Relaunching securitisation in the EU

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Securitisation done right

Securitisation done right has benefits for lenders and institutional investors alike. Securitisation done wrong, however, can amplify economic crises and bring the global economy to its knees. The EU's securitisation regulation created a standard that allows for the benefits of securitisation, while avoiding the pitfalls. Under the right economic circumstances and with the endorsement of regulators, securitisation can play a pivotal role in recapitalising banks in the post-COVID, Basel III regulatory environment.

Pooling illiquid assets into tradable securities allows lenders to increase lending capacity while transferring risks to investors according to their preferences. It is important however, that these risks do not remain in (the systemic part of) the financial sector, so that overall stability is guaranteed. Besides, when low trenches of asset-backed securities are repeatedly packed in collateralised debt obligations, it quickly becomes impossible to analyse the product's creditworthiness. Since such CDOx products helped propel a US housing crisis into a global financial meltdown, it is only right that a certain stigma is attached to – complex – securitisation.

When, after the financial crisis, European securitisation remained subdued, the European Institutions reset the market through a regulatory framework for "good" securities. It set rules on due diligence, risk retention and transparency for all securities, and enabled the identification of simple, transparent and secure (STS) products. With level-2 measures published, we now see the first early results. In 2019, 143 transactions were notified to ESMA as STS. In the first two months of 2020 over 30. STS is thus a workable standard, allowing the reaping of securitisation's rewards, without suffering its drawbacks.

Expansionary monetary policy means the use of securitisation to increase lending capacity is limited. Why pay fees to a range of credit rating agencies, underwriters or credit enhancers, when you can secure cheap capital with the ECB? But, with EBA estimating that banks need over €100bn to fulfil Basel III requirements, securitisation can help reduce risk and improve one's capital base. Given the sector's efforts during the current COVID-19 crisis, this amount is only set to increase. Securitising outstanding loans will be essential to reach Basel III standards.

However, the EU regulatory environment means that using STS securities is not yet fully rewarded. For example, the standards for other financial products have not caught up with those for securities. Products such as covered bonds lack securities' transparency and due diligence requirements. With ambitious regulation on these products, the EU can set off a race to the top while guaranteeing a level playing field.

As EU we can be proud to have eliminated the most stringent risks associated with "bad" securitisation while creating the global standard for the "good" kind. Yet, the combination of expansive monetary policy with an imbalanced regulatory environment means the EU is not fully capitalising on this standard. With lenders seeking the capital base increase that securitisation provides, this is something to set right. Upcoming reviews of financial legislations provide a good opportunity to do so. ●

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The STS label has kicked off to a good start, but fine-tuning needed

Securitisation plays a key role in the Capital Markets Union (CMU) creating a bridge between bank lending and the CMU objectives. Overall, it is expected to contribute significantly to unlocking the benefits of the Single Market for EU businesses and households by providing more innovative, sustainable and diversified sources of funding. When soundly structured, which was one of the aims of the overhaul of its legislative and regulatory framework, securitisation allows banks to transfer assets to institutional investors and free up capital for new lending, while providing markets with a broader scope of investment opportunities.

The EU securitisation market got off to a slow start in the beginning of 2019, ▶

in the first months of application of the new framework, but activity picked up thereafter. The authorisation of third-party verifiers seems to have had a very important positive effect on the STS market, helping operators navigate the new framework. The first STS deal, a private RMBS securitisation, was notified to ESMA on 22 March 2019. Thereafter, originators started 'taking the plunge' and nearly 200 STS deals were notified to ESMA by mid-March this year.

It is early to make definitive conclusions about the state of the market and the impact of the new framework after just one year of application. The take-up of the STS label does point to strong demand among investors. Thus, the new label has helped to reduce the stigma among investors. However, the fact that we have not yet seen a broadening of the investor base and, more generally, a significant rebound in the securitisation market suggests that additional action might be needed.

The European Commission is finalising the Level 2 measures which, together with the Q&As by the ESAs, should dispel any lingering uncertainty about the application of the new rules. To support issuance, the Commission will explore extending the STS label to synthetic deals and facilitating securitisations of non-performing exposures, based on input from the EBA.

The upcoming comprehensive review of the securitisation framework, mandated to take place by January 2022, will look carefully at all of its aspects, including the Level 2 measures. Moreover, The CMU High Level Forum is preparing recommendations with the objective to relaunch and scale up EU securitisation as it can bring considerable benefits to the European financial system.

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With regard to the capital treatment of securitisation exposures, there is widespread acknowledgement that it needs to be adapted to the specific features of non-performing exposures. The EBA and BCBS are already actively working on possible adjustments in particular to the formulaic approaches for the calculation of capital charges. Another area requiring potential improvement is that of the recognition of significant risk transfer where stakeholders claim a more uniform interpretation and application of CRR provisions by supervisors.

The EBA is expected to produce a report by the beginning of 2021 that could serve as a basis for a delegated act by the Commission. The Commission is also working on the adoption of the RTS that will allow a more widespread use of the Internal Ratings Based Approach, the most risk-sensitive method for the calculation of capital charges for securitisation exposures.

Supporting the EU securitisation market remains a priority for the Commission. The aim of the securitisation framework is that the market functions on a solid and sustainable footing, subject to clear criteria and appropriate supervision and prudential rules, in order to ensure that the securitisation duly contributes to the CMU objectives. ●

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STS: unleasing the potential of EU-27 Securitisation Market

In each of the last two years EU-27 issued €370-€400bn of covered bonds, placed €7-€9bn of RMBS, and €50-€60bn of other securitisation bonds. The STS introduction in 2019 did not boost issuance volumes; it is unlikely to do so in 2020. By way of comparison, securitisation represents 12.5% of GDP in the US (excluding GSE securitisations) and 12% in the UK vs. 3% in the EU-27; covered bonds represent 21% of the EU GDP and 4% of UK GDP.

Securitisation represents 6% of all green bonds in China and about 1% in the EU. Many factors affect securitisation activity: ECB policy, non-bank lending, bank capital needs, but they alone cannot explain the low utilisation of securitisation in EU-27. Securitisation has an important role to play in the EU-27. The introduction of Basel 3 will increase bank capital requirements by an estimated EUR100bn.

> *The securitisation regulatory regime must be realigned with that of other fixed income sectors.*

The focus on sustainable finance and ESG impose new criteria on bank balance sheets. Banks must address the new capital and financing needs through sale of assets, balance sheet optimisation and/or securitisation. Banks offload assets to asset managers and finance companies, which in turn finance their acquisition via securitisation. If half of the bank capital increase is due to residential mortgages and half of that is addressed via securitisation, then a need for EUR800bn of RMBS issuance in the next 5-10 years will arise.

Funding the EU Green Plan also needs a functioning EU securitisation market. EU-27 needs to scale up its securitisation market, but it remains underutilised. ▶

▶ With the introduction of STS in 2019 the regulatory capital for securitisation increased on average under CRR, remained unjustifiably high under Solvency 2, there was no change in liquidity and repo treatment of securitisation bonds, and detailed disclosure and due diligence requirements (unparalleled in any other fixed income sector and in any other jurisdiction) were imposed. The calibration of regulatory capital for EU securitisation does not reflect its historical performance and is subject to non-neutrality.

The securitisation regulatory regime must be realigned with that of other fixed income sectors, especially loans, corporate and covered bonds. Several changes can be introduced in the near term to allow for the EU securitisation market to scale up and to provide the much needed support for the EU economy and banking sector: A/ Modify securitisation capital and liquidity treatment under CRR (e.g. LCR treatment, p factor, WAM); B/ Recalibrate capital treatment for securitisation for insurers under Solvency 2 in line with covered bonds for STS and corporate bonds for non-STS securitisations; C/ Simplify significant risk transfer requirements for cash and synthetic securitisations, expand the STS for synthetics beyond SMEs to include other granular exposures. D/ Differentiate between disclosure and due diligence requirements for public and private securitisations applying proportionality and allow for longer-term use of ND fields.

EU-27 securitisation market has a crucial role to play in deepening of CMU, in greening the EU economy, in strengthening bank balance sheets while introducing new capital and sustainable finance requirements. Key measures necessary to ensure that it fulfils that role lie in the hands of the EU policymakers. ●

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Five "game-changers" to scale-up securitisation in Europe

Following the implementation of a burdensome STS regime, European issuance dropped to EUR 131 bn in 2019[1], down by 6% y/y, compared to USD 2.5trn in the US. As long as such a gap exists, every banking regulation will have a disproportionate impact on the EU compared to the US.

While the goal should be to develop pan-european home loan securitization, this can only be a mid-term project. In the short term, the current EU prudential framework should be urgently adjusted, with five regulatory changes needed as "game-changers" to scale-up the EU securitisation market:

1. Unlock the Significant Risk Transfer Assessment process

This process is essential, for issuing banks to benefit from a reduction in capital charges, commensurate with the risk transferred to the market. While the CRR defines specific quantitative and qualitative criteria to meet this Significant Risk Transfer, the additional discretion provided to competent authorities has turned into a major obstacle, with multiple metrics added.

- When the level 1 quantitative and qualitative criteria are met, banks should be considered as achieving significant risk transfer, with no additional supervisory scrutiny.
- Such simplified rule would still result in a very prudent framework, given the conservativeness of the RW of the retained tranches, even after the proposed recalibration as per below.

2. Recalibrate capital charges applied to senior tranches, in line with their risk profile, for originating and sponsor banks

The implementation of the STS framework aimed at defining strict criteria for a safe securitization, but instead of reducing the RWs of the senior tranches, it has actually increased them. Also, it did not address the issue of "non-neutrality", whereby the cumulated RWA of securitized tranches is between 2 and 4 times the RWA of the loan pool prior to securitization, making securitization economically unviable.

- The non-neutrality should be reduced by recalibrating the "p factor" that drives this multiple
- The RW floor applied to senior tranches should be reduced for originators and sponsors, as they have a perfect knowledge of the securitized pool.

3. Enlarge STS benefits to synthetic securitisation beyond SMEs

Synthetic securitizations are easy to execute, standard, and very useful to transfer risks and release capital. Protection sellers are highly specialized, and they perfectly understand the risk.

- The same RW should apply as for cash securitizations.
- STS synthetic securitisations scope (currently limited to SME's) should be extended to all corporates and retail exposures.

4. Upgrade eligibility of senior STS tranches in the LCR ratio

The revision of the LCR Delegated Act has not improved the treatment of senior STS tranches.

- Senior STS tranches should be promoted to Level 1 (for residential and auto loans, the most liquid types of securitization) and Level 2a (SME loans and other ▶

consumer loans), with same haircuts as for covered bonds.

5. Review the Solvency II calibration of senior tranches

Insurance companies should be able to invest in senior tranches instead of investing directly in the underlying assets with no credit enhancement.

- The credit spread shocks applied to senior STS securitization positions could be aligned with those applied to the bonds and loans.
- Finally, removing ESMA disclosure constraints on private transactions also appears as a pressing issue.

Those five measures are needed to rebuild a functioning ecosystem for securitization, allowing for a significant scale up of issuance, far above recent levels, which represent only about 1% of EU banking assets. Given the upcoming Basel III regulatory pressure, the need to finance the energy transition, while reducing the over-reliance on bank funding, the EU should take prompt action to significantly scale-up the securitization market. ●

1. Figures based on SIFMA, BNPP data. European securitisation placed issuance (EUR bn); scope: ABS, CDO/CLO, CMBS, RMBS, SME.

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EU regulation supports functioning of the securitisation market in a prudent way

A well-functioning securitisation market improves the funding capacity of the real economy and contributes to completing the Capital Markets Union. At the same time, securitised assets may provide an alternative investment opportunity to insurance and reinsurance undertakings, which need to diversify their portfolios in a low yield environment. As institutional investors, insurance and reinsurance undertakings should be fully integrated into the Union's securitisation market.

It is important that Solvency II, as a risk based regulatory framework, provides a sound basis for (re)insurers to invest in securitisations without jeopardising the regime's prudential risk-based nature. In 2013, EIOPA proposed a solution to reduce capital requirements for specific securitisations by a more granular treatment of securitisations. For identifying less risky securitisations, EIOPA developed a set of criteria related to the structure of securitisations, the quality of the underlying assets, the underwriting processes and the transparency for investors.

The proposal was based on analysis which had shown that those types of securitisations meeting a set of quality criteria had a good track record of performance. From a supervisory perspective, EIOPA proposed to apply lower capital requirements to those instruments.

> *EU regulatory frameworks including Solvency II support the functioning of the securitisation market and long-term growth objectives in a prudent way.*

To ensure a sound recovery of the EU securitisation market after the financial crisis, in 2017 a new overarching securitisation framework was introduced. The new framework includes criteria to identify simple, transparent and standardised ('STS') securitisations and a system of supervision to monitor the correct application of those criteria by originators, sponsors, issuers and institutional investors.

The Regulation also provides for a set of common requirements in relation to risk retention, due diligence and disclosure for all financial services sectors[1]. To avoid double regulation and for reasons of clarity and consistency, the Solvency II framework was adjusted accordingly in 2018. The amendments to the Solvency II Delegated Regulation[2] introduced a more risk-sensitive calibration of the solvency capital requirements for STS securitisations held by undertakings.

The level of the calibration and the risk sensitivity across tranches was aligned with the features of STS securitisation, and is now consistent with the prudential requirements developed for credit institutions and investment firms. The objective is to provide the right incentives across different forms of securitisation investments and allow for better alignment between risk and capital management. A more detailed review of the Solvency II reporting and disclosure requirements will be part of the 2020 review. ●

1. Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.
2. COMMISSION DELEGATED REGULATION (EU) 2018/1221 of 1 June 2018 amending Delegated Regulation (EU) 2015/35 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertaking.

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Securitisation and STS: contribution to financial markets stability in the EU

In order to asses this question, the review of the last financial crisis provides two important insights: First, default rates of European securitisations were consistently low and did not cause losses and bank bailouts.

Rather, securitisation as a highly collateralised financing tool has contributed to financing the real economy in times of crisis. Secondly, the European legislator and the ECB have rightly adopted a number of important regulations in the period 2009 to 2011 that will prevent securitisation types that were responsible for the financial crisis 2008, especially: 5% risk retention, loan-level data, no originate-to-distribute models and ban on re-securitisation.

Now how is securitisation used in practice and what impact does the new EU Securitisation Regulation (applicable since 2019) make? Firstly, banks can provide its customers with solutions for funding and capital relief, products employed are public term ABS with placement to investors, and private securitisation financed via bank balance sheets and including ABCP programs (Asset Backed Commercial Papers). Secondly, banks securitize own assets from their ordinary course of business to achieve funding and capital relief. This again involves term ABS as well as private, bilateral securitizations for risk transfer. This differentiation is necessary in order to understand what contribution the EU Securitisation Regulation has made and what problems still need to be solved.

The EU Securitisation Regulation overall and also the STS criteria for simple, transparent and standardised securitisations as a quality segment distinguish between ABCP and non-ABCP (i.e. term ABS). Term ABS issuance of €220bn in 2019 has declined by ca. 15% compared to 2018, and no new issuers or investors could be attracted. On a positive note, STS has gained broad acceptance as new market standard in the asset classes residential mortgages (RMBS), auto, consumer and equipment leasing ABS.

This has been supported by the independent third-party verifications of the STS criteria. The strong regulation, acceptance of STS and increased transparency have strengthened confidence of politicians, central banks and supervisory authorities. However, this positive aspect only applies to the Term ABS market.

The picture is different for private securitisations and ABCP, as well as the market for capital relief trades, together making up a volume of ca. €200-250bn p.a. in Europe. The new Securitisation Regulation does not reflect the particularities of these market segments, with sometimes inconsistent, inappropriate and prohibitive rules and reporting obligations. ABCP securitisations should be treated as what they are: Highly secured funding instruments, allowing banks to finance the real economy and receive secured refinancing with short maturities, similar to covered bonds at the longer end of the maturity spectrum.

> *Securitisation will contribute to stability and be part of the solution this time.*

Still a series of changes and improvements need to be made to the level 1 regulation and certain level 2 RTS issued by the respective ESAs. The level playing field of securitisation with other products like covered bonds as part of the Capital Markets Union still needs to be achieved. A clear and consistent ruleset for banks applying significant risk transfer (SRT) for capital relief needs to be established by the legislator and applied uniformly from supervisors across Europe.

Especially in the context of the current situation with severe consequences due to Covid-19 for the real economy and the stability of the financial system, this once again shows the necessity for clear and consistent rules, limited complexity and no procyclical consequences. Under these premises and based on trust, securitisation will contribute to stability and be part of the solution this time. ●