RELAUNCHING SECURITISATION

DOMINIQUE LABOUREIX

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

Deepening the EU securitisation market: a key step for the Capital Markets Union

Securitisation can play a decisive role to support the objectives of the Capital Markets Union but needs to be properly regulated to address financial stability considerations. The EU financing market still relies heavily on banks. Securitisation, through diversification of funding sources, risk diversification and liquidity upgrade, can help deepen the Capital Markets Union. Banks that outsell or protect assets through securitisation may benefit from liquidity and/or preferential risk weights and get more flexibility to provide funding to the real economy. However, securitisation is a complex product that can endanger the financial stability when inappropriately used and hence deserves a robust framework.

To this end, increased attention has been paid to the regulation of the EU securitisation market in the wake of the Great Financial Crisis. A new simple, transparent and standardised (STS) framework has been adopted to fix the weaknesses identified during this crisis. This framework has been crucial in strengthening the investors' confidence. EU legislators also intend to improve further the framework in 2021 by introducing (i) a more risk sensitive approach to deal with the securitisation of non-performing loans and (ii) a differentiated regulatory treatment of STS synthetic securitisations.

However, the market has not yet fulfilled its potential. In 2020, primary public ABS issues in Euro fell by ca 40% from 2019 (from €39 bn to €22 bn). The low level of holdings by insurers is also a striking feature. Although the new framework entered into force in January 2019, the market is far from mature. The Covid-19 crisis has played a role in this regard. However, apart from short-term considerations, wehave to admit that the securitisation framework has not reached all its promises yet and still needs some fine-tuning to help support its revival.

Refining the securitisation regulatory framework remains a priority. Securitisation, in its well-designed form, may be part of the solutions to face post Covid-19 crisis challenges, such as: accompanying NPL off-loading, capital freeing, through an efficient significant risk transfer (SRT) assessment, and further expansion of the ABCP segment in order to support the European real economies and meet their financing needs. Developing green securitisation is also a promising tool. Accordingly, EU regulators should continue improving the framework by implementing a risk-based approach, consistently with financial products subject to similar credit, liquidity and agency risks. This would facilitate origination and investment in a wider range of operations. Areas of improvements may include: (i) developing a EU label for sustainable securitisations; (ii) removing remaining barriers, through a careful risk sensitivity evaluation, by reassessing the calibration of capital and liquidity requirements to encourage investments by banks and insurers.

The upcoming reviews of Solvency II and the securitisation framework provide the ideal opportunity to progress on these questions.

FAUSTO PARENTE

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

Securitisation: an appropriate treatment to ensure policyholder protection

What is special about securitisations is that they should not be special. In other words, the prudential framework for insurers, including capital charges, should reflect the riskiness of the securitisation. Only through such treatment can the principal aim of protecting policyholders be best realised.

Not treating securitisations does not mean discriminating against them. Insurers and pension funds should have the opportunity to invest in securitisations. Indeed, where justified Solvency II makes a risk-based distinction in its treatment of spread risk between asset classes.

EIOPA provided advice on the recalibration of spread risk charges for the identification and calibration of infrastructure investments in September 2015 and infrastructure corporate investments in June 2016; on reducing reliance on external credit ratings and the treatment of exposures to regional governments and local authorities in October 2017; and on the treatment of unrated debt in February 2018.

EIOPA provided advice on more favourable but still prudent treatment of securitisations as long ago as 2013. EIOPA proposed a category of securitisations with lower capital requirements as there is clear evidence that many securitisations displayed lower spread volatility and performed well from a fundamental credit risk perspective.

This advice was subsequently implemented. These qualifying securitisations have to meet a number of criteria on their structure, the quality of the underlying assets, underwriting processes, and on transparency. In the meantime, insurers among others have benefitted from the introduction of simple, transparent and standardised (STS) securitisations, though use has not yet been significant.

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EIOPA's most recent review of the EU's prudential framework for insurance did not recommend disturbing the current treatment of securitisations nor indeed the treatment of spread risk more generally. Nonetheless, securitisations will benefit from some broader changes being proposed. For example, one recommendation is to simplify the calculation of the risk mitigating impact of a number of techniques including securitisations.

All these measures reflect that securitisations are likely to be a relatively small – 2.4 per cent of overall investments by insurers at end-2019 – but material area for insurers.

Ensuring a well-functioning and stable insurance sector is part of a robust financial services sector in Europe. A risk-based regulatory framework is fundamental to achieving this and to ensuring, both policyholder protection and policyholder trust in the sector.

EIOPA's advice and activity on the areas of securitisation will always follow these considerations so that Europe's insurance sector works for the benefit of people, business and society.

PAULINA DEJMEK HACK

Director for General Affairs,
DG for Financial Stability, Financial Services and Capital Markets Union,
European Commission

What is next for EU securitisation?

When structured in a sound way, securitisation provides a tool for efficient risk and capital management, diversifies funding sources for banks and companies and enables a broader range of investors to fund the economy. However, as the Global Financial Crisis demonstrated, poorly regulated securitisation can be a source of risk for the financial system.

Therefore, regulation and supervision of securitisation need to walk the fine line of ensuring that we continue to draw the lessons from the crisis so that risks do not re-emerge while, at the same time, supporting a beneficial expansion of the market to the benefit of companies and the economy as a whole.

As one of the priorities of the CMU project, the EU aimed to do just that with the securitisation framework that became applicable on 1 January 2019. The new framework is meant to promote the revival of the EU market, in particular through the creation of the STS (Simple-Transparent-Standard) quality label and the prudential benefits attached to it, while also drawing the lessons from the financial crisis by adequately protecting investors and managing potential systemic risks.

Regulation and supervision need to walk the fine line of ensuring that we draw the lessons from the crisis while supporting expansion of the market.

Last December's agreement on the Capital Markets Recovery Package (CMRP) amplifies the potential benefits that securitisation can bring for the economy by extending the STS label to on-balance-sheet (synthetic) securitisations and removing regulatory obstacles to the securitisation of non-performing loans.

The swift conclusion of the political trilogues shows that the legislators share the Commission's ambition to revive this important market, provided that legislative proposals are based on a solid analysis and thorough preparatory work.

As markets and policy makers gain experience with the framework, we also note that the appetite for its reviewis growing. The Council Conclusions on the renewed CMU Action Plan mentioned a review of the securitisation framework as one of the important and urgent deliverables for 2021. This was echoed also by the European Parliament in its own initiative report on the CMU from September 2020.

In any event, the legislation in force requires the Commission to review the functioning of the securitisation framework and deliver a report to the legislators by 1 January 2022. Like the CMRP, the upcoming review – and any legislative proposals that may follow – will have to be based on thorough preparatory work by and input from the European Supervisory Authorities. Further technical work should identify areas where the rules could be improved in order to foster the market, without compromising on investor and consumer protection.

While we are still gaining experience with the framework and its practical effects, the review will be the next important stepping-stone for the market after the CMRP. The review will also look at the important issue of green securitisations, to see what can be done to encourage this market segment to grow further and support the green transition.

The Commission stands ready and is looking forward to the work with the European Supervisory Authorities and all relevant stakeholders to continue to develop EU's securitisation framework in the context of the CMU and beyond.

NATHALIE ESNAULT

Managing Director Securitisation, Crédit Agricole CIB

Securitisation at the service of the European economy

While significant progress has been made to restore the place of securitisation in Europe, securitisation issuance fell under €200bn in 2020, its lowest level since 2013. This is explained by conjectural reasons like the pandemic but there are fundamental reasons at work.

Tremendous effort to restart the market

EU securitisation has been significantly reshaped after the financial crisis and the subsequent adoption of new regulations, providing notably for a new label for “simple transparent and standard” (STS) securitisation. New regulation was also needed to overcome deficiencies, in particular a lack of risk alignment and comparability in structures and reporting. Since its entry into force in 2019, STS has been largely adopted for asset classes by design eligible to STS. Significant effort has been made in reporting for public and private transactions and ABCP.

Public volumes falling short of expectations

In 2020, publicly placed issuance was €81.4bn after €116.8bn in 2019 and €135.8bn in 2018 (record year post crisis). Overall, €194.7bn of public securitisation was issued in 2020, a decrease of 10.4% from 2019. 2019 was a transition year for adapting to the new framework. 2020 has been clearly hit by the pandemic, especially placed issuance.

More fundamentally, bank-led securitisation issuance is impacted by the availability of cheaper alternatives like the TLTRO scheme of the ECB, which has been loosened again and extended until 2024.

Banks need well-functioning securitisation in their toolbox to contribute to recovery and assist in the strategic redeployment of their balance sheet.

Strong latent potential

Public volumes do not reflect the entire market. Banks often use private securitisation for managing their balance sheet. Private securitisation also accommodates diverse non-bank issuers and asset classes (transport assets, trade receivables etc.), with banks providing critical funding to this market, directly or through ABCP.

Finally, securitisation is growingly used in sustainable green finance. Social securitisation is also emerging as a way to support disadvantaged borrowers or projects with social utility.

Which priorities to improve the situation

While securitisation is well equipped to support the CMU, its development is hindered by significant obstacles. In order to make it attractive to banks, it must remain economic and manageable. Therefore, measures should focus on

- Reducing punitive capital charges: measures should focus on reducing the non-neutrality of the capital regime and lowering capital floors for senior tranches. Solvency 2 should also be recalibrated, in particular for STS;
- Facilitating significant risk transfer (SRT): the process for SRT should be improved to ensure consistency and better predictability. Visibility is also needed on key features such as synthetic excess spread;
- Improving liquidity treatment (LCR): securitisation should be treated equally to covered bonds – e.g., senior STS qualified as Level 1 for most liquid assets;
- Revisiting disclosure requirements: full disclosure templates should apply only to public issues in line with the proportionality principle.

Generally, measures should ensure level playing field with other products and sustainability of the operating environment over time. EU banks need well-functioning securitisation in their toolbox to contribute to recovery and assist in the strategic redeployment of their balance sheets.

ALEXANDER BATCHVAROV

Managing Director, Global Research, Bank of America

EU securitisation revival requires CMU level-playing field

Re-launching the securitisation market has been a long-standing objective in the context of the deepening of the EU CMU. Measures adopted in recent years with much fanfare have not delivered the desired results. The market data informs us that 2020 recorded a third-year-in-a-row decline in both placed and retained securitisation volume. STS framework has been in operation for about 2 years now, but we are yet to see a pick-up in its use by new issuers. Over the years total prime Euro area RMBS supply declined to reach €45bn in 2020 (down almost 40% in the last 5 years), while annual mortgage covered bond supply varied between €412bn and €612bn in the last decade. Other ABS volume has been volatile around the €50bn mark from one year to the next. The potential introduction of ESN (e.g. auto loan covered bonds) will likely replicate the negative experience of prime RMBS issuance in auto ABS space.

We must note the increase in direct loan portfolio investments by insurance companies and pensions fund, eschewing the more protected and liquid structured finance bond format. We are also observing a shift away from use of securitisation to use of credit claims pools as general collateral since the changes that ECB introduced in April 2020. We observe a declining use of prime quality asset cash securitisations with the increase of synthetic balance sheet securitisations, including that of SME loans thanks to the support of EIB/EIF. That contrasts with the pick-up in NPL and in non-conforming (non-prime) mortgage loan securitisations, along with higher-yielding leveraged and commercial real estate loans.

The decline of broadly available securitisation market expertise and its concentration in a small group of investors is underway; a smaller investor base is a challenge to the EU securitisation market revival.

In many EU quarters there is a support for securitisation market re-launch as part of the deepening the CMU, turbo-charging the post-pandemic recovery, transitioning to a sustainable economic model and in response to Basel 3 roll-out. Last year the High Level Forum on CMU prioritised the steps necessary to achieve that goal.

Undeniable need for a level playing field across capital markets instruments on the EU capital markets.

Without enumerating them here, we emphasise that they are only partly addressing the undeniable need for a level playing field across capital market instruments on the EU capital markets in terms of their political, capital, liquidity and monetary treatment. The regulatory treatment of securitisation must reflect the strong credit, price and liquidity performance of EU securitisation bonds without much external support when compared with instruments that were subject to very favourable - in every respect - regulatory treatments. The systemic risk consideration of the use of such other instruments should not be overlooked.

In short, the revival of the securitisation market in the EU requires as a minimum a realignment of its regulatory, political and monetary treatment with that of other fixed income markets. Additional targeted support for certain securitisation market sectors (SME, project finance, green and social finance) is necessary to help EU securitisation achieve its full potential for the benefit of the EU economy and the long-term objectives of EU CMU.