Securitisation in the EU: future prospects

1. The European securitisation situation is unique

A supervisor stated that Europe is faced with significant financing needs, not only for funding investment in digital but also for the sustainable economy. The question that arises is where to find the means to fund these changes, and how to push towards the capital markets union and the completion of banking union. There are a number of discussions around the role that securitisation could play in this process. The specificity in Europe is that since the great financial crisis, securitisation has kept delivering below its potential. Securitisation is quite different in Europe in terms of underlying assets compared to other regions.

1.1 Securitisation can help to free up capital and finance investment but a stigma remains

A public representative stated that there is every reason to see a booming securitisation market. In a sometimes rather unstable environment, it would help banks to free up capital. Huge investment is needed in the green economy. Capital is needed and securitisation can be one instrument to help to free up capital and finance investment.

One thing that does hold securitisation back is stigma, though there is no stigma in the European Parliament. In this mandate, synthetic securitisation has been dealt with. There is also green securitisation. Parliament is positive towards securitisation, but is waiting for the market to develop.

A regulator suggested that many factors and parameters play a role in the market not being vibrant. While the market lacks energy, the situation seen before the great financial crisis is not what is wanted. Everything concerning the issuers and the environment, whether they want to use this for shedding risk is one factor. There has been an environment where liquidity was abundant, so the instrument was not needed as there were other sources of funding.

Investors should also be considered. Disclosure is part of the issue. Then there is the regulatory treatment itself. Everybody wants to make sure that the instruments are well designed, well used and do not lead to the excesses of the past.

A great deal of improvements have been made in that area, because of the simple, transparent and standardised (STS) product. There have been large reviews by the European Insurance and Occupational Pensions Authority (EIOPA), European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) on what can be improved. New proposals continue to be developed. ESMA recently embarked on a review of the disclosure rules.

There is a simpler instrument with STS framework, which could be used much more systematically in the current environment, which also sees a pickup in interest rates. Investors and issuers should embrace that.

A Central Bank official noted that promoting this market could bring benefits and support the capacity of the banking sector to channel lending to the real economy. In addition to the transition to the green economy, there is also the need to develop digitalisation. It also allows the transfer of risk to investors in an appropriate way.

Supervisors also need to see how these benefits could be achieved. There has to be a sound approach. There would be a need to keep good risk management standards, to increase transparency and to increase the simplicity of the transactions. There should be consideration not only from the supply side but also the demand side and how to provide a shift for that development.

A regulator added that the insurance sector could give help, but so far there has not been much appetite to invest in this kind of asset. Even after the introduction of STS, securitisation did not change much. A paper was given to the Commission on revisiting the capital requirement, and in the survey insurers indicated that the main driver for them to invest is the risk return profile, matching the liabilities and the complexity of some of the products. These seem to prevent them from investing, rather than the capital requirement.

A regulator remarked that there is willingness to see securitisation as a tool to manage the transition. In the context of the green bond standard there have also been recommendations that the proceeds of securitisation, rather than the collateral being securitised, could be used for qualifying a securitisation as a green securitisation.

1.2 Securitisation is particularly helpful for green transition financing needs

An industry representative noted that banks have substantial capital levels, but these will also be required by the increase of capital requirements with the Basel III transposition. There is a need for capital markets to relay these efforts and to contribute to these efforts.

Capital markets can finance corporates directly. The granularity and specificity of loans, for example for small and medium-sized enterprises (SMEs), cannot be made by ad hoc financing directly in the market, at least for a large part of these pools. In the US there is a combination of deep capital markets with direct issuance and a vibrant securitisation market. This is also needed in Europe, and that is why securitisation is needed.

Agency risk is addressed by the P-factor. The P-factor means that there is the feeling that when comparing the risk weighted assets (RWA) there needs to be a gap,

with the capital requirements a bank has on the assets it holds, with the capital requirements if the bank invests in all the securities and tranches. That is because it is assumed that in the originate-to-distribute model, if the assets are not on the books, the worst assets will be chosen to sell to the markets. There is a need for this gap, and the P-factor is this increased level of capital requirements.

This is not consistent with the European model, which is not an originate to distribute model. When the banks securitise their portfolios, they keep other exposures on the borrowers. There is a genuine structural alignment between the bank's interest and investor interest. This P-factor should be reduced in order to avoid the disincentive both for funding and transfer of risk. When the risk is transferred the entity is not looking for funding. It is kept in the tranches. If the senior tranches are highly weighted, that is a disincentive to keep them on the balance sheet, because it makes the economics of a transfer risk unworkable. If an entity is looking for funding, it sells this in its tranches as well. It is not attractive for banks as investors.

1.3 Securitisation recovered globally

An industry representative remarked that the synthetic technique for risk transfer and managing bank capital is functioning. The introduction of STS for synthetics helped. The EBA released three documents, including on synthetic excess spread and STS eligibility for synthetic transactions. The synthetic technique will likely continue to be used and banks will be able to continue to manage capital. Australia has about a 10 times smaller GDP and a 10 times smaller mortgage market, but it issued 35 billion last year. This lack of recovery is in spite of the introduction of STS.

A Central Bank official remarked that there is a slight increase in the numbers referred to in terms of significant risk transfer (SRT) transactions.

An industry representative noted that the real market that is distributing securities to the market and contributing to the capital markets union is cash securitisation. Europe is the only market that has not recovered. Last year the EU placed about 55 billion of cash securitisations. Without the Collateralised Loan Obligation (CLO) market, it was about 30 billion. Of that market, only 10 billion was prime residential mortgage-backed securities (RMBS).

2. There are many reasons why the EU securitisation market is not taking off

2.1 Why European cash securitisation has not recovered

An industry representative noted, regarding the level playing field, that last year Europe issued more than 500 billion of mortgage covered bonds. With that incumbent large amount of mortgages there is very little left for RMBS. The two instruments are complementary and should work in tandem to support risk transplant funding for banks, but the regulatory framework is not complementary and, in fact, is contradictory.

US insurers buy between an estimated 10% to 30% of the tranches of most securitisations. In Europe, the estimate is that the insurance companies with an internal model last year purchased about 2-5%, and usually of the most senior tranches. From 2007 to 2010 securitisation represented about 10% of the fixed income assets under management of European insurers. Today, it represents 2%. There is a need to fix the issue with the investor base in Europe. There is something about proportionality, which requires specialisation and a high level of expense by the investors.

There are discrepancies in the national implementations. Some banks wanted to increase the share of asset-backed securities (ABS) in their liquidity coverage ratio (LCR) portfolio, but that was not looked upon favourably by national regulators. October 2022 and February 2023 proved that it is very important to have floating rate instruments on the balance sheet. The fact that the banks cannot build up their LCR adequately to 15% with ABS is a problem.

Securitisation is a match-funded instrument. The only flow-back risk exists in credit card master trusts in the UK. They effectively do not exist anywhere else, and the UK regulator is addressing that issue.

There are discrepancies in the interpretations that need to be addressed. There are many visible and invisible barriers, but ultimately the level playing field is not working.

A Central Bank official noted that though there is huge potential for the securitisation market to finance the transition to the green economy, granular data will be needed to identify these pools. The risk might be that then there will be very fragmented information across different access points. Having registered securitisation repositories could be a way to address the issue. The originators will need to start preparing to be able to have these data going forward. Having a transparent market is critical for its success.

An industry representative suggested that nobody is opposing transparency and due diligence, but it has to be proportionate and comparable across instruments. The fact that loan-by-loan data will be collected for every mortgage or auto loan is fine, though it will take time and money, but that is not a requirement for the products. That makes securitisation much more expensive to execute and much more expensive to buy, because it has to be analysed.

European auto manufacturers declared that they are issuing green bonds, but they do not issue green securitisation. They are green companies, but there is no green auto securitisation in Europe.

Insurance companies in Europe currently hold about 7-8% of mortgage portfolios as part of their assets under the management. They bought them from banks, but that is not considered an originate to distribute model. If the banks sold an RMBS to an insurance company that is considered to be the originate to distribute model. That does not make sense.

2.2 In the EU, banks favour retained securitisation in order to address repo needs

An industry representative noted that in the previous year Europe had about 50 billion of securitisation placed. The volume of retained securitisation in the EU was about 70 billion. Retained securitisation exceeds placed securitisation. The ECB holds about 340 billion of ABS in repo. It is easier for an issuer to do ABS, repo it and get the funding when doing public placement. It is easier, faster and cheaper to do a covered bond when looking for funding for RMBS.

In the UK, the placed volume exceeds the retained volume. There is not active use of MBS and ABS in repo, and the investor base in the UK is much more proactive. The pension fund crisis in the UK showed that UK pension funds have bought very large amounts of triple-N double-A securitisation across products. That product found a very easy market in October, but the majority of the purchasers were American asset managers.

European investors could not participate in the price correction for a number of reasons. One was due diligence. If an entity is trading, it has to respond immediately. Additionally, many European risk managers do not allow their banks to buy on the secondary market even if they are holding the same position. Also, much of the paper was sterling, which many EU investors do not buy.

For issuance, the retention is very peculiar for the EU. Australia had a very small retention volume of prime mortgages because the Australian Office of Financial Management established the programme to support liquidity on the securitisation market for about a year during the pandemic, and that is where the banks used some of their RMBS.

Regarding differentiation, Australia, Singapore, Canada and the UK all have visible or invisible asset encumbrance limits for covered bonds. When the banks in Australia reach their limit they have to do RMBS. That does not exist in Europe.

2.3 Prudential demands applied in the EU are tighter

An industry representative noted that the option provided by Basel on simple, transparent, and comparable (STC) is not applied in the US, and nor are the Basel III requirements. The level of interest rates will not be sufficient to trigger a take-off of the securitisation market. Much still has to be done on the prudential treatment. There is still room for improvement on the P-factor, but just ensuring that the situation will not worsen is not sufficient when the EU is far from the development of other countries.

2.4 Making the different regulatory frameworks consistent

An industry representative noted that there are more than 100 criteria to meet STS eligibility, and a large part of the market has been missed. There is a risk that the STS framework is considered the only potential development for securitisation. Currently, it represents 30% of the market, and not because the rest is toxic. The rest is not eligible because of historical data, granularity or homogeneity. Improvements in the prudential treatment should be included not only for STS but also for non-STS.

A public representative commented that there is a lack of a level playing field with covered bonds and securitisation. However, that does not mean there is also a need to boost the non-STS part, because that is not holding back. The distinction between STS and non-STS should be maintained, otherwise there would be a step back to before the financial crisis. The market should be transparent. An industry representative remarked that the idea is not to merge both categories but to improve both while keeping the difference.

A public representative stated the securitisation market is not thriving either because there is not enough room for non-STS or because there is too much room for covered bonds. The latter is more believable. That does not mean that the first has to be boosted. The desire is for a transparent market. A move towards private transactions rather than public transactions is concerning.

3. Conditions for improving the EU securitisation framework

3.1 Improvements cannot be at the expense of banks appropriately managing risk

A Central Bank official stated that the growth of the market should not threaten adequate risk management and capital planning from banks. If it is just used for loopholes to optimise capital then it does not help much. Without trust in the market it will not develop or it will develop in the wrong way.

3.2 Improving the framework require multiple adjustments

A regulator noted that there was a need to improve the consistency, clarity, and risk sensitivity of the framework as a whole, but also to work on other aspects like disclosure and proportionality. A targeted reduction of the risk weights for banks originating the transactions should encourage the banks to originate resilient transactions. There is also investor demand for synthetic securitisation, which dominates the STS significant response from the market.

The P-factor has been looked at very carefully. It does not do just one thing. It is not only about the agency risk model. It is also about avoiding cliff effects in the way different parts of the securitisation transactions are used.

When trying to fix something, unintended consequences should be avoided, such as incentivising banks to invest in under-capitalised mezzanine tranches. It is a fragile equilibrium, and certain things can be achieved with the reduction of the risk weights. There might be a need to revisit, more systematically, the full design of the risk weight formula, but for that there needs to be evidence and the preference is for that to be in a broader context with peers from other jurisdictions.

Market participants should embrace the change and see that it is going in the right direction. It might not meet all of their expectations, but not everything can be achieved at once.

3.3 Analysis of banks' investment needs and the P-factor

An industry representative commented that the banks have historically not been investors in the mezzanine tranche but rather in the senior tranches. If there is concern that it could be a risk in the future then there can be differentiation in the new framing of this P-factor between senior tranche and mezzanine. If the level of the P-factor is maintained to address this point then it will have a very negative impact on other aspects.

3.4 Data is required for recalibration of the securitisation framework

A regulator noted that there is yet to be evidence justifying changing the capital requirement. Even the improvement in the regulatory framework for the non-STS in general needs to be reflected in data, because otherwise the capital requirement in Solvency II cannot be changed in a qualitative way.

The major groups in Europe use an internal model for their capital requirements, and they even charge government bonds with a capital requirement when using the internal model. It is not that those companies invest massively in securitisation. There is investment and there is appetite, but it is not completely different from those who are under the standard model in terms of capital requirements. The others with the internal model look at data. The comparison with the US market suggests something needs to be explored still, but the markets are different and the capital requirements are different.

3.5 Dialogue between policymakers and the private sector is a key success factor

A public representative remarked that over time the analysis has become much more sophisticated. There are probably visible and invisible barriers, and discussion has to be held repeatedly to work towards a credible, transparent and booming market.

A supervisor suggested that there is agreement that it would be useful to relaunch this market. The dialogue is as alive as could be expected. Both sides have to continue having discussions. It is not a revolution. It is important to manage expectations.