SOLVENCY II AND STS SECURITISATION: AN UNFINISHED BUSINESS

In December 2017, the STS Regulation was published in the Official Journal. It saw the creation of a new category of simple, transparent and standardized (STS) securitisations that avoided the structural weaknesses that had allowed some highly rated securitisations to collapse during the 2007/2008 crisis. This regulation was the product of four years of work by the European authorities and co-legislators.

In April 2018, the Commission laid down a level 2 amendment to Solvency II that substantially lowered the capital charges for senior tranches of securitisations that met the new STS standard.

These amendments were welcome and produced for senior tranches a sensible level of capital compared to other potential investments by insurance companies. However, the reductions to the capital requirements for non-senior tranches of STS securitisations are small and maintain a large regulatory capital cliff between senior and junior STS tranches. This is unlikely to stimulate the interest of the insurance companies in such investments.

(As an aside, no changes in the regulatory capital for non-STS securitisations were made or proposed, thus creating an even bigger regulatory capital cliff between STS and non-STS securitisations.)

This, in our view, is inconsistent and difficult to justify from both a logical and a regulatory point of view. In particular, it leaves open an unfortunate regulatory arbitrage that will continue to push European insurance companies into investing in less liquid, riskier products when safer alternatives are available.

To understand this regulatory arbitrage, one needs to remind oneself of a number of defects in the original design of Solvency II and in the incorporation of the STS regulation into the existing design.

Broadly, the capital calibrations of the original Solvency II regulation distinguish between capital market instruments and loans such as residential mortgages. Because capital market instruments are considered liquid instruments, it was decided that the capital to be set against them by insurers should be based on the volatility of their market price. Since mortgage loans cannot be readily sold, the capital required by an insurance company to hold them is based on their underlying credit risk. Furthermore, a duration multiplier is applied only to the former and not the latter.

At first blush, this may seem logical. If something has a market price, use that to value it. If it does not, you need to look at something else, such as its credit performance. However, this surface logic leads to illogical consequences. The capital for a highly rated, tradeable and liquid instrument (such as RMBS, auto ABS and SME ABS) is many times higher than the capital for non-rated, non-tradeable and illiquid instruments (such as residential mortgages, auto loans and SME loans).

It is clearly more prudent for an insurance company to hold investments that it can readily sell. But, as prices can fluctuate in turbulent markets, this means that for high quality/low risk assets, the capital required for holding them can be much higher than their underlying credit performance warrants.

This problem was exacerbated for securitisations by the choice of the period for which statistics were gathered to measure market volatility. The market volatility of various instruments available to insurance companies was calculated by the Commission based on performance during the 2007/2008 crisis; in other words, during a liquidity crisis of EU securitisation. As was pointed out at the time, this unfairly treated this one instrument compared to all others: corporate bonds during a corporate bond crisis (eg Enron) or sovereign bonds during a sovereign crisis (eg Greece) or covered bonds during a banking and sovereign crisis (eg 2010-12) will all suffer greater volatility than other comparable instruments.

The result of this was that if an insurance company purchased low credit risk but illiquid loans the capital, calculated on underlying credit risk, would be no greater – and in some cases, substantially less- than the capital required to purchase exactly the same asset risk but (a) in liquid form and (b) with credit protection layers. Put simply, insurance companies were required to set aside less capital if they bought more risk in an illiquid form (ie raw mortgage loans) than less risk in liquid form (ie the senior or mezzanine tranches of the same mortgage loans in a securitisation bond format). For example, taking into account the application of the duration multiplier, there is a lower capital requirement to hold a 30-year mortgage pool than a five-year senior or mezzanine tranche of an MBS based on the same mortgage pool.

But what about the price volatility of bonds? We must remember that liquidity illustrates an option. There is no obligation on an insurance company to sell a bond when its price falls. If, like the vast majority of European securitisations, the investment is of a high credit quality, the insurance company can hold on to that investment to maturity. It is not good prudential policy to punish regulated entities for giving themselves more options.

The result of the original design to Solvency II is that European insurance companies have withdrawn from the securitisation market but are aggressively purchasing whole loan pools. These are illiquid pools of loans without the credit protection that securitisation tranching

provides, involving also substantial operational risk. The legislation, as designed, is therefore (i) constraining the supply of European capital market instruments thus weighing down any progress of the CMU, (ii) pushing insurance companies to purchase less liquid and more risky assets thus lowering rather than increasing prudential stability, (iii) limiting the issuance of high quality STS securitisations thus limiting the diversification of funding for banks and reducing therefore the macro-stability of the European banking sector, and (iv) reducing the possibility to distribute risk across the financial system by preventing insurance companies from investing in mezzanine tranches of STS ABS, for which they are uniquely qualified to analyse, price and hold, and which offer diversification and yield enhancement opportunities for their portfolios.

Since Solvency II's original design two developments have taken place. First, despite the original concerns over European securitisation that emerged with the problems suffered by US sub-prime mortgage products in 2007/2008, traditional European securitisations performed spectacularly well throughout the crisis. Investment grade traches (senior and mezzanine) of securitisations in the traditional asset classes (mortgages, consumer and SME loans) suffered no losses at all, notwithstanding some extreme economic and credit conditions (eg. Spain and Greece).

Secondly, deep analysis of the crisis by academics and authorities such as the EBA allowed us to understand the precise characteristics of the flawed securitisation instruments that performed catastrophically during the crisis. This understanding was incorporated in the criteria defining the new STS asset class.

Reflecting these developments, the Commission modified the capital requirements for STS securitisations but the recalibration was inadequate especially for the non-senior STS tranches. This strikes us as a missed opportunity to remedy inconsistencies and irrationalities in the current set up.

Currently, the rules still leave non-senior securitisations in an anomalous position. For example, the capital charges range for single-A non-senior STS tranche with a duration of up to 5 years (4.6%-23%) is comparable with a BB rated corporate of similar duration (4.5% - 22.5%). This incentivises still an insurance company to buy, in this case, a non-investment grade concentrated single name risk over a good investment grade tranche of securitisation of diversified portfolio of say European SME loans.

STS was also designed to focus on the whole securitisation, not the senior tranche only. So, all the advantages in terms of transparency, structural resilience and stability of STS apply to all the tranches of an STS securitisation.

This issue matters because high investment grade mezzanine tranches of securitisations offer comparatively good returns to insurance companies, especially when set against the low risk of STS securitisations and are safer than many of the more lowly rated products they are incentivised to purchase by the current regulatory capital structure.

By not extending adequate capital treatment to non-senior STS securitisations in the context of Solvency II capital requirements, the Commission left open a regulatory arbitrage that incentives sub-optimal prudential outcomes, did not follow through on the logic of its own and the co-legislators new regulatory architecture, and provided an unjustified brake to its own CMU program realisation. ■

This paper was drafted by Ian Bell - Head of the PCS Secretariat