

# Securitisation in Europe: quick fixes or deep overhaul?

## 1. Despite varied legislative initiatives the securitisation market in the EU has stalled

### 1.1 Securitisation is promising for EU financial markets

A regulator commented that securitisation is a hot topic, but certainly not a hot market. The European Banking Authority (EBA) is in the process of finalising a call for advice that was requested by the European Commission (EC). A workshop held with the industry before the summer managed expectations. Anything that could happen between now and when the EBA makes a statement publicly would be either the same or an improvement. That is probably the best position possible. In the past, securitisation was very promising, with hope in the market, interest from market participants and enthusiasm in the public sector for those products to disseminate risks in the system and provide new asset classes for investment for long-term investors. Then the market ground to a halt.

These instruments could potentially damage the economy and the financial sector itself if they are misunderstood or misused. Effort in Europe, from the legislative and regulatory sides, has been focused on starting afresh. The EBA produced the simple, transparent, and standardised (STS) framework. The STS, to some extent, replaced some of the amortisation products and did not enlarge the market segment. The current situation in Europe is not working. In the US and other jurisdictions, the situation is different. Securitisation is back. The discussion will consider why it is not working and whether that is related to the environment or regulatory constraint. There is probably a need for movement on both sides.

### 1.2 Further than funding, securitisation provides capital relief for banks

An industry representative commented that, although true sales securitisation is very important for banks to obtain funding at an attractive level, banks also need to hold capital for the risk that a loan may not repay. Their organisation invests in synthetic securitisations, which help with capital relief. It takes over the first loss credit risk from these banks. The banks pay a premium for that. The industry representative's organisation then tries to achieve more premium than is paid out in losses to the bank.

## 2. A vanishing market

### 2.1 All the figures, in absolute and relative terms, suggest a vanishing market

An industry representative noted that the total issuance in the EU market to the end of August was

€35 billion. €12 billion of that was STS. €6 billion was residential mortgage-backed securities (RMBS).

The comparable issuance in mortgage-covered bonds for the same period is €145 billion. €6 billion of systemic risk is not comparable to €145 billion. Europe has retained volume. Globally, banks do not typically retain asset-backed securities (ABS) or RMBS in order to go to the central bank.

The European market outstanding is shrinking. The outstanding ABS/RMBS market in Europe is less than the annual issuance of covered bonds in Europe. Covered bond issuance is more than half a trillion every year. The covered bond market increased from €2.1 trillion to almost €3 trillion in the last 10 years. Europe issues less ABS per annum than Australia. It is a misperception that the US market is all an agency one. Last year, the US issued more than \$800 billions of non-agency securitisations against an agency market of around \$3 billion. About \$60 billion of that was private sector RMBS, which could not be eligible for the agency market.

An industry representative noted that the role of securitisation in the capital management toolbox has, unfortunately, reduced over time. This is a missed opportunity, given the additional investments that are needed to finance the green and digital transition in Europe and strategic autonomy. His firm has currently outstanding securitised loans to the tune of €47 billion. In one year, it has securitised only €12 billion, compared to a balance sheet of €2.6 trillion. Securitised loans represent 1.7% of his banks' total assets, compared to an average of 9% for US banks, excluding agency RMBS.

### 2.2 Synthetic securitisation is now increasing

An industry representative commented that the good news about the securitisation market is that the market for synthetic securitisations is growing. Synthetic securitisation is also called 'credit risk sharing' because it is about sharing the credit risk with banks. In the first six months of this year their organisation has done more than on average in a year in the past. Europe is a world leader in this. Some of its investments in the first six months of this year have been STS-qualifying transactions.

There is also an STS qualification for credit risk sharing transactions, after it has been introduced for the true sale. Most of the transactions closed have this STS qualification and there a number of new issuers the industry representative's organisation's books. The Landesbanken in Germany are looking at this market. Their organisation did a transaction with Helaba in June. There is a securitisation market in Europe that is working, growing fast, and seeking more investors.

### 3. Nowadays, the longstanding stigma does not weigh on EU legislators, but reinforcing supervision and resolving the factors holding back this financial technique is necessary

A public representative commented that there is no stigma currently. In 2016, regulation was concluded by Council and Parliament after work on securitisation. PGGM is heavily involved in synthetic securitisation. As part of the green bond standard, work is now ongoing on the possibility of green securitisation. For the European Parliament, it is one of the instruments. Historically, it was not just the market that failed, but also the supervision. The European Parliament is looking forward to a review, which will enable the European Insurance and Occupational Pensions Authority (EIOPA) and the EBA to share their views on development and possible improvements. The article by Ian Bell considers the P-factor in depth. Contributions from supervisors are welcomed. The European Parliament is open to it if supervision is adequate. The European Parliament and others are concerned about a systemic-risk build-up, as seen in the past. This should be avoided.

An industry representative commented that stigma is not mentioned elsewhere. The regulation is done. It is 17 years after the crisis. The products that caused the crisis were outlawed. In Europe, the underwriting criteria were tightened.

An industry representative stated that enthusiastic investors are available. BNP Paribas is one of the most active banks in Europe in the securitisation area. This began prior to the 2008 crisis and even during the financial crisis the credit track record was excellent in Europe. What happened in the US should not be confused with what happened in Europe. This is a very safe type of asset.

A regulator stated that there are no concrete suggestions to improve the framework for insurance undertakings. However, EIOPA will retain an open mind and continues to receive feedback, analysis and data and provide technical advice. The supervisory community cannot do more to encourage insurers to invest more. Supervisors must be neutral on investment choices.

### 4. Regulation, in particular, is questioned by EU market figures

#### 4.1 The financial industry considers that insurance securitisation-related capital constraints are unnecessarily penalising

An industry representative stated that investors are needed to grow a market. The insurance companies in the US are between 10% and 30% ABS issued. In Europe, the holdings of the insurance companies have dropped from

8-9% in 2010 to 2-3% now. The EIOPA paper indicates that solo insurers are at 0.5% of assets under management.

An industry representative suggested that the lack of issuance is not due to a lack of investors. On the insurance side, investors have disappeared because the regulation has been as punishing as for the banking side. The shock that is applied when assessing the capital requirements for insurers is heavily penalising and unrealistic. Insurance companies have almost stopped investing but are ready to restart if the regulation allows. It is hoped that this will be included in EIOPA's report to the EC.

#### 4.2 Making consistent regulatory frameworks across financial products is necessary

An industry representative stated that diverting collateral to another instrument leads to a difference in the treatments of collateral and instrument, incentivising banks to go elsewhere. For example, the Netherlands was a major RMBS issuer, but no longer is. There is current discussion about potentially auto loan covered bonds, which would end the auto ABS market as a funding instrument.

#### 4.3 Combining transparency with appropriate capital charges is essential for incentivising investors

An industry representative commented that stigma is the wrong name for complexity. It is not a simple instrument. Knowing what is being invested in requires information. In addition to some regulatory changes, good data that is ready to be used will make the market more attractive for investors. Enormous amounts of time are spent reviewing the data to assess an investment.

#### 4.4 Banks suggest that the capital relief accepted by the prudential framework deters issuers, though they increasingly need freeing capital

An industry representative commented that there is no lack of willingness to securitise. Their firm uses securitisation mainly for risk transfer purposes. It aims to sell the equity tranches and, the mezzanine tranches, but retain most of the amounts, included in the senior tranches with a very low level of risk. This reduces risk-weighted assets and offloads risk. The huge amount of liquidity provided by the European Central Bank (ECB) is irrelevant in explaining the reduction of securitisation. Ongoing supervisory pressure on capital increases the necessity of securitisation, particularly in relation to the upcoming Capital Requirements Directive VI (CRD VI). The reason for not securitising is the difficulty in achieving the conditions to get the economics required to securitise. To be an attractive transaction, the cost of securitisation plus the revenues transferred to sold tranches should be lower than the cost of the equity that is saved. This is difficult to achieve because the capital relief is limited, due to the calibration of the rules for the securitised product. This does not create any incentive to securitise the portfolio.

A regulator noted that there is a tension around the size of the capital relief. Regulators should propose improvements.

An official commented that there is an issue when talking about levers or stocks. The market is very thin

when compared to others. It is also an issue of the flows. Since the end of the financial crisis there has been a divergence. The gap has not been closed. This gap is often attributed to structural differences between markets, particularly the US and EU markets. The residual unexplained difference tends to be assigned to regulatory differences.

## 5. The limited involvement of insurance companies cannot be explained only by existing capital requirements

A regulator stated that there is no stigma from an EIOPA perspective. In 2015, EIOPA differentiated treatment of capital for the less risky assets. EIOPA worked on the call for advice with the EC and tried to manage expectations. The consultation paper states the possible approach, the data available and the analysis conducted. The final document will be ready shortly. EIOPA has asked insurers why demand is low. The main reasons for the low appetite are the availability of more appropriate assets, for example those that present a better risk return profile or better match their liability, the availability of data and the capital requirement. As such, EIOPA is reviewing the capital requirement. However, fewer entities are investing, and this cannot be explained simply by the capital requirement.

## 6. The positive impact of the STS framework on the previous stigmatisation of securitisation, the need to finance green and digital assets, and the much-needed strategic autonomy should favour the revision of the securitisation framework

An official commented that the 2019 reform did not achieve much in terms of volumes. The importance of STS can be seen in how the market is qualitatively composed, with an increase of up to 30% in recent years. This reduces the stigma. Given current discussion around strategic autonomy and the green and digital transitions, EU member states must unlock their full investment potential, including public and private funds. Securitisation will be one of the key elements going forward to complement the public investment effort. The green transition highlights the importance of green securitisation, which is at a very incipient stage. Challenges ahead include developing sustainable assets as a basis for green securitisation and developing the applicable framework. There are recommendations in this area from the EBA. The green bond standards would be a good basis for discussion.

## 7. Possible areas for progress

### 7.1 Further distinguishing the regulatory treatment of STS and non-STS securitisation

A supervisor stated that the evolution of this framework will facilitate a number of goals mentioned by other speakers. For insurers as investors, distinguishing more between STS and non STS securitisation and developing a more incentivising way of weighting these STS securitisations in Solvency II would be beneficial. It has been stated earlier that, if supervisors were ready to support changes to the framework, Parliament could follow. The Autorité de Contrôle Prudentiel et de Résolution (ACPR) is ready to support changes to the framework on Solvency II and is comfortable with insurers investing within stated limits.

### 7.2 A possible recalibration of the P-factor should be undertaken carefully at the level of the Basel Committee

A supervisor noted that non-neutrality of capital is addressed through the P-factor, which can be calculated from 130-200%. A simple idea would be to lower the P-factor. However, there could be unintended consequences of lowering the P-factor because there is a nonlinear element that could create more volatility. That does not mean that the P-Factor does not need to be decreased, but it should be done collectively at the Basel Committee meeting after a full assessment and not when discussing the next steps in the European context. Within Europe, without creating a big deviation compared to the Basel framework, the risk-weight floors, which determine the minimum risk-weight applicable to securitisation positions, could be easily lowered.

### 7.3 Under scrutiny of supervisors, capital charges should factor in that agency risk is, by essence, reduced for originators

A supervisor stated that the level of agency risk for the originator is lower than for the external investors because originators handle their own data. Under the scrutiny of supervisors, a lower risk-weight floor could be introduced for senior securitisation tranches retained by the originators, provided that safeguards are in place. This would be a less costly step in the right direction rather than a big deviation.

An industry representative noted that capital charges for those retained tranches, through the flow and the P-factor, could be recalibrated. The P-factor is supposed to compensate for asymmetry of information in the context of STS, but this asymmetry does not exist for a retained tranche.

But he warned that adding limited safeguards and new restrictive rules at the same time would offset the positive impact.

### 7.4 An explicit target for the involvement of insurers in the securitisation market should be reflected in any recalibration of the capital charges

An industry representative suggested that European insurers should be brought into the European

securitisation market to the same degree as US insurers. Capital neutrality is not only for banks. It does not make sense for a triple-A tranche to attract four to six times more capital than the underlying. The methodology is different, but action should be taken.

#### **7.5 Addressing the genuine complexity of securitisation requires sufficient data as well as issuers having an appropriate level of 'skin in the game'**

An industry representative commented that banks originate the risk, know the risk and have the data. Insurers want to see the data, but do not need to know the names of clients. The credit work is not going to be redone. To ensure origination proceeds in a sound way, banks should keep 'skin in the game', which means 20% and not 5%.

#### **7.6 Improving the regulatory treatment of project finance securitisation is essential to developing green securitisation**

An industry representative noted that their organisation has done a number of transactions since 2008 on project finance portfolios, some for green energy projects. Portfolios can be made up of grey and green. The economy is gradually transitioning from grey to green. A deal in which a bank gets the green parts and a pension fund is stuck with the grey parts is not a great proposal. Sharing that transition in portfolios would be preferable. Their organisation did a transaction this year with such a transition agreement in place.

An official noted that the most frequent request from the industry, aside from issues related to proper risk-based calibration or regulatory arbitrage considerations, is to optimise the administrative burden. This issue would be easy to address going forward.

#### **7.7 An important issue is to increase the contribution of securitisation to bank liquidity ratios**

A supervisor noted that it had been stated that liquidity was not the purpose for originators. For investors, subject to the liquidity coverage ratio (LCR), it can be an issue. The treatment of some STS securitisation tranches in the liquidity ratio could be revisited.

#### **7.8 An appropriate combination of regulatory recalibration and improved supervision is necessary**

A public representative advised that clear supervision is needed. Supervisors will play an important role, whether that is in adjusting the P-factor, the senior tranches or elsewhere. Fortunately, the European Parliament does not do risk calibration. Digitalisation and sustainability are demanding, so private investment needs to be unlocked. In that sense, there is cause for optimism that the market will grow. The era of cheap money is over. This will also provide a boost for the securitisation world.

complexity must be tackled, but STS is helping here. This complexity includes the data needs of investors and the problems for issuers of complying with administrative burdens. On capital neutrality, work is needed to make the products more appealing for investors and for issuers willing to share the risks. That may not be systemic, given the volumes seen so far. On the data gap, the originators' idiosyncratic information gives them an advantage. That will assist in considering calibrations of the capital treatment, maybe not with regard to the P-factor but floors instead. The title securitisation products, not only the synthetic ones, might be very much needed in the near future, given the new environment that is developing.

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## **8. Conclusion**

A regulator concluded that securitisation needs to be back at full force in Europe. There is appetite on all sides, but supervision must be appropriate. Issues of