

PRIVATE RISK SHARING AND TRANSFER: THE ROLE OF SECURITISATION



FAUSTO PARENTE

Executive Director - European Insurance and Occupational Pensions Authority (EIOPA)

Insurance regulatory framework for securitisation

The securitisation market in Europe, while smaller than pre-2007 levels, is now of higher quality and better regulated. Despite efforts to facilitate insurer and reinsurer investments through preferential treatment for Simple, Transparent, and Standardized (STS) securitisations under Solvency II, the appetite for securitisation investments remains low. Five years after the regulatory change, securitisations are an immaterial asset class for the average European insurer.

According to an analysis that the Joint Committee (JC) of the European Supervisory Authorities carried out in 2022, most insurers cite mismatched risk-return profiles and asset-liability management preferences as reasons for limited interest in securitisations.

The JC's analysis, based on responses from 98 European insurance and

reinsurance undertakings, stakeholder input, and an open consultation, aimed at assessing the impact of recent changes, especially the introduction of Senior Simple, Transparent, and Standardized (STS) securitisations in 2019.

The JC supports the objective of reviving the EU securitisation markets for insurers prudently. However, despite acknowledging the low participation of insurance undertakings in the securitisation market, the JC did not recommend changes to the current Solvency II framework for the prudential treatment of securitisation.

Concerning the key findings from the advice on the investment behaviour of insurance undertakings, approximately 12% of European standard formula insurers have investments in securitisation, with around 60% investing below 1% of their total assets. The introduction of STS securitisations in 2019 has not had a significant impact on insurers' investment behaviour. While 37% of respondents express an intention to increase securitisation investments in the next three years, the majority foresee no change. The Solvency II framework does not appear to be a significant driver for insurers' investment activity in EU securitisation, with preferences on risk-return profiles and asset-liability management.

The appropriateness of the framework is likely to stay on the regulatory agenda.

On the topic of the assessment of capital requirements, the evidence does not support a change in the calibration for securitisations meeting STS criteria or for the non-STs segment based on historical spread volatility analysis. The JC concludes that the current framework is fit for purpose, and no changes are warranted at this time.

Moreover, the analysis explores potential changes to the risk sensitivity of the capital calibration for mezzanine and junior tranches of STS securitisations and senior and non-senior tranches of non-STs securitisations. The JC suggested no changes to the existing framework due to uncertainties about their effec-

tiveness and the potential high cost, considering the low investment volumes and industry participation.

The European Commission sought an assessment of whether Solvency II could align with the Capital Requirements Regulation's securitisation framework. Also in that respect, the JC proposed no changes to the existing framework, citing concerns about increased complexity, uncertain effectiveness, and high potential costs.

In summary, the JC recommended maintaining the status quo within the Solvency II framework for insurers' prudential treatment of securitisation. The analysis indicates that proposed changes may not be effective or justified at this time, considering the complexity of the existing framework and the low volume of investments in the securitisation market by insurers. The survey carried out with (re)insurers as part of this JC work showed that the main drivers for them to invest are the risk return profile, the matching of the liabilities and the complexity of some of the products. These seem to prevent them from investing, rather than the capital requirement.

A more recent development is that the outcome of the Solvency II review might include a request to review the capital requirements for securitisation investments in Solvency II. Such a review could for example consider a more granular set of risk factors depending on the ranking of the securitisation tranches or differentiating different types of non-simple, transparent and standardised securitisation depending on their risks. Provided the availability of data, EIOPA stands ready to provide technical support to such a risk-based and evidence-based review.



JON RELLEEN

Director, Infrastructure
and Exchanges - Financial
Conduct Authority (FCA)

FCA supports a well-functioning and prudentially sound securitisation market

Securitisation is an important part of global wholesale markets. It is the process of bundling together loans and debt instruments (like residential mortgages or auto loans) and distributing the risk associated with them using a variety of investments that offer different tranches of exposures to investors. This means that they carry different levels of risks and reward to suit the appetite of different investors.

Securitisation is considered to have played a significant role in the Global Financial Crisis, due to insufficient transparency of the risk involved and the misalignment between investors' and manufacturers' interests. This created an impetus for reforms globally, with the introduction of criteria for simple, transparent and comparable securitisations by the BCBS-IOSCO, and the implementation of a new Securitisation Regulation in the EU and UK, in line with these international criteria.

The FCA believes that a well-functioning and prudentially sound securitisation market supports the real economy and can distribute risk efficiently across

the financial system. We acknowledge that compared to traditional financial assets, securitisation is relatively complex, making it more challenging to assess, measure and manage the risks and impacts of its interconnectedness with other markets. But we also view securitisation as a vital link between the financial markets and the real economy, facilitating funding, enhancing liquidity, and promoting economic growth. By providing access to capital and enabling risk sharing in the financial system, securitisation is pivotal in supporting lending, investment, and economic activities in various sectors. We therefore support a framework for securitisation that benefits businesses and consumers whilst ensuring the safety and soundness of the financial system.

We recognise that regulation is not necessarily the key driver in origination/investment choices by manufacturers and investors in securitisations, and that several other factors have significant impacts on securitisation market trends.

Firstly, macro-economic conditions drive both the amount of lending and the ability to issue securitisation. We have seen, for example, the significant drop in securitisation issuance during the recent pandemic.

Clear and proportionate rules for the securitisation market will also support its growth.

Secondly, the availability of alternative funding sources from Central Banks at relatively lower costs has decreased issuers' economic incentives to securitise. As Central Banks reverse quantitative easing, volumes in securitisation, particularly from banks, are expected to pick up. Additionally, in the UK, alternative funding sources are available, including covered bonds, which offer a secured long-term funding option at costs which are lower than the costs of funding through securitisations, irrespective of the macro-economic framework.

Nevertheless, ultimately, the FCA is of the view that clear and proportionate rules for the securitisation market will also support its growth because they help maintain market stability through appropriate management of, and sufficient transparency on, related risks. Market stability protects investors and consumers and builds confidence in the asset class.

With the Securitisation Regulation, the UK (and the EU) have sought to balance the needs of originators/sponsors with the protections of investors, aiming to address the harm identified during the Global Financial Crisis. A review of the regulation by HM Treasury in 2021 concluded that the regulation remains important to the functioning of securitisation markets in the UK but identified specific areas where improvements could be considered.

The UK authorities are in the process of making improvements through their work in transferring the Securitisation Regulation to the new UK regulatory framework. In particular, the FCA and the PRA are proposing rules which reflect a change from the regulation's provisions in order to provide greater clarity, improve the proportionality of the requirements, and remove unnecessary barriers to the issuance of – and investment in – securitisations, while maintaining appropriate protections for investors. In particular, because securitisation markets are international, it is important that we remove barriers to investment on a cross-border basis to promote the growth of a healthy and liquid global securitisation market. We must work together internationally to facilitate this while maintaining the appropriate guardrails.

Finally, the consideration of the environmental impact of financial activities has become commonplace in discussions of a future financial sector that supports an economy which is more sustainable. The FCA believes that a 'green' securitisation framework could support the transition to a sustainable, low carbon economy. While no consensus exists globally on what a green securitisation framework would look like, it could have the ambition of incentivising the use of securitisation as a method of refinancing green underlying exposures.



CECILE NAGEL

Global Head of Corporate Trust - BNY Mellon

Facing Europe's financing gap: the role of securitization

The EU has ambitious goals in green development, new technologies and SME growth. These goals require closing a funding gap estimated by some market sources to be as high as €700bn per annum for Europe's green and digital transition alone.

Yet traditional bank lending does not have the capacity to satisfy that need. Securitisation can play a much greater role in Europe's future economic landscape.

The potential role of securitisation

IMF data show under one-third of economic financing in Europe derives from Capital Markets compared to banks, versus over two-thirds in the U.S. In its Securitisation Data Snapshot for 2022, AFME identifies that in 2022 total European securitisation issuance was less than 10% of the size of U.S. securitization issuance, compared to 85% in 2008.

Regulatory action and investor appetite in the U.S. have helped securitisation flourish and provided financing beyond traditional consumer-facing asset-classes to receivables arising from, among others, data centres, fibre optics, mobile phones and infrastructure, and solar/wind farms.

A new European legislative cycle provides an opportunity to close this gap. As such, now is a critical moment to make securitisation a reliable mechanism for capital diversification. Doing so could deliver benefits such as investment diversification, credit risk distribution, market resilience and balance sheet efficiency.

The structural challenges

Policy makers and market participants learned many lessons from the events of 2008. More discipline around underlying assets and structures and more robust risk controls have already come into play. There is also a deeper understanding of the operationally stabilising effects provided throughout the investment lifecycle via the role of trustees, agents, and other similar institutional providers.

Further strengthening securitisation's post-crisis credibility - and realising its benefits - requires action from public entities and private market participants to achieve greater clarity and stability without limiting innovation.

Simple, Transparent, and Standardised (STS) criteria are one such mechanism. STS disclosure rules have already improved investor perceptions and will continue to spur confidence among investors. However, issuing parties must carefully manage their minimum risk retention requirements. Documentation and data quality also need to be addressed to avoid undue operational stress on issuers and their service providers.

Another relative European success story in recent years, helped by regulation including STS, has been the increasing use of Significant Risk Transfer (SRT) mechanisms by banks. As more banks and investors explore this approach, policymakers may wish to consider ways to streamline the current supervisory assessment process to manage increasing volumes, albeit without diluting standards.

The path forward

Forward momentum for securitisation hinges on further work from public authorities and private stakeholders.

Policy-making: Action on building a Capital Markets Union (CMU) is essential. The lack of an integrated market that explicitly supports securitisation is a significant gap. Securitisation and its regulatory framework should be high on the list of CMU priorities of the next European Commission.

Issuance: Aside from disclosure templates, private market stakeholders should also

consider whether more should be done to standardise rules, harmonise transaction documents, and rationalise post-issuance reporting and compliance. Doing so may alleviate complexities and expedite the issuance process while lowering the operational barriers that create friction for issuers and investors. Participants across the securitisation value chain should find agreement and put it into common practice.

Investor access: Investors need smoother inroads into securitisation. Institutional investors face stringent capital controls (e.g., Solvency II) that impact their participation. The critical question is how to recalibrate the capital framework without undue risk exposure. Expanding participation routes for individual investors (as envisaged by some regulators) may also help increase the size of Europe's capital market. However, retail investment creates challenges in managing amendments or defaults; it may be difficult to balance the interests of individuals and sophisticated institutional players. Both investors and trustees will need greater clarity on how to make this work.

Now is a critical moment to make securitisation a reliable mechanism for capital diversification.

The power of shared commitment

The potential future benefits from new and bolder policy changes are significant. Rebuilding market confidence is essential for making securitisation a larger element in Europe's capital markets. Important public policy steps have already been taken. The role of trustees and agents in providing confidence and operational stability for investors should also be recognised and supported. A larger role for securitisation can help drive sustainable growth and stability across the bloc.



ALEXANDER BATCHVAROV

Managing Director -
Bank of America

EU CMU and EU securitisation: time to re-launch?

In 2023 EU securitisation (SF) issuance comprised: €70bn placed true sale, €110bn retained for repo and c. €150bn notional synthetic securitisations. In 2005, EU (ex-UK) issuance comprised €155bn of placed true sale and €116bn notional synthetic. To illustrate the economic impact, without multiplier and balance sheet effects: EU true sale SF was about 1.9% of EU GDP in 2005 and 0.4% in 2023, it offered €170bn of bonds in 2005 vs. €85bn in 2023. SF's contribution to EU economy today is much smaller, but much more needed, given the challenges of EU economic acceleration, digital and climate transformation, strategic autonomy in a multipolar world, etc.

Last 10 years, annual SF volume was about 0.4% in the EU GDP, 0.85% in the UK, above 2.0% in the US, c 2.5% in Australia. The average annual share of transferred loans (via securitisation or direct sales) in total bank balance sheet loans was about 1.8% in the EU and more than 10% in the US. US non-Agency SF issuance is almost on par with that of US Agency securitisation (\$700-\$900bn vs \$800-\$1,200bn p.a. recently). US Agency MBS (asset-backed un-tranched securities) are more comparable to EU covered bonds (CB) than to EU RMBS. EU CBs encumber more than €3trn of

resi mortgages on EU banks' balance sheets, while US banks have moved c €8trn out of balance sheet to the US Agency MBS market.

SF is not just a financing and risk management technique, but the main, often the only, technique that can offer:

- a conversion of illiquid assets into investable/tradeable securities accessible to a large diverse group of investors; smooth transformation of bank balance sheets from 'brown' to 'green';
- an increased velocity of bank balance sheet to induce more lending without generating need for expensive capital;
- simultaneous financing for a large number of small companies, e.g. EU SMEs, where financing through capital markets on individual basis is not possible or economically viable;
- a mobilisation of retail savings to direct to consumer and SME financing under EU economic priorities; access for corporates/sovereigns to the capital markets in times of duress;
- private sector solution to the ESG and climate risk dislocation in the insurance market;
- conduit for ECB monetary policy;
- support to transfer the credit risk of the large mortgage portfolios retained on banks' balance sheet to support their covered bonds, etc.

EU's 'securitisation stigma' narrative is non-existent in the rest of the world.

All that is along with funding against assets and risk transfer via notes with different risk profile to match different investors' risk preferences.

It is noted that securitisation is complex, but it is overlooked that the complexity arises from its application to many situations and assets. It is argued that the originate-to-distribute model is to blame for GFC but is forgotten that it is not only how the banks distribute the risk, but also how they originate the assets whose risk they shed. It suffices to compare EU and Australian resi performance with

that of the US, or of US consumer credit with US subprime resi loans.

The GFC and other crises clearly highlighted the need to differentiate among credit risk, downgrade risk due to exogenous factors and liquidity risk of SF instruments along their capital structure. Sadly, this is omitted in EU public debates. Almost-nil default rate and very small downgrade rate of investment grade tranches, better than corporate bonds, are rarely mentioned.

EU's 'securitisation stigma' narrative is non-existent in the rest of the world. It informed EU policy actions and led to the very onerous EU securitisation regulation (EUSR). It raised the cost of doing business and raised the barriers to entry for both issuers and investors. The STS framework has not met its goals. The number of EU market participants has not materially increase post EUSR. To illustrate the demand side: a typical STS EU auto ABS has 20-25 (35 active) vs. typical US auto ABS has 60-65 (over 200 active) unique auto ABS investors.

The EU intro of STS synthetics boosted volume along with private execution and no secondary market - the exact opposite of the US expected path given recent US regulatory guidance and related synthetic supply surge under way. Now AAA prime RMBS RAROC under solo Solvency II is nearly 11 times less than resi mortgages, 4 times less than equity, and about half of the charge for resi mortgages under CRR. AAA CLO RAROC under CRR is 30 times that under Solvency II. Despite evidence to the contrary, 'EUSR is fit for purpose' is often repeated.

The High Level Forum on EU CMU made many proposals in that respect, but their adoption is very limited to-date. We believe that time is of the essence for CMU and the challenges that the EU is facing now require urgent action. Action plans for short-term (disclosure, due diligence, policies realignment, synthetics, etc.) and long-term (Solvency II, CRR, LCR, etc.) changes are already drafted, but must be implemented quickly. Securitisation is key to both EU CMU and EU banking union: neglecting it puts these unions in peril.