Future of securitization in the EU

Edouard Fernandez-Bollo

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

A robust EU securitisation framework that remains to be fully finalized

The new EU simple, transparent and standardised (STS) framework paves the way for a strengthening of investors' confidence in the securisation market and in turn for a relaunch of the latter. Indeed, it is designed to fix the main deficiencies identified in the prior framework.

The Securitisation Regulation (Regulation EU 2017/2402) establishes a set of criteria which must be met by all securitisations and also defines what are 'STS' securitisations, while the targeted amendments to CRR (Regulation EU 2017/2401) set out a framework for a more risk-sensitive regulatory treatment of exposures to securitisations and a preferential treatment for those complying with the STS criteria. By providing clarity, enhanced regulatory requirements and the right incentives, this regulation will improve efficiencies in the financial system and offer additional investment opportunities. Safe securitisation is useful for financial actors but also for the financing of the economy.

Indeed, the crisis highlighted several weaknesses within the previous framework. They were, among others, related to the calibration of risk weights and a lack of incentives for good risk management. These flaws have been translated into specific objectives that the revised framework has sought to achieve, therefore creating a simpler, more transparent and more standardised approach for securitisations. Among the most significant revisions are the reduction of the automatic reliance on external ratings and the enhancement of the risk sensitivity of the securitisation framework.

Yet, in order to be fully implemented within the Union, the revised framework must be completed by technical instruments, some of which are still to be published.

The revised framework is applicable since 1st January 2019. For the securitisation framework to be fully finalised, the Commission and the ESAs must still provide the market with a series of technical texts including several necessary guidelines and technical standards, relating for instance to risk retention, homogeneity, disclosure or interpretation of the STS criteria.

Despite the dedication of the teams of the ESAs involved in the process, complying with the deadlines set out by the legislator has proved to be challenging. The uncertainty about the content of the standards may limit the relaunch of the EU securitisation

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>>> market on the short term but one can be confident that in the medium term (hopefully before end 2019) these issues will be solved.

Work is still in progress regarding the harmonisation of the concept of significant risk transfer (SRT) and the potential development of a framework for STS synthetic securitisations.

Synthetic securitisations have been mostly excluded from the STS scope (apart from certain senior positions in SME securitisations under specific circumstances). Yet synthetic securitisations can be executed promptly and, through an improvement of the credit risk position of the originators, help their ability to support the financing of the real economy. The EBA shall publish a report on the feasibility of a specific framework for STS synthetic securitisation, limited to balance-sheet synthetic securitisation: the analytical work to come will be most interesting.

Above all, the EBA has been mandated to treat the overall subject of SRT. If SRT has been put on the back burner following the implementation of the revised framework, the subject needs to be further scrutinised, in light of the responses to the Discussion paper that was published in September 2017 by the EBA on this theme. Further analysis at Basel level would also be desirable to achieve a harmonised global framework on SRT, considering the importance of this concept on the overall economics of the transactions.

The completion of a global and comprehensive approach to securitisation still remains challenging but nevertheless the Europe has made good progress. The entry into force of the STS framework is already an important step towards both a safer and well-functioning (therefore actively funding) securitisation market. ●

Philippe Bordenave

Chief Operating Officer, BNP Paribas

Relaunching securitisation in Europe: where do we stand?

For some years after the financial crisis, European policy makers have considered securitisation as one of the main source of the crisis, not differentiating between the US and Europe, although default rates in European securitised assets resisted much better than US ones. Securitisation is only as good as the underlying asset pool... "Garbage in, garbage out!"

ECB, Bank of England[1] and Banque de France[2] were the first in 2014 to call for a revival of securitisation, to rebalance the financing of the European economy which may be dried up by the progressive roll-out of restrictive bank regulations. Securitization hence became an essential building block of the Capital Market Union.

The concept of "Simple, Transparent and Standard" securitisation was coined by EBA in 2014, and was welcomed by the industry, as there were few, if any, criteria which would not make sense from a risk management standpoint. However, the EBA proposal paved the way for slippage in the regulatory design, as (a) many criteria were expressed in a subjective manner, which led to further conservatism throughout the process, (b) the criteria did not differentiate between types of securitisations (cash, synthetic, ABCPs, public vs private,...) leading to some impracticable requirements, and (c) capital charges for originators and investors remained punitive, with an intended " non-neutrality" between capital required before and after securitisation. Actually though, apart from the legitimate layer of

>>> operational or counterparty risks that are created by securitisation, the credit risk of the underlying pool is the same, whether securitised or not, and such "capital neutrality" would be necessary for a sound market to develop, where offer and demand can match.

Not only those comments were not heard, but the political debate added even more conservatism. As the STS legislation enters into application in 2019, we are now facing, in the real life, the issues raised 5 years ago! There should be no surprise that the market is not taking off...

For originators and for investors, the STS framework introduces so many regulatory and operational constraints that, instead of reviving the market, it may rather further disincentivize securitization issuance. Indeed, issuing a STS securitisation is extremely demanding, with limited benefits in cost and capital, and major liabilities if some of the 100+ criteria may prove to be unmet. And issuing non-STS securitisation has become more costly.

Contrary to the growing US market, the European securitization market never recovered from the crisis, and issuance remains at half of the already low pre-crisis level. It has even continued to decrease in 2018 and since the beginning of 2019. If Europe wants to constrain the size of banks, like in the US, and substitute it by the development of a securitisation market, like in the US, it should go without saying that we should be inspired by the way the US market works: investor confidence relies on scoring rules defined by the GSEs, which allows to issue low rate securities and organize the transfer of conforming mortgages to investors via securitisation.

In Europe, long term savings are abundant, housing loans are high quality, and we have supranational institutions active in the debt market, and competent to buy/enhance credit portfolios. What we miss is a true willingness to develop capital markets, which continue to inspire mistrust to regulators and supervisors as in 2009.

But then, we must make a choice: constraining both the size of banks and the functioning of markets is highly detrimental to the capacity to finance European growth recovery. ●

1. «The impaired securitisation market: Causes, roadblocks and how to deal with them», March 2014.
2. See for instance the French ESNI initiative, April 2014.

Alexander Batchvarov

Head of International Structured Finance Research, Bank of America Merrill Lynch

EU securitisation market still awaits regulatory clarity and level playing field

EU securitisation market is in a wait-and-see mode. The delays in the finalisation of the EU securitisation regulations, the remaining grey areas in their scope and implementation, and the regulatory complexity have significantly delayed the re-launch of the European securitisation – a key EU CMU initiative. They, in conjunction with the loose harmonisation of covered bond regulations, have further tilted the playing field against traditional cash securitisation market recovery in the EU, in sharp contrast to the post-financial crisis market developments in the US, China, Australia and Japan.

To illustrate: in the first six weeks of 2019, EU RMBS issuance was a mere €0.7bn, only one deal from the UK and mostly placed in the US, while EU benchmark covered bond supply reached €45bn, a 30% growth over the same period of last year. Even the >>>

>>> total (including CLOs and corporate sectors) securitisation supply ytd of €5.5bn pales in comparison with the covered bond market new issuance. On the positive side, the placement of the small EU securitisation issuance is mainly with non-bank investors, thus dispatching credit risk away from the banking system and improving market transparency. Disconcertingly, half or more of the covered bond placement is exchanged between bank issuers, raising questions about interdependence and systemic risks in the EU banking system. Covered bonds are the funding instrument choice for banks, while bilateral synthetic risk transfers are their choice for risk capital management. This is at the expense of the transparency and liquidity of the broader fixed income markets in the EU.

Many challenges still cause consternation on the EU securitisation market. Among them is the question of the extra-territorial application of the EU securitisation regulations to non-EU investors managing money for EU based investors in non-EU securitisation markets and to non-EU based issuers marketing non-EU securitisation deals to EU-based investors. Another question is whether there is a differentiation in the scope of disclosure for public, private and bilateral securitisations. Yet another challenge is the application of SRT requirements which are goldplating the current SRT regulations. A further and lasting problem is the disparate treatment of securitisation exposures between banks and insurance companies for regulatory capital purposes and the large regulatory capital differential between STS and non-STS securitisations under Solvency II. Yet another one is the large discrepancy in liquidity treatment of residential mortgage covered bonds (Level 1B) and prime residential mortgage securitisations, qualifying for STS, (Level 2B). All these issues underlie the systemic and liquidity risks that we highlighted above, and distort markets' level playing field.

These challenges need to be addressed sooner rather than later. One necessary step is the coordinated guidance by ESAs on securitisation matters; the set-up of a joint securitisation subcommittee will not be a sufficient step if such committee cannot clarify and resolve conflicts in regulatory texts. Another step can be a clear differentiation among markets and regimes for deal execution on the example of the US: a (SEC-) registered deal, a deal for qualified institutional investors (144A) and a private placement deal. Another useful reference to the US securitisation regime is the reduced regulatory overreach especially as it concerns qualified institutional investors and private placements. Building a framework for STS synthetic securitisations is important, but their execution will be dependent on resolving some broader issues such as SRT and disclosure regime. Clarity is also needed on SRT for NPL disposals and securitisations in order for securitisation markets to help address the backlog of non-performing loans in Europe. A useful tool to borrow from Australia, Canada and the UK regulations to level the playing field between covered bonds and RMBS, and reduce the system risk and interdependence among banks is the introduction of asset encumbrance limit for covered bonds at low single digit levels. ●

Felicia Stanescu

Head of Policy Definition and Coordination, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

A more secure path ahead for EU securitisation

Reviving the securitisation market on a sound basis with a view to strengthen banks' ability to finance the economy, provide additional funding sources for companies, and enhance private risk sharing is among the key building blocks of the Capital Markets Union.

To this end, following negotiations with the European Parliament and the Council, the new securitisation framework was published at the end of 2017 and entered into application on 1 January 2019. >>>

>>> This initiative aims to revive the market in several ways. Firstly, it establishes a clear and consistent legal framework, thus ensuring clarity for all parties involved. The harmonised regime includes common rules for due diligence on investors, risk retention, transparency, credit standards as well as a ban on re-securitisation.

Secondly, the Securitisation Regulation creates a new asset class of high-quality structures – Simple, Transparent and Standardised (STS) securitisation. The STS product has high standards for the manufacturing process, legal certainty and comparability across securitisation instruments. This aims to facilitate the issuance of securitisations by originators and sponsors as well as the due diligence process by investors.

A set of regulatory and implementing technical standards are being developed in order to specify the details of the revamped securitisation framework and ensure its clarity and consistent application in order to achieve the policy goals.

Finally, the prudential treatment for the major investors, banks and insurance companies, has been amended in order to establish a closer relationship between the riskiness of a securitisation and the prudential capital required. This aims to further incentivise the development of the STS market.

Securitisation issuance in the EU has not bounced back after the financial crisis in the same way that it did in other developed markets across the globe. The new EU securitisation framework addresses the key deficiencies of the past – regulatory inconsistencies across the EU and the flawed pre-crisis "originate-to-distribute" business model that also led to a significant investor stigma towards securitised products thereafter.

The regulatory efforts are geared towards creating a solid and sustainable footing, on the basis of which a safer securitisation industry can grow. The European Commission and the European Supervisory Agencies will closely monitor market developments and take action, as appropriate, in order to facilitate the transition to the new regime. ●

Contributor: Presiyan Petkov, DG FISMA, European Commission