SECURITISATION IN THE EU

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Securitisation: time to turn the bridge into a viaduct

Securitisation is generally described as a bridge between credit institutions and capital markets, allowing the former to free up lending capacity, diversify their funding mix and reduce their financing costs, while allowing the latter to enlarge investment opportunities with a broad variety of risk-returns profiles. Time has come to help make this bridge a viaduct: keeping its foundations solid and trustworthy while acting to grow its size, up to its full potential.

This fine-tuning is all the more needed in the current context of economic challenges, driven both by the end of central banks' accommodative interest rate policies and accrued financing needs arising from the digital and green transitions. Therefore, maybe now more than ever in the post-GFC era, securitisation has a critical role to play, making it our responsibility as regulators, policymakers and stakeholders to allow and incentivize its unharmed and sustainable development, as a key pillar of the Capital Markets Union.

Indeed, the mechanics of securitisation, when soundly structured, make it a unique tool for financial institutions acting in various roles, which furthermore provides additional benefits for a large array of stakeholders, both businesses and individuals.

As a funding tool, securitisation first allows the diversification of funding sources and as such, can be regarded as an integral part of the capital and liquidity management strategy of credit institutions. Beyond the financing component, the singularity of securitisation lies in its capital reallocation power: operations, for which a Significant Risk Transfer is recognized, allow the originating institutions to free up some capital initially set aside to cover the risks embedded in the securitised exposures, therefore turning into a powerful capital management tool.

Both a refinancing lever and a risk reallocation tool, securitisation is also expected to ultimately benefit the economy as a whole. First, by allowing originating banks to enhance their lending capacity. Second, by contributing to distributing risks across the financial sector, therefore also contributing to the overall stability and resilience of the financial system.

Securitisation has a key role to play to foster digital and green transition in Europe.

While the benefits of well-functioning and soundly structured securitisation markets should not be doubted upon, these should be embedded in a safe and robust regulatory framework to ensure both the high quality of assets and the adequacy of the requirements and supervisory schemes. To that extent, the implementation of the new European framework in 2019 was an important and much welcomed step forward, setting both high-level principles and functional requirements needed to revive the market in a sound and prudent manner, despite the stigma inherited from the GFC turmoil. A few years later, we must nevertheless acknowledge that the European market is still delivering below its potential, which might – to some extent – be due to a lack of risk-sensitiveness in the capital treatment framework but also reflect a lack of attractiveness of securitisation in a prolonged low interest rates environment. At the same time, improving the regulatory environment has never ceased to be a policy priority, as evidenced by the various steps already taken.

Indeed, the new rules were enhanced as soon as spring 2021 with the implementation of the Capital Markets Recovery Package, that resulted in the extension of the STS label to synthetic securitisation, the introduction of preferential risk-weights for senior tranches retained by the originator, and the removal of regulatory obstacles to the securitisation of non-performing exposures. No later than a few months afterwards, the Commission opened a targeted consultation on the functioning of the framework and addressed a Call for Advice to the Joint Committee of the ESAs with regard to the prudential treatment. The resulting report on the functioning of the framework was published in October 2022.

As regards the prudential treatment, the ESAs published their advice by the end of 2022, suggesting – in addition to a set of technical quick fixes – to improve risk sensitivity in the capital treatment by acknowledging the merits of a reduction in model and agency risks associated to originators retaining senior securitisation tranches, should adequate safeguards be met. ACPR supports this reasonable and well-balanced orientation.

Although a more holistic approach should certainly be considered by EU policymakers, the risk-sensitiveness of the framework remains constrained by the Basel standards, that is to say the formula-based approaches that – as underlined by the ESAs conclusion – might prove unsatisfactory in achieving the various goals of the regulation.

Turning the bridge into a viaduct will not succeed without reshaping the cornerstone of the prudential regulation: Basel is the right place to do so, whilst ensuring the level-playing field.

PAUL TANG

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Towards transparent securitisation

Fifteen years after the start of the Great Financial Crisis, financial markets are getting nervous once again. While the underlying causes are radically different, nervousness has been worsened by a similar factor: a lack of transparency. The risks of rising interest rates are not evenly distributed. "Whenever the Fed hits the brakes, someone goes through the windshield," reminded J.P. Morgan's chief economist the New York Times. But we do not know who.

The securitisation market has of course been long seen as a prime example of opaqueness. This was something the Securitisation Regulation helped to address. By establishing a data repository for securitisation transactions, the market has become more transparent. Not just for investors, but also for regulators and interested external parties. All can become aware easily of what transactions are taking place, and what these transactions look like.

During the negotiations, however, a compromise was needed, leading to a differentiation between public transactions, i.e. those that require the issuance of a prospectus, and private transactions. Private transactions did have to collect all relevant data and share it with the investor, but did not need to make this information on the securitisation repository.

With the review of the securitisation regulation approaching, this differentiation will be revisited. This because an increasing size of the securitisation market is in the private segment. While growth in the public part of the securitisation market has been stagnant, there are some indications that private transactions, including synthetic SRT securitisations, are undergoing rapid growth. The mission of the Securitisation Regulation to provide transparency for the entire market might therefore come in peril. Indeed the Commission stated last year that "the number of private STS securitisations has indeed risen considerably since March 2019." However, given the short timeframe and the lack of data on the number of private non-STS transactions, a comprehensive assessment of the market is difficult, according to the Commission.[1]

And this is precisely the problem. Because, as the European Supervisory Authorities write "it is difficult for supervisory authorities to become aware of the issuance of private securitisations if they are not notified and even when competent authorities are notified, it is difficult to access the information relating to a private securitisation, since it is not made available via a securitisation repository".[2] When even regulators are not able to fully assess the size and details of a market with potential financial stability concerns, it hampers our ability to avoid crises, and can worsen nervousness in the market when a crisis comes.

When even regulators cannot fully assess the market, it hampers our ability to avoid crises.

Luckily the market is moving rapidly towards increased transparency. Recently, this drive has been spurred by rise of sustainable finance. The insatiable need of sustainable investors to increase data flows has led to multiple regulatory initiatives that will also touch the securitisation market.

Firstly, the European Green Bonds Regulation provides a framework for issuers of green securitisation using the "European Green Bond" designation to disclose in detail the sustainability performance, not just of their use of the proceeds of the transaction, but also of the underlying assets. These reporting frameworks can be used, not just by issuers using the EuGB designation, but also by those seeking to showcase the green credentials of their bond without adhering to some of the stricter requirements of the Green Bond Regulation, such as the taxonomy-alignment of the use of proceeds.

Secondly, the European Single Access Point (ESAP) will provide a single database for financial information. This clearly sets the standard that financial data in Europe should be public and easily accessible. Any deviations from this rule will come under pressure and will have to be explained. As such, the European Parliament seek to include also data relating to the securitisation regulation in the database. The exact scope of the database is still under discussion, but even if securitisation is not included in the ESAP immediately, in the revision of the securitisation regulation, the issue will be on the table again.

Financial crises are of course not caused by a lack of transparency, but they can very much be made worse by it. The memory of the Great Financial Crisis has slowly ebbed away, at least in my mind, but has flooded back by recent events. It puts the importance of transparency, for supervisors and the market as a whole, back at the centre of discussion. Inevitably, this will shape also the review of the Securitisation Regulation.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0517
[2] https://www.eiopa.europa.eu/system/files/2021-05/jc-2021-31-jc-report-on-the-implementation-and-functioning-of-the-securitisation-regulation.pdf

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Improvements to the securitisation framework

The EBA, EIOPA and ESMA have recently reviewed the state of play of the EU securitisation prudential framework. They reached the conclusion that the capital and liquidity framework per se - albeit demanding - does not constitute a key obstacle to a revival of the EU securitisation market. Other factors beyond the prudential framework should also be considered. This includes a need for increased proportionality of the current transparency and due diligence requirements. The low interest rate environment of recent years also played a role together.

There is however room to improve the prudential rules applying to securitisation. In this spirit the EBA proposes technical adjustments to bring more consistency, clarity, and risk sensitiveness to the banks' capital framework.

A careful reduction of the risk weight floor for originators could be envisaged given that agency and model risks have decreased compared to the early days of securitisation. This would encourage banks to originate resilient securitised instruments to shed and diversify their risks. As there is investor demand for synthetic securitisation (which constitutes the bulk of the Significant Risk Transfer market), this would also help revive the securitisation market, without raising prudential concerns.

On the other hand, a reduction of the capital requirements arising from the "p-factor" was not proposed. Such a change was seen as having the potential of creating cliff effects in the capital requirements and incentives for banks to invest in undercapitalised mezzanine tranches, contrary to revisiting the risk weight formula which would not have such adverse effects.

A better fit of the current shape of the risk weight function to actual distributions of losses and an improved ability to account for non-granular pools could also be envisaged. Changes should in any event preferably be first discussed in the Basel Committee.

Such adjustments matter as securitisation can offer a key risk management tool in the transition to a greener economy.

The EU legislation on the Green Bonds Standard (EU GBS) will create an official standard in the area. As there are not so many taxonomy-aligned assets available yet the EBA recommends aligning with the EU GBS and rely on the use of a securitisation proceeds rather than develop a new approach based on the green credentials of the securitisation's collateral. In the case of securitisation, and generally for any bond issued via a special purpose vehicle, the requirements about use of proceeds should be shifted from the issuer to the originator.

Rules applying to securitisation can be improved - also to support the green transition.

Focusing on the use of the proceeds allows banks and issuers to shed non-green assets and start investing in assets supporting the transition to a greener economy immediately. This would of course need to be monitored and the EBA stands ready to do so. Additional disclosure on the green characteristics of an asset pool and the green credentials of the originator would help.

The need to create a separate label for green securitisation could be re-assessed at a later stage. While supporting the green transition, the development of green securitisation would also foster a more vibrant securitisation market.

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Investment of insurers and reinsurers in securitisations

Securitisation volumes in Europe have never reached their peak of 2007, before the financial crisis. Overall, the current market is smaller, but of a higher quality and more prudently regulated. The pre-crisis levels of securitisation volumes were unhealthy and unsustainable and should not serve as a benchmark to be targeted. Still, some stakeholders expect that the securitisation market should revive to a higher level than where it currently stands. In particular insurers and reinsurers are seen as a possible source of high demand, yet the appetite of insurers and reinsurers to invest in securitisations remains low.

There have been efforts to remove obstacles to insurers and reinsurers investing in securitisations and indeed the European Insurance and Occupational Pensions Authority (EIOPA) was a pioneer in this regard. As early as 2013, EIOPA proposed a preferential treatment for higher quality securitisations. The European Commission made such a change to Solvency II, and it came into effect in 2019. The amendments introduced a specific treatment for simple, transparent and standardised securitisations (STS securitisations) in the standard formula for the calculation of capital requirements under Solvency II.

According to that specific treatment, the capital requirements for investment in STS securitisations were significantly lowered. For example, the charges for senior STS securitisations are now close to those for corporate bonds of the same credit rating. In contrast, non-STS securitisations have higher risk charges.

The aim of the amendments was to support investments in securitisations by insurers and reinsurers in a prudent way. However, three years after the new treatment has come into effect, investments in securitisation have not materially changed. The volume is overall stable at a level of approximately 12.5 billion euro for the European insurers and reinsurers that apply the standard formula. This is a small fraction of the European securitisation market. It is also small compared to the total investment volume of the insurance sector. At European level, securitisation investments represent 0.33% of total investments of the insurers and reinsurers applying the standard formula. Investments in securitisations are concentrated in a small number of the insurers and reinsurers.

The appetite of insurers and reinsurers to invest in securitisations remains low.

At the end of 2021, 12% of the insurers and reinsurers were invested in securitisations. Among those undertakings, 85% do so for an amount of less than 5% of their total investments. Only a small number of insurers seem to be active players in the securitisation market. Furthermore, we can observe that the majority of securitisation investments of those companies are made in the class of non-STS securitisations which have higher capital charges.

The Solvency II framework does not seem to be a significant driver for the investment decisions of insurers and reinsurers in relation to securitisation. In a survey that EIOPA carried out in 2022, only a few insurers mentioned that the capital charges are one of the reasons that is holding them back from investing in this asset class. The vast majority of companies do not seem to be interested in securitisations because they do not match their investment preferences which are focused on the risk-return profile of the investment and asset-liability management.

Other asset classes seem to show better risk-return profiles. Securitisations do not fit into the asset-liability management of many insurers and reinsurers who are long term investors, in particular life insurers. These companies have long-term insurance liabilities and typically seek to cover them with long-term fixed rate investments in order to reduce the risk that changes in the level of interest rates lead to a deterioration of their capital. The importance of an effective asset liability management became evident during the past years when interest rates varied a lot. Another reason for the lack of demand for securitisation investments from the insurance industry seems to be that investors perceive securitisations as a complex product with extensive due diligence requirements.

Focusing only on the prudential framework makes it difficult to take account of the interlinked and complex nature of the factors in play. That is in line with recent technical advice of the Joint Committee of the European Supervisory Authorities. The Joint Committee does not advise changes to the current framework of Solvency II with regards to the prudential treatment of securitisation.

For the time being, while there is little appetite for investments in securitisations by (re)insurers, this is not a result of the current regulatory framework.

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Overmedication risk on a safely predictable EU asset class

Securitisation is a technique aimed at transforming given risks from an originator (e.g. loans from a European bank) into sequenced credit exposures. Hence, a mere tranching of a given risk does not create additional risk per se. Still, blatant case of cumulated agency and model risks erupted when the *originate*-single-recourse-loans-to-distribute model used for US subprime securitisation triggered the infamous global financial crisis (GFC). Originators of subprime mortgages were fees-driven only while the benefit of geographical diversification was overestimated so that the thickness of the senior tranche could be oversized.

The global regulatory answer to the GFC included a securitisation-specific component, which introduced a new non-neutrality parameter known as *p-factor* designed to address agency and model risks. The higher that factor, the more the weighted average risk-weighting of all tranches shall be above the single risk-weighting of the underlying exposure liable to securitisation.

The current paradox is that the EU has transposed international guidance in a most stringent fashion even though EU securitisation has been least exposed[1] to the agency and model risks most targeted by the BCBS framework. In addition to the tight transposition of the BCBS *Framework* and its optional *Standardised Transparent and Comparable* dispositions, EU regulators have added extra requirements along the way applicable to reporting, due diligence, supervisory recognition of Significant Risk Transfer (SRT). Meanwhile, as pointed out by the latest non-paper of Commission, "the US continues to apply a modified version of the Basel II securitisation framework that markedly differs from the EU framework with respect to p factor levels"[2].

The good news is that some voices among co-legislators have joined to the push for lesser non-neutrality *p-factor* while not closing the door to reconsider regulatory HQLA eligibility criteria in a direction more in line with comparable secured funding market instruments such as EU covered bonds or US GSE mortgage-backed securities.

At the time of writing, the Parliament has amendments aiming at temporarily halving the *p-factor* for output floor purposes, along with a mandate to the EBA to report to the Commission on the prudential treatment of securitisation transactions. The industry strongly favours this lifeline granted to EU securitisation in general: a do-or-die amendment for deconsolidating SRT deals in particular.

EU securitisation has been least exposed to structural weaknesses targeted by the BCBS framework.

Furthermore, a recent non-paper from the Commission proposes a reduced *p-factor* under both standardised and internal approaches that would apply to simple transparent and standardised (STS) transactions until future BCBS guidance is available. The industry will welcome this condition for the development of securitisation, especially if not segregating against non-STS deals as there is no mechanical linkage between the STS eligibility of a given transaction and the magnitude of putative agency/model risk (e.g. securitising solar panel loans does not pass STS criteria, all else equal).

Thus, mutually shared objectives should include:

- Implement the CMU while making room for to the substantial financing need for the incoming green and digital transitions;
- Secure a more diversified funding market: financial stability, both systemic and idiosyncratic benefitting from better risk sharing across market participants;
- Preserve retail origination capacity – including SME lending – from the most knowledgeable and risk-aligned lenders, i.e. the banking sector, through both funding and/or risk transferring securitisations.

In line with those objectives and in contradiction with current p-factors calibrations best suited for originate-to-distribute models, structural risk alignment between banking originators and securitisation end-investors derive not only from the legal 5% risk retention rule but also from:

- the full recourse nature of banking loans being securitised that implies shared risks on shared obligors (regardless of specific loans) along with;
- the material interest to protect the franchise of established securitisation repeat-originators that are also repeat-issuers of their own debt.

A revived EU bank-originated-securitisation market does not create additional agency risk: a more commensurate risk-adjusted regulatory treatment is a prerequisite for a larger CMU-friendly primary market, SRT deals included, along with a renewed liquidty of secondary market, senior tranches most concerned[3].

[1] *"From mid-2007 to the end of 2010, only 0.95% of all European structured-finance issues defaulted, compared to 7.7% of all US structured-finance issues, and 6.3% among the universe of global corporate bonds"* (OECD)
[2] *Current EU vs. US p-factors: either 0.5 or 1 (STS or non-STS) vs. 0.5 under SA; 0.3 and 1.5 vs. ≈ 0 under IRBA*
[3] *"prior to the GFC, banks constituted the primary investor base for securitisations in the EU and provided ample liquidity for the tranching of senior tranches"* (Commission)

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Why securitisation slumped in EU, but resurged in the rest of the world?

In recent years, the EU securitisation market averaged about EUR30bn of placed ABS/MBS supply annually and more than triple that for retained issuance. This is a far cry from the roughly five times the placed volume averaged in the years pre-GFC. It is often assumed that this decline is repeated across other securitisation markets, but nothing can be farther from the truth. After a hiatus of a few years, the US ABS issuance bounced back up to the pre-GFC levels (c. $200bn per annum). The US non-agency MBS issuance took a decade to breach the $100bn ceiling, given that Alt-A, Option ARM and subprime loans were left behind and the US agencies stepped up their game.

Australia and Japan new issue volumes also recovered to levels about 20% below those of pre-GFC. Australian RMBS issuance now exceeds EUR RMBS placed issuance five times, despite Australian mortgage market being a fraction of the EU's. US annual CLO volume advanced to the $100bn mark and EUR CLO – to about €30bn; both markets exceeded the pre-GFC issuance levels, while many CDO variations disappeared. CMBS issuance contracted, significantly from the pre-GFC levels, apart from the US, helped by US agencies. New markets developed: China is now the second largest securitisation market in the world; synthetic securitisation took off in the EU in recent years.

In short, the non-agency US securitisation market recovered and flourished despite the scars of the US subprime crisis. Australian and Japanese securitisations were not scarred by the GFC. The EU securitisation market did not recover. While in the rest of the world the investor base for securitisation multiplied, in the EU it shrank. Why?

It is easy to point to excess liquidity that the central banks provided, but that argument stands true for all countries. In Europe, covered bonds (CB) diverted mortgage pools from RMBS; from the Eurozone crisis onwards, mortgage covered bond issuance averaged €500bn p.a. The Netherlands clearly illustrates the cannibalisation of RMBS by mortgage covered bonds post-GFC. The same could have happened in Australia, but the bank regulators prudently imposed asset encumbrance limits on the banks, and provided liquidity support for RMBS during the GFC and the pandemic. In comparison, ECB use of ABSPP was limited. In Australia, unlike in Europe, the view that CBs will be bailed out in times of trouble is not entertained by investors.

The lack of level playing field in the EU regulations bears responsibility for the slump.

We have long pointed to the lack of a level playing field in the EU between securitisation and other investment instruments in every respect: disclosure, due diligence, LCR treatment, capital weights, among others. The capital charge discrepancies are substantial in Solvency 2, but they are not immaterial in CRR either. EU insurers bought large volumes of floating securitisation notes up until 2011, and then withdrew, coincidentally, as the Solvency II drafts were circulated.

While the focus often is on capital and liquidity treatment, the discrepancies are quite large as far as initial and ongoing due diligence and disclosures are concerned. The due diligence requirements for purchasing and holding AAA prime RMBS are burdensome in comparison to those for buying and holding high yield bonds, bank AT1s, mortgage loans and covered bonds. The focus on agency risk in any asset securitisation is overwhelming, but it is not factored in buying the same pool of assets, if not securitised.

In our opinion, agency risk should be addressed in loan underwriting, rather than in loan securitisation. No loan-by-loan disclosure, no stress testing, no regular internal reporting to, no risk retention is required to buy any secured or unsecured investment, but they are all enforced for any EU investor buying any securitisation tranche regardless of its riskiness.

While regulation declared EU securitisation bonds to be of low liquidity, the reality of the crises of the last six months proved otherwise: investors sold ABS over corporate and sovereign bonds, because they furnished them with the best cash price. These crises also highlighted that EU investors could not take advantage of market dislocations because of the codified due diligence requirements for securitisation, which have no parallel in any other investment instrument in Europe and the world. In the rest of the world, the fiduciary duty of the investor stands equal in weight across all investment instruments, not in Europe.

It is well understood now that EU securitisation did not commit the crimes it was accused of in the aftermath of the GFC; it was simply judged guilty by association. That led to a distorted regulatory framework and lack of level playing field across investment instruments. EU securitisation regulations need a radical revamp to level the playing field (or other regulations need realignment with those for securitisation). The sooner the better for the EU economy and for the EU CMU.