SECURITISATION: CALIBRATION ISSUES AND FUTURE STEPS

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The European securitisation framework: some fine tuning still needed

Securitisation is key to further enhance the Capital Markets Union. It allows investors to get different risk/return profiles depending on their appetite and enables banks to reduce their capital needs and obtain liquidity by selling the different tranches of a securitisation. Thus, it helps diversify the financing sources of the economy and should therefore be supported, while learning from past mistakes: in view of its complexity, securitisation requires a robust and prudent regime that limits harmful practices but does not contain undue obstacles to its use by originators and investors, including insurers.

The new European framework, with the introduction of the simple, transparent and standardised (STS) label in particular, aimed at encouraging the creation of a safe, robust and transparent market. However, the recovery of the market has been fairly limited since its inception in early 2019.

Even though progress has been made after a period of slow implementation, the market is still struggling to develop. It is probably due in part to sanitarian conditions, even if securitisation instruments proved robust following the COVID19 crisis, since banks have kept originating transactions in 2020 and 2021 and no material financial losses on STS products have been recorded. But the struggle is also partly due to some elements in the regulation that could likely be improved so that the framework makes securitisation more competitive with comparable products and eases its liquidity while maintaining the necessary transparency.

The High level Forum for Capital Market Union conducted a useful work in 2020 to pave the way for an overall reflection by highlighting the main issues regarding securitisation in the European Union. It provides a strong input for the upcoming review of the European securitisation framework expected in 2021/2022.

Significant developments have already taken place to improve the functioning of certain securitisation segments.

First, the legislative framework has been amended. The publication, in April 2021, of two regulations on securitisation under the Capital Market Recovery Package, introduced a more appropriate treatment for securitisations of Non-Performing Loans based on the new Basel framework. It has now to be closely monitored to assess whether further improvements would be needed. The 2019 EBA proposals, aimed at making the treatment more risk-sensitive and avoiding incentives to arbitrage, could serve as a common reference in this regard, if necessary.

Second, as said, the European legislators have introduced a welcome STS framework for synthetic securitisations that should ease financing of the economy by lowering the capital requirements of originators.

Third, useful clarifications have also been provided to the market. One example is the publication of a recent EBA report the recommendations of which are aimed at harmonising the assessment of the significant risk transfer. It was also clarified that the originator's prudential supervisor should supervise certain requirements of securitisation regulations (such as retention or transparency).

The 2021/2022 reviews should go a step further while ensuring a robust framework.

We value the conservatism that the current framework for securitisation introduces for banks. However, we should stand ready to continue to improve it and would accordingly support a reassessment of the regulatory capital calibration to address certain technical shortcomings; in particular, it might be relevant to revise the range of the non-neutrality factor «p» (which was introduced to create an additional layer through a capital surcharge for securitisations) to make it more risk sensitive.

Depending on an impact assessment, the treatment of securitisations in the LCR might also be improved, for instance through an upgrade of STS securitisations to Level 2A and the recognition of the eligibility of certain non-STS securitisations to Level 2B, along with adequate haircuts to be determined.

To support the Capital Markets Union, the role of insurance companies as investors is also particularly needed. In this regard, the prudential framework for insurers could be made more risk-sensitive. Indeed, Solvency II capital charges encourage insurers to invest in senior STS categories only, putting aside other categories of securitised products. An area of improvement may be, for example, to include a segmentation of the non-STS category into two sub-categories (senior and junior) - as in the banking prudential framework. Such a segmentation would allow these products to benefit from a more risk-adjusted treatment.

The upcoming reviews of Solvency II and of the securitisation framework provide the ideal opportunity to progress on these topics.Taking into account their overall market knowledge, supervisors should extensively contribute to these reviews.

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Careful securitisation can help

As shown by the Great Financial Crisis, securitised products can create new asymmetries of information and systemic risk if they are not used and regulated adequately. On the other hand, careful securitisation offers credit institutions and investors a powerful tool to manage their risks and shape their balance sheets in line with their risk appetites. Getting the balance right so that securitisation can contribute to economic growth has featured high on the EU's agenda over the past decade, including as part of its Capital Markets Union (CMU) strategy. Safer EU securitisation markets are now surfacing but further efforts are needed.

STS securitisation is gathering speed

The EU securitisation regulation has come far since 2007. As a result of the crisis and thanks to a new EU framework for securitisation, opaque structured products have largely vanished. More straightforward and better-priced ones have gradually developed. This has helped to establish securitisation as a viable and safe product for European banks to manage their balance sheets more actively.

Despite a slow start in the first years, issuance under the EU's simple, transparent, and standard ("STS") label is now gathering pace and represents about 40% of all new EU securitisation.

How can securitisation help in the EU at the current juncture? In a (post) COVID environment, STS transactions can definitely help EU banks to further evolve their business models, originate new loans to viable borrowers, and finance important long-term public goods such as the EU Green Deal.

The main contribution of securitisation can evolve over time. In the coming months, it is probably less about funding (other sources are available to banks) than about helping banks manage their balance sheet management, giving them the capacity to originate fresh loans to viable projects or helping them to manage their stocks of non-performing exposures (NPE). On the latter aspect, an EBA Opinion in 2019 highlighted that securitisation can make a difference. Further such efforts may soon be critical again. They would also benefit from the "NPE templates" that the EBA is currently streamlining.

Regulatory adjustments are on the way

Despite encouraging developments, the EU securitisation market has however not reached its full potential yet. In particular, the expected broadening of the investor base has not materialised, and issuance volumes remain subdue. This was sometimes attributed to the complexity of the EU securitisation framework (including for STS) and to other shortcomings. This suggests that further adjustments are needed.

To that purpose, the EBA has been recommending action in three main regards:

i. Clarifying the rules to get the significant risk transfer (SRT) recognition. Uncertainty or lengthy supervisory processes may indeed have deterred banks from using securitisation more pro-actively to manage their balance sheet. In 2020, the EBA has addressed its recommendations to the European Commission to improve the efficiency and predictability of the SRT framework.

ii. Extending the STS label (and its prudential benefits) to synthetic securitisation. This was endorsed by the co-legislators, who introduced a differentiated regulatory treatment for cash and synthetic transactions. The EBA is now developing the related implementing standards. This will provide further clarity on the prudential treatment on key features such as synthetic excess spread.

iii. Removing some regulatory constraints to the securitisation of NPEs. Key legislative amendments taking into account the specificities of NPEs in securitisation retention rules were introduced by the EU Capital Markets Recovery Package, and the EBA is now implementing them into the Single Rule Book.

Is anything else needed?

As more experience is being gained with the implementation of the EU securitisation framework market participants sometimes call for a recalibration of the capital and liquidity treatment of securitised products. The European Commission's review of the securitisation regulation expected by early 2022 might offer an opportunity to investigate the issue.

Securitisation can help EU banks evolve business models, finance viable borrowers and public goods.

This should however be done carefully. While market data on the performance of STS securitisation are becoming available, there may not be sufficient evidence available yet to already substantiate a re-calibration of the prudential treatment. Moreover, the lessons of the 2007/2008 financial crisis should not be forgotten: the specific risks stemming from securitisation transactions and the recent progress in terms of simplicity, transparency, and pricing should be fully acknowledged. This may warrant a fine-tuning rather than a complete overhaul of the current framework. Finally, there should be close coordination with the Basel Committee.

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Securitisation: the upcoming review of the framework

Securitisation, when structured in a sound and transparent way, is an important element of well-functioning capital markets. The EU securitisation framework has been in application since January 2019 and was amended in April 2021 in the context of the efforts to support the economic recovery following the COVID-19 induced recession. The framework addresses the problems identified in parts of the securitisation market in the past by putting in place provisions preventing the re-emergence of harmful market practices, increasing market transparency to facilitate supervision and investor due diligence as well as enhancing legal clarity for all participants in the market.

To help investors identify high-quality securitisation structures, the EU framework identifies conditions for Simple, Transparent and Standardised securitisation (STS). To reflect the simple and streamlined nature of STS positions, banks and insurance companies investing in STS now benefit from a more risk-sensitive prudential treatment in the Capital Requirements Regulation and in Solvency II.

Whilst it is still early days to conclude whether the EU securitisation framework has worked as intended, it is nevertheless useful to examine the preliminary impact of the framework on the market. EU securitisation markets have not yet rebounded as hoped for. The Commission will now analyse developments which will lead to a report which will be submitted to the European Parliament and the Council by January 2022. If the analysis finds that legal amendments are necessary, the report may be followed by a legislative proposal.

The report will cover a number of areas, as set out in the mandate for the review in Article 46 of the STS Regulation.

First, it will assess to what extent the securitisation framework has delivered on its policy objectives and the broader aims of the Capital Markets Union in terms of increasing access to finance, widening the issuer and investor base of securitisation products, enhancing market transparency, enabling investor due diligence, and increasing investor protection.

On 23 July, the European Commission launched a targeted public consultation to gather feedback.

Moreover, the review will assess: (i) the disclosure regime for private securitisations (i.e. transactions that do not have to issue a prospectus), (ii) the need for an equivalence regime for STS securitisations (currently the sell side parties of an STS transaction must all be established in the Union), (iii) the disclosure of information on the environmental performance of the underlying assets, as well as (iv) the case for establishing a system of limited licensed banks performing the functions of securitisation special purpose vehicles. In the area of sustainability, the EC work will benefit from input from the European Banking Authority in the form of a Report on developing a specific sustainable securitisation framework for integrating sustainability-related transparency requirements.

In addition to the mandated topics, the review of the securitisation framework will consider a number of additional issues with a potentially important impact on the market, that have been flagged by the EU supervisory community and the High-Level Forum of the Capital Markets Union. These include the due diligence requirements for institutional investors, the application of the Securitisation Regulation when non-EU entities are involved in the transaction, and supervision. As regards the prudential treatment of holdings of securitisation positions, the report may cover the issue of capital treatment for banks and insurance companies, the liquidity treatment with respect to the Liquidity Coverage Ratio, and the significant risk transfer assessment.

Any potential changes to the legal regime will need to be based on thorough analysis and convincing evidence. On 23 July, the European Commission launched a targeted public consultation in order to gather feedback from stakeholders on the functioning of the framework, which will feed into the mentioned Report under Article 46 of the Securitisation Regulation. This questionnaire will be followed by a Call for Advice to the Joint Committee of the European Supervisory Authorities on the appropriateness of the prudential treatment of securitisations.

The European Commission remains fully committed to reviving EU securitisation on a sustainable basis. The review of the legislation governing that market, work on which has now started, is the next step in this process to ensure that securitisation duly contributes to the Capital Markets Union and provide an efficient channel to managing risk, liquidity and capital.

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A thriving securitisation market for a thriving capital market in the EU

The size of the EU securitisation market, including the United Kingdom, was 75% that of the US in 2008, and just 6% in 2020, according to the ESM. European insurers held about 10% of their fixed income AUM in structured exposures in 2010, that share today is just 3%. Moody's 12-mo historical average impairment rates for European SF (structured finance) in the period 1993-2020 is 0.1% for CLOs, 0.2% for ABS, 0.3% for RMBS and 1.3% for CMBS with the majority of impairments at the sub-IG securitisation tranches. By comparison, Moody's 12-mo corporate default rate for the period 1985-2020 stands at 0.13% for IG credit and 3.27% for non-IG credit for a total of 1.03% in Europe vs global rates at 0.08%, 4.23% and 1.7%, respectively.

Further, Moody's 10-year downgrade ratio of AAA European ABS/RMBS/CMBS of 5.33% in the period 1993-2020 compares favourably with the average down-grade ratio of 6.5% and 24% for covered bonds in jurisdictions with AAA and non-AAA country ceiling in the period 1997-2019. Academic research demonstrates higher liquidity of HQS (high quality securitisation, aka STS) tranches compared to non-HQS (aka non-STS) tranches, and that ABS and covered bonds do not exhibit radically different levels of liquidity, with some ABS exhibiting higher liquidity than covered bonds.

The EU SF market was rigorously tested during several crises over two decades and its performance was in line with and often above market expectations. These positive facts did not find an adequate reflection in the EU securitisation regulatory framework (EUSR). By contrast, covered bonds were never tested on a stand-alone basis during the above crises, as the bank issuers or their covered bond programmes were bailed out. These negative facts were reflected in a very favourable regulatory treatment.

European SF has performed well on both a stand-alone and a relative-to-corporates basis, be it in terms of default and loss metrics or in terms of market liquidity. But the uninitiated observer would not be able to determine that when comparing their respective divergent regulatory treatments and listening to the public commentary surrounding different fixed income market sectors.

The EU SF market was rigorously tested during several crises over two decades and its performance was in line with and often above market expectations.

As mentioned above, European insurers' presence in the European SF markets is limited, in sharp contrast with their US counterparts who have been active buyers of IG senior and mezzanine tranches of securitisation around the world for decades. What could explain such differences? The comparison across comparable exposures under Solvency II shows that the capital charges for senior STS AAA and AA tranches are 30-40% higher than those for covered bonds, and for non-senior STS AAA and AA tranches – 300% to 400% higher than those for similarly-rated covered bonds. The SF capital differential vs corporate bonds is more or less the same. By comparison, there is no major differential in the US under the NAIC rules, including their recently revamped, more risk-sensitive calibration.

Likewise, the capital cliff of Non-STS Securitisation vs. STS securitisation and corporate exposure is steep: the nominal capital for 5-year BB and B rated leverage loans stands at 22.5% and 37.5%, while such capital for a senior-most AAA CLO tranche backed by a pool of such loans would be 62.5%. The nominal charges for the BB and B tranches of such loans would attract 410% and 500% capital, i.e. 13 – 18 times more than the similarly rated constituent loans. The reason for these discrepancies across different exposures lies in the different methodologies used for the derivation of the capital charges. Some of them appear to be based purely on default risk (e.g. residential mortgage loans), others on both default and spreads risk (e.g. STS senior tranches), and yet others on the latter incorporating additional factors (e.g. liquidity risk, perhaps, for Non-STS Tranches).

In our view, an adequate calibration of securitisation capital charges under Solvency II is long overdue. We think US NAIC, BIS and IAIS ICS can be good starting reference points. We believe that while the different calibration between STS and non-STS should be maintained, the existing steep cliff between the two is not justified. We also question the need for a differentiation between the capital charges for securitisation senior and mezzanine tranches when rated investment grade.

In the EU, securitisation can help boost the post-pandemic recovery and the development of the CMU, free bank capital for more lending, bring SMEs into the capital markets, and help with the greening the EU economy – all that by facilitating bank and new business financing, dispersing risk across markets and geographies, freeing bank capital, creating tradable liquid securities ... if ... the well-known, extensively-debated and long-outstanding issues to create an adequate, risk-sensitive, level-playing-field regulatory framework across securitisation and all other fixed income instruments is at long last resolved.

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Towards a bigger, broader and deeper EU securitisation market

By turning illiquid credit pools into marketable securities with different risk profiles, securitisation brings huge benefits to both the EU economy and EU objectives through:

- developing EU capital markets in line with the CMU goals
- diversifying funding sources for EU SMEs and corporates that have no direct access to capital markets thus increasing their competitiveness
- broadening the range of green assets available to capital markets investors in the context of the EU Green Deal
- funding the growth of innovative fintechs and digital lending platforms in line with the EU strategy on shaping Europe's digital future

By sharing the risk of bank's credit portfolios with non-banks capital markets investors, securitisation plays a key role for EU banks and the EU financial system:

- enabling banks to continue to lend more to the real economy by achieving capital relief
- facilitating the absorption of upcoming regulatory pressure on bank's capital
- making banks more resilient to an economic downturn
- transferring NPE portfolios from banks to non-bank investors

As noted in the Final Report of the High-Level Forum on CMU (June 2020): « Securitisation can play a key role in addressing the consequences of the Covid-19 crisis, by raising liquidity for banks, helping manage their balance sheet exposures, reducing the link between sovereigns and banks given the large volume of sovereign guaranteed loans, and eventually contributing to setting the post-pandemic EU economy.»

Despite its many benefits, the EU securitisation market remains underdeveloped. The observable public market for placed issuance, which grew to €400bn p.a. pre GFC, has been ranging from €80bn to 130bn since 2008. The implementation of the so-called "Simple, Transparent and Standard" (STS) framework in 2019 has not stimulated the market. Non-STS issuance still outweighs STS, and STS has not led to new issuers or investors entering the market. Overall, the EU securitisation market is 5 to 6 times smaller than the US one, for a similar size of the two economies. The US market is not just bigger but also broader in terms of asset classes and deeper with more investor's participation, especially insurers. Even the more recent Chinese securitisation market is now bigger than the EU one.

The comprehensive review of the securitisation framework is a game-changing opportunity.

The underdevelopment of the EU securitisation market is rooted in harsh regulatory treatment. Due to excessive capital requirements, the capital-adjusted cost for banks through securitisation is often too high. In addition, the STS regulation has created higher hurdles for both originators and investors without sufficient recognition in capital and liquidity rules. As a result, the EU economy continues to rely excessively on banks with 68% of private sector debt financed by banks versus 15% in the US.

Securitisation remains the main gap between the EU and the US financial systems. As long as such a gap exists, every banking regulation will have a disproportionate impact on the funding of the EU economy.

The High Level Forum on the CMU identified securitisation as one of the top priorities. Extensive technical work enabled to identify the key regulatory obstacles constraining the market. The comprehensive review of the securitisation framework is a game-changing opportunity. It is essential that it results in a holistic implementation of HLF securitisation recommendations as all those proposals are jointly necessary to create a viable securitisation ecosystem:

- Capital requirements: recalibrate capital charges and lower the floors applying to senior tranches, in line with their low-risk profile. The impact of the Basel III output floor on securitisation needs addressing, via a recalibration of the "p" factor in the SEC-SA.
- Significant Risk Transfer: provide more clarity and predictability, and ensure a faster SRT assessment process
- Liquidity treatment: upgrade LCR eligibility of senior STS and non-STS tranches, to reduce the current gap with covered bonds
- Disclosure requirements: streamline ESMA templates, currently excessively burdensome for issuers and of little use for investors especially in the private securitisation market
- Insurers' participation: address in Solvency II review the current flaws that make securitisation investment unviable for EU insurers
- Opening to global financial markets: ensure that EU investors can operate on a level playing field in non-EU financial markets by clarifying that the investor's due diligence and associated originator's disclosure obligations under Article 5(1) (e) can be met through a proportionate approach

Finally, for the comprehensive review to deliver meaningful results, a horizontal securitisation policy coordination role is required given the number of different EU institutional bodies involved. This would greatly facilitate a constructive and focused discussion between the authorities and market participants.

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Areas of focus to create a better functioning securitisation market

It is welcome that policymakers both in the EU and UK recognise the benefits of a well-functioning securitisation market. It is an important part of the capital markets ecosystem and a crucial tool in helping the post-pandemic economic recovery, especially for SMEs. As both jurisdictions review their securitisation regimes, there is a unique opportunity to address some areas where the current rules may not have had the intended impact, and also to extend some of the existing benefits further in order to allow the market to reach its full potential.

Both the EU and UK securitisation reviews are fundamentally seeking to understand what impact the Securitisation Regulation has had on the market since it came into force, in order to inform what could be improved. This has been difficult to gauge as the implications of Brexit and central bank liquidity interventions resulting from the pandemic have clouded any direct impact assessment.

In addition, public securitisation supply in the EU and UK has been constrained as a result of cheaper funding provided by central bank lending schemes and simpler regulatory compliance for covered bonds. In addition liquidity has been plentiful and bank deposits have risen, so the need for securitisation as a funding tool has materially reduced.

Whilst it seems clear that the Securitisation Regulation has delivered some harmonisation benefits and has ensured certain minimum standards are met, for banks these benefits need to be weighed against the higher compliance requirements (and associated costs), which do not yet appear to have been matched by significant increased enthusiasm from investors.

A particular area of market concern is in respect of disclosure requirements, which can be costly and extremely time consuming for originators, without appearing to provide significant benefits to investors. This is especially the case for private securitisations. The ESMA template requirements, resulting in increased costs for originators to provide the reports and increased costs for investors to ensure compliance with due diligence requirements, come on top of the reporting requirements which are typically agreed on a case by case basis between originator and investors. These requirements also make securitisation of certain asset classes more challenging, in particular in respect of compliance with confidentiality obligations.

Address prudential bottleneck impediments to create a more dynamic securitisation market.

Partly as a result of the above factors, the EU securitisation market has not seen the desired growth in market size or influx of new investors, but instead it has shrunk: the overall size of the EU securitisation market, (if we include the UK), was 75% that of the US in 2008. In 2020, it was just 6%.

Clearly some of the reasons for these reduced market volumes are outside of policymakers' control, but steps could be taken in the areas set out below to address some of the prudential bottlenecks which are impediments to a more dynamic EU securitisation market, with a deeper investor base.

Firstly, the capital and liquidity treatment of securitisation positions, which is currently very conservative compared to similarly risky instruments, should be re-examined and adjusted. This should include the capital treatment for insurers holding securitisation positions, which currently disincentives their participation in the market.

Secondly, we should recognise that synthetic securitisations are an important element of the market, and they are often used to manage risk and concentration limits, or for efficient capital management, which in turn supports further origination/lending. In our view, policymakers should continue to focus on developing more efficient synthetic securitisation options, in order to bring the capital treatment into line with true sale transactions.

The introduction of the synthetic EU STS regime is therefore encouraging, although there are elements which may need to be refined, in particular the treatment of excess spread. In addition, the disclosure requirements for private securitisations in particular should be reviewed, to determine whether they are adding any real value for investors or improving the safety of the market. If they are not, then a move away from mandatory templates to a reporting approach agreed with investors would likely increase volumes, reduce costs and free up significant resource across the industry.

Finally, the introduction of the Basel IV output floors could be a significant headwind for the market, leading to significantly higher capital requirements for issuers with retained positions, particularly given standardised risk weights. It is important that the industry and policymakers fully engage on this topic, to develop solutions which do not further inhibit the development of the market.