EU securitisation relaunch: critical political decisions and timing

A public representative stated that securitisation regulation was introduced five years ago, establishing the Simple, Transparent, and Standardised (STS) framework. It now has to be reviewed. It should have been reviewed in the previous January by the Commission, but it was not.

1. Despite the improvements brought about by regulatory improvements, the securitisation market in the EU is not equal to the challenge faced by the banking sector of the €650 billion digital and sustainability transformations investment need

1.1 The EU STS reform reduced the stigma and today securitisation in Europe is perceived as sound

An industry representative stated that the earlier STS reform did not help to develop the market, but it at least helped to smooth out and reduce the stigma to create a safer environment. The regulation has achieved a great deal, with the retention rules, the supervision of ratings agencies and the systematic assessment of the Significant Risk Transfer (SRT) by the competent authority. Psychologically, a change in mindset is about to happen: today securitisation in Europe is sound and has been useful as a tool to transfer risk from banks to educated investors.

An official commented that a very productive framework in Europe has been developed over the past decade to address specific risks stemming from securitisation. Re-securitisation has been prohibited. Risk retention rules have been established to ensure the originator remains exposed to possible losses on the loans being securitised. Disclosure requirements have also been introduced to ensure investors have the information they need to understand the risks they are taking. These safeguards will remain in order to build up trust in securitisation in Europe and to alleviate risks to financial stability. The view of securitisation should be changed. This tool could be used to address the financial needs of the economy, including the green and digital transitions. Securitisation can help free up capital from already very constrained banks' balance sheets and enhance their competitiveness.

1.2 The wall of investment faced by the EU means that the take-off of the EU securitisation market must be accelerated

An official commented that it is urgent that the necessary steps are taken to allow the market to grow to address the wall of investments that is faced. The European Commission has suggested that the additional investments in relation to the green transformation and digital transition will reach around 650 billion per year until 2030, which is not within the capacities of the banking system in Europe or within the supervisors' appetites for banks' balance sheet growth.

1.3 What banks are missing is sufficient regulatory capital, not funding

An industry representative stated that funding is available. However, it is very clear that the banks have ever rising capital constraints and cannot raise all the capital that corresponds to the 650 billion. The only solution is securitisation. The name of securitisation is misleading because it is about risk sharing. Banks need to be able to originate. Banks have the reach, know the companies, and can accommodate the needs of each of their clients. Banks have then to find a way to transfer part of the risk to investors that are eager to take those risks. The current regulation does not allow that kind of bridge.

An expert noted that it is often stated that we [banks] do not issue residential mortgage-backed securities (RMBS) because they have a lot of funding for targeted longer-term refinancing operations (TLTRO) and all the other systems. This is not true. The banks issued €120 billion benchmark covered bonds, which are based on mortgages, while the total issuance of covered bonds in 2020 was €570 billion. This is three times more than the placed and retained issuance of securitisation in Europe, suggesting that there are other factors involved.

A public representative commented that it is correct that risk sharing and raising capital is critical. The banks had a need for that, so it was not that Europeans did not need the capital. Capital was needed in the past years, but covered bonds were chosen.

An expert noted that covered bonds are cheap and easy to issue. The whole system favours the covered bond market. It is often stated that RMBS creates systemic risk with 0.5% of gross domestic product (GDP), where covered bonds have 50% of the European mortgage market.

An industry representative stated that covered bonds do not address the capital issue. In covered bonds, the investor is protected by the mortgage, but the bank keeps all the risk. Standard securitisation is about risk sharing. Covered bonds are not helping banks reduce their risk-weighted assets (RWA). Covered bonds address liquidity, not the capital as needed.

A regulator stated that the securitisation market in Europe is underdeveloped. This is a problem because capital is scarce within the banking sector, and it is becoming even scarcer, because there are more things requiring financing while bank prudential requirements will be tightened in the future. An instrument is required

to enable the banking sector to efficiently use available capital in front of the risk that needs to be retained. The absence of this has been possible up until now for a variety of reasons, including the presence of other refinancing tools, such as covered bonds. Covered bonds only address the very specific issue of refinancing and do not allow the freeing up of capital.

1.4 As a risk sharing tool, securitisation should make an important contribution to deepening the banking union

A regulator commented that banking union progress has stalled due to the choice to make progress as far as possible in terms of risk reduction. Reviving securitisation could adjust the degree of exposure the banking sector has to the risks that stem from the real economy by using private risk-sharing agreements rather than public risk-sharing agreements with the banking sector.

2. Policy makers must answer the question of why, despite the benefits of the STS regulation, the EU securitisation market is a fraction of the size of similar markets in other parts of the world

An expert stated that, in 2008, the European securitisation issuance was 75% of US securitisation issuance. It is currently 6%. There has been a collapse of the European securitisation market. In the US, Australia and China, securitisation issuance is 2-4% of GDP. In Europe, it is 0.5%. Last year, Europe issued €90 billion of securitisation, versus €750-800 billion in the US. A common belief is that this is because the US has agency, but this is incorrect as the figures completely exclude the US agency market. Australia does not have an agency market and still issues significantly more securitisation as a percentage of GDP relative to Europe. STS was needed, but what it contributes is questionable. Of the €90 billion issued last year, non-STS was €60-65 billion. STS is more relevant to political recognition of securitisation than market stimulation. Only €7 billion of the €25-26 billion STS issuance last year was RMBS.

2.1 The cost of securitisation impedes swift development of the market

An expert stated that there are many reasons why banks did not resort to securitisation when capital was needed. First, there was massive support from the monetary system. Secondly, there was a very long period of implementation of the output floor. Securitisation is difficult to do and expensive. It takes one to two hours to syndicate a covered bond. A repeat issue of 20 experience of RMBS will take at least a week. There is very little disclosure for covered bonds. Securitisation disclosure is loan by loan and there is the prospect of having two parallel disclosures under the European Securities and Markets Authority (ESMA) and the European Central Bank (ECB).

2.2 The investors regulatory framework does not help

An expert noted that securitisation holdings in European insurance dropped from 10% in 2010 to 2% in 2020. This is partly because the regulatory capital is incredibly high for insurers. For a deal in the US[?], the aim is for 10-30% participation of insurance companies. In Europe, 2-4% is considered a success. All the issues outlined make securitisation very expensive, which prevents the bank moving the assets to share the risk and reduce the capital. In addition, the velocity of the balance sheet of the European banks and their competitiveness relative to US banks are reduced.

2.3 Fragmented EU financing needs also explain the limited success of securitisation

A regulator commented that regulators should be humble because there are fundamental reasons why the securitisation market in Europe is not as successful as that in the US. These reasons are not always easy for regulation to circumvent. An example in relation to RMBS was provided. In securitisation, the law of large numbers is used to predict the credit risk on a pool of assets. The pool of assets must be homogenous, but mortgages are not homogenous in Europe. These difficulties do not mean that financial regulators should not try to do something.

3. Investors in the EU are eager to invest in securitisation and the multiple tools to share risk with banks

3.1 The various forms of securitisations make it possible to address a wide range of risk appetite specificities of the investors

A public representative noted that there has been a change in the regulation, where synthetic regulation was used.

An industry representative commented that it is helpful to distinguish between true sales securitisation, which has been a flourishing big market and should re-flourish, and balance sheet synthetic securitisation, where the loans stay with the bank. Institutional investors and banks teaming up will be a win-win, because banks have an excellent network, know their clients well and have long-term relationships that we [investors] could never mimic. We [PGGM] is looking to diversify its credit risk as an institutional investor. Securitisation is vital for the European economy to prosper and flourish. Expansion by investors will be possible if good investments are available.

A better term for 'synthetic' is credit risk-sharing transactions. STS rules are very helpful in creating a solid and sustainable market. A significant part of the true sale securitisation is there to also attract the senior funding of a bank. It is a different kind of market. Very often, banks hold the first losses themselves. It is an efficient way to attract liquidity into a bank. The current risk sharing transactions are focused on providing the

capital that banks need. Synthetic securitisation and true sale securitisation are both very important markets. Investments are needed for the transition to help fight climate change. There is technological risk inherent in this. It will be important to spread risks across the banking sector and institutional investors.

3.2 Tailoring securitisation transactions to both the bank's and the investors' needs is necessary, though it makes securitisation a more complex financing tool

An industry representative stated that it is incorrect to believe that securitisation is about taking a loan, putting it into the form of a bond and selling the whole thing. Loans are tailor made for specific clients. When a bank wants to offset or share the risk with investors, it has to consider the needs of the investors. It is not exactly what the borrowers require, so the risk must be changed and cut in another way. It is not possible to take a loan and sell it to somebody else. The originate to distribute (OTD) is not like a bond. Securitisation implies some work on the pool of loans in order to propose tranches with the relevant level of risk, which can be bought by investors, with the rest remaining in the bank, so not everything will be sold. This is more complex. Securitisation will never be simple.

3.3 The stability of the investors regulatory framework regarding securitisation is a prerequisite for investors

An industry representative stated that, for a long-term strategy, a good, solid, and sustainable market is needed. Rules that change all the time discourage banks and investors. Clear rules must be set for these investments, because they are new to many investors. New investors joining the market is a very positive development for credit risk-sharing transactions, but new investors should be supported to interact with the market in the correct way. The last few years have been benign in terms of credit risk, so the risk is that people's standards become looser.

4. Main reasons for the current poor performance of the EU securitisation market and ways forward

4.1 General reasons

An official stated that there are three main reasons for the weak performance of this market in the EU compared to the US. First, there are more attractive sources of financing, for example covered bonds. Second, the prudential framework discourages holding securitisation positions, which is why the investor base has not broadened in the last decade. In particular, insurance companies remain marginal in the European securitisation market. Third, there is a degree of legal uncertainty to be tackled, particularly regarding the SRT test, which creates uncertainty around the ability to obtain prudential deconsolidation. It may be too early to judge the STS regime because the label was extended to synthetic securitisations in 2020 as part of the recovery package.

4.2 A remaining stigma among policy makers, which is driving unnecessarily restrictive regulations, is the possible overarching problem, according to the High-level Expert Group

An industry representative noted that the high-level working group identified five gamechangers. One of these is the overarching problem that there is still a stigma within the authorities. Tone from the top is needed on securitisation in order to smoothen the old restrictions in the regulation and in terms of the way the regulation is implemented by the supervisors. The regulation should be reviewed and implemented with an open mind. Banks are supposed to practice OTD. Banks lend money and then have to distribute. The supervisor does not approve each lending transaction. Similarly, there is no need for constraints and limits when banks are selling part of the risk. It is the normal day-to-day job of banks to originate and distribute. It is a problem if supervision is such that in practice banks can only originate and not distribute.

4.3 Fixing regulation excesses is essential to bring issuers and investors back to the market but also to levelling the playing field among the various bank financing tools

An expert stated that the investors must be brought back in, so the insurers are needed. The opportunity to fix Solvency II is being missed. As there is the synthetic risk transfer and many banks are systemically importing sophisticated banks, the securitisation internal ratings-based approach (SEC-IRBA) and securitisation standardised approach (SEC-SA) must be fixed. The P factor must be fixed. The P factor is a constant input in a formula that increases the capital for securitisation because of a number of issues like agency risk and so on, which do not exist.

An industry representative outlined that bank loans have an associated RWA, because there is a certain level of risk. When the loan is securitised, suddenly the regulatory capital associated with that loan becomes P times the previous figure. The P factor is the multiplier of capital requirements required just because a loan is securitised. Up to a certain level this is acceptable because there is a little more operational risk with securitisation, but it should be 1.2 or 1.3, not two to three times as it is now.

An industry representative commented that STS provides good, standard rules, robust structures and a benefit to the bank. In the original rules, there is a lot of slack in how much capital must be allocated after having securitised. STS already corrects this a bit. It has a lower risk weight for the senior tranche that is kept by the bank, which improves the metrics. This could be further improved. If all the tranches are compared to the original portfolio, it is ridiculous that the amount of additional risk weighting is much higher. That reduces the economic basis for the transaction.

An expert added that the playing field among capital market instruments should be levelled. It is not possible to have 2.7 trillion of mortgages out of 5 trillion into covered bonds, state that this is not systemic risk, and, at the same time, try to revive the RMBS market.

A regulator stated that there is no level playing field between securitisation and covered bonds because covered bonds are very different instruments. Covered bonds are claims on a bank that are secured by the asset, so there is no direct exposure to the underlying assets. Considering whether securitisation, RMBS and covered bonds are treated equally is not necessary. There are legitimate reasons why they are treated differently.

An industry representative commented that the STS rules intended to make the collateral rules clear for investors. Unfortunately, the result is that a straightforward cash deposit with a bank, without collateral, is what STS requires. That is a risk to the investors. To ensure the market is good and stable, it should be collateralised and opened up to repos money market funds (MMF). The money is there and safe in escrow, but not with the bank. Otherwise, in a dire situation, the hedge is lost and the capital is lost because it was on a cash deposit, which is in the bank. This is not logical.

An official stated that the prudential treatment has been dealt with already and there is a great deal to be done. Discussions are ongoing on Solvency II and Basel III. It is obvious that there is an issue. The requirements for private securitisations are too burdensome and redundant. Streamlining these would be welcomed. The EU Commission would need to ask ESMA for an assessment of this.

4.4 One key added value of the STS regime is the mandatory portion of risk retained by the bank, which is intended to reduce moral hazard and ground investors' confidence, particularly regarding less transparent securitisations

An industry representative stated that it is welcomed that STS has a clear rule on risk alignment. The big lesson from the global financial crisis is that the originator, even if it does some OTD, should take ownership and keep risk. There is a 5% risk retention rule generically in the market for securitisation, specifically for credit risk-sharing transactions. True sale transactions is a different market. On credit risk-sharing transactions, we [PGGM] puts money in to cover the bank's losses, but the bank is fully independent. Banks should continue to have responsibility and for a bigger percentage. 20% is in our [PGGM's] mandate and this should be retained as a market to protect the stability of the market. If this project is successful, it will be a structural way for banks to capitalise their lending books in a very cost efficient way. More progress has been made in the EU than the US up to now. Very clear and high-risk alignment measures must be retained, to avoid market players originating to get rid of the risk.

An expert commented that it is necessary to differentiate between black box transactions and transparent transactions.

4.5 The predictability for banks of the effectiveness of the credit risk transfer is an essential area for progress

A regulator acknowledged that the prudential debate is not within the market regulators' remit. There are issues with the parametric treatment of securitisation exposures on the asset side of the banks, but the main issue is the credit risk transfer, meaning the proof that the supervisor requires that the risk of the assets has been transferred to a third party outside the banking group. This frees up capital. However, this credit risk transfer is completely unpredictable. Greater clarity on the expectations of supervisors regarding risk transfers is needed. However, is not possible to have a point beyond which supervisors cannot question risk transfers.

4.6 Further clarity is required regarding EU/Third Country securitisation transactions

A regulator stated that the territorial scope of the regulation in terms of disclosure and transparency requirements should be clarified. This would be a significant help to EU investors in securitisation. Currently, the most likely reading of the regulation is that EU rules should be applied, including for third-country investors and in countries that have their own regime for transparency and disclosure, which does not make any sense.