concern. There should be a decisive levelling of the regulatory playing field for comparable instruments in Europe. It takes around 60 minutes to place a covered bond and several weeks to place a securitisation bond. If a level playing field is not achieved in all aspects of the issuance and investment process, transparency and due diligence of placements, there will be no meaningful development of the securitisation market in Europe.

An industry representative commented that, if the European securitisation market does not grow, the only way an investor can build a securitisation portfolio is through the broader global markets.

An industry representative stated that the current template requirements on disclosure requirements for private transactions do not work from a cost-benefit perspective. It was initially expected that the templates would only apply to public transactions, because more standardisation is needed for public trade and transferable securities. The European Securities and Markets Authority (ESMA) consulted on that basis, but made a different proposal after that consultation closed, with private transactions also in scope. The templates have now been in use for around a year and most originators agree that they are not appropriate for private transactions. They require a lot of data to be collated, which is expensive and time consuming. For certain asset classes, the granularity and precision of the data can be a breach of confidentiality obligations.

An industry representative stated that in his experience investors do not want or need this additional data. The industry representative's organisation has been producing the templates for around nine months, but only one out of around 50 investors has actually asked to see the templates. The requirements could be slightly relaxed for private transactions, maybe with a comply or explain approach in the templates. Carving private transactions out of the disclosure requirements entirely is the preferred solution. At the same time, it should be clarified that private securitisations are trades that are not publicly offered or publicly distributed.

An industry representative commented that it is difficult to understand why there is such a big difference between securitisation and corporates regulatory treatment under Solvency II, when in the US the respective regulatory capital was realigned. However, the US regulation (NAIC) for insurers was not risk sensitive enough. The new NAIC proposal, which is now being finalised and is going to be implemented soon, makes US securitisation solvency treatment much more risk sensitive, the cliffs are not there and that is very positive.

3.3 To calibrate the capital charges stemming from agency risk appropriately, one should leverage the STS rules and retention obligation added value, and factor in the regulated private markets' specificity

An industry representative stated that capital calibration is very harsh and has been designed in the wake of the financial crisis to address issues such as agency risk. An awareness of the different segments in the market is needed when recalibrating the capital charges. The most extreme example is the SRT market, or a market where the banks are retaining senior tranches of their own assets. In these cases, there is zero agency risk. The banks have full information, so there is no need to have a capital surcharge for SRT transactions and for transactions where the originator senior tranches of its own assets. The public market is at the other extreme, where the risk of agency has been significantly reduced with the new regulation. Retention has greatly improved the alignment of interest between the originators and investors. There may be some scope to reduce the capital charge, but it should be limited in the public market.

An industry representative noted that another segment is the private market whereby banks fund their clients through ABCP and warehousing. Banks involved in this market have more information on the assets than investors in the public markets, because they have direct access to the company and a better understanding of the structure. Indeed, they arrange a structure that is adapted to their risk appetite. The banks design reporting consistent with the way the transaction is structured, so do not need the ESMA templates.

3.4 The actual risk suggests a relaxation of the P-factor and securitisation related bank liquidity rules

An industry representative commented that the p-factor needs to be reduced materially by at least 50% from current non-STS and STS levels with even higher reductions required for SRT transactions. With the implementation of the new Basel rules and the output floor, there could be a significant stop on SRT transactions if these changes are not implemented. Consideration of how to improve demand in the public market is necessary. The liquidity capital ratio (LCR) is extremely restrictive and could be revised. In the private funding market, the credit conversion factor, which is 100% for committed undrawn lines, could be revisited. This is completely unjustified, because for corporates, the CCF is 55%. There are more conditions to draw on a securitisation facility than on a corporate facility. The EBA paper on tranche maturity guidelines was very helpful for the market, but it only addresses public deals and should also cover private deals.

A regulator stated that there has possibly been a collective overshoot in relation to due diligence and the granularity of the data. Feedback from the private sector is useful and evidence on calibration will need to be carefully reviewed, although the STS market segment has only been operational for two years.

3.5 Dramatic reductions of SRT related SSM approval timelines and their test assumptions should also be envisaged.

An industry representative commented that the SRT process is a key issue for banks that need to manage their capital. Despite improvements, there is still a disconnect between these transactions, which have a commercial timeline, and the deadlines requested by the ECB. The EBA paper on SRT has introduced welcome clarity but could stop the market. Some aspects in the proposal are welcomed but some will not work. The market test to show that the transaction

has been priced correctly by the market requiring selling 25% of the senior tranche, compared to the ECB requesting 70% now, is a welcome development. However, some of the tests in this paper, such as the CRT test, have some unrealistic assumptions that the unexpected loss only occurs in the last year.

3.6 Deeply negative impacts of the Basel III output floor on SRT are anticipated and clarifications are urgently needed

An industry representative commented that there is uncertainty around Basel IV output floors and how they will apply to securitisation positions. It is difficult to plan a securitisation now that has a five-year legal life because there is uncertainty about what the capital rules are going to look like in four years' time. The main concern is how output floors are going to apply to synthetic risk transfer trades on advanced portfolios[1]. Under the output floor proposals, capital requirements for a retained securitisation tranche on an advanced basis will be floored at 72.5% (in the end state) of the RWAs calculated for that same tranche under a standardised approach. If a base case of needing to use the SEC-SA approach (standardised approach) is taken, the result is likely at least a factor of three times more capital requirement than required now. If STS cannot be achieved, the requirement is likely to be significantly higher than that. That will mean that a lot of transactions that are in the market now will simply not work.

An industry representative stated that many SRT securitisations are carefully structured to be optimised under an advanced model approach. A standardised approach will always lead to a very high RWA requirement, because the first loss tranche or the sole protection tranche will not be thick enough. It is probably an area where the capital floor does not work very well. One approach to mitigating some of the negative impact may be SEC-ERBA, the external ratings based approach, being available as a different standardised approach. That is counter to the express policy requirement to rely less on external ratings but should be considered. Industry policymakers are encouraged to decide precisely how securitisation will be treated under these capital floors as soon as possible.

3.7 On SRT, beside the legislative process initiated, the EBA could make significant progress in the short term. Regular work between issuing banks and their supervisor should create mutual trust and reduce securitisation cost

A regulator commented that it is comforting that there is agreement that the framework needs to be improved as soon as possible. The openness of the consultation indicates that there is also willingness in the public sector to review the framework. To some extent, good progress is being made. A great deal of progress could take place around SRT in the short term. An even slightly stronger mandate for the EBA to advance the issue would be of benefit. Several things can be done to harmonise SRT and make it work a bit more quickly. Ex ante discussions about those structures are needed between the banks and their supervisors.

A policymaker commented that the interactive process of considering the current framework is positive. However, the energy and effort spent on improvements should not take all the attention away from trying to make the current framework work as well as possible in the current situation.

A regulator added that it is important for banks to understand that they also benefit. Although the excess spread, they will be able to read from a specific transaction may not be exactly the one they would like to benefit from, in the medium to long run repeated use of the same structure and supervisors being more comfortable with that will improve the velocity of the asset.

1. The advanced measurement approach (AMA) In the Basel Framework allows a bank to calculate its regulatory capital charge using internal models, based on internal risk variables and profiles