Securitization: regulatory priorities and impact on private risk sharing and transfer

1. There is a need to make progress on securitisation in the EU

The Chair opened the panel on private risk sharing and the role of securitisation. There is a need to make progress on securitisation. There is a huge need for investment in Europe from both the public sector and the private sector to meet new challenges such as increased defence expenditure and the green transition. Securitisation helps by transferring risk and ensuring that private risk is shared. Over time, Parliament and the Commission have adopted policies on synthetic and green securitisation. The legislators are ready to move forward, but it is not clear what to do next.

An industry speaker emphasised that there is still a substantial challenge in Europe. In the EU, one third of finance comes from capital markets and two thirds from banks. In the US, one third comes from banks and two thirds from the capital markets. Recent statistics published by the Association for Financial Markets in Europe (AFME) indicate that in 2023 billion 200 of securitised products were issued in Europe. In the US, it was 1.5 trillion. Much of the risk continues to be retained by issuers. This trend has increased in recent quarters. 50% to 60% of European issuance continues to be retained by issuers. Significant risk transfer (SRT) securitisation has been a success, however. This market continues to grow. It will help by providing funding tools to banks, enabling capital and balance sheet relief, and allowing non bank institutions to increase their funding activity and foster long term investment in the EU.

2. Europe's misunderstandings about securitisation are obscuring huge investment opportunities and benefits to the financing of the economy

2.1 Securitisation has not reached its potential in the EU

An industry representative opined that securitisation is widely misunderstood. It is often suggested that agency securitisation drives the US market, but this is not correct. US agency securitisation is between 1 trillion to 1.5 trillion per annum, but non agency securitisation is around 1 trillion. The number provided by AFME for Europe is 200 billion, but only 100 billion is placed with investors. Therefore, private sector securitisation is 1 trillion in the US, while in Europe it is only 100 billion. Converted into GDP, this is about 0.3% to 0.5% of European GDP over the last five or six years. For the UK, it is 0.7%. For the US, it is 2%. For Australia, it is 2.5%. Australia has a fraction of Europe's GDP, but it generates more securitisation per annum.

2.2 Securitisation's poor reputation in Europe needs to be fixed

An industry speaker noted that securitisation was very popular in Europe before the subprime crisis, but it has unfairly gained a bad reputation. Without securitisation, it will not be possible to finance the green transition, digitalisation, and the wider economy. There must be securitised products on the balance sheets of European banks to enable them to compete with US banks. Securitisation should be a priority for capital markets union (CMU). It would be better to act at European rather than national level. The creation of a safe asset held by the European Investment Bank (EIB) is a good idea, but it will take some time. Securitisation should be one of the priorities of the next Commission.

2.3 The benefits of securitisation: funding, liquidity, risk management, investment opportunities, higher stock valuations

An industry representative emphasised that securitisation is more than a funding and risk transfer tool. Securitisation creates liquidity from illiquid assets. These assets can be converted into bonds and placed with European investors. Every year, between 60 billion and 70 billion flows out of Europe and into other markets. Europe could have its own investable instruments, which could feed European pension funds and in turn fund the economy.

Securitisation has many other benefits and uses. First, there have been discussions about how to manage the output floor. Going forward, banks will have to apply a portfolio approach and manage around the output floor to use capital optimally. This cannot be achieved without risk transfer, securitisation, and insurance mechanisms. Secondly, securitisation will be very useful for greening balance sheets, for example. It is possible to go to the market without securitisation, but this requires banks to have more capital and more debt. At present, the cost of capital is extremely high. Finally, EU banks' price to book ratio is 0.5. For US banks, this ratio is 1.5 to 2. If this does not change, Europe will not be able to get the funding it needs.

An industry speaker emphasised that securitisation is an important funding tool for banks and non banks which can channel more investment into the real economy. It is also important for pension funds and insurers because it creates another source of long term and low risk investment assets.

3. The UK is consulting on some adjustments to its securitisation regulation

A regulator stated that the UK remains committed to a well functioning and sound securitisation market. In the euro area, two thirds of funding is provided by banks and one third by non banks. In the US, it is the opposite and the UK lands somewhere in the middle that there is a 50:50 split between bank and non bank finance.

The securitisation market is very important. It supports bank lending by allowing banks to shift assets into the non bank system and enables them to hold risk in different forms, which helps to diversify the flow of finance to the real economy. It is crucial to have a diversified mix of funding tools and securitisation is one of the tools for providing finance to the real economy, alongside the covered bond market and traditional forms of bank lending and non bank finance. There is some complexity in securitisation structures compared to other forms of finance, so it is important to ensure that these products are properly regulated. In the UK, we have published a consultation to transfer regulatory requirements to the FCA rulebook, as well as to consider how to tweak or simplify inherited EU regulation to remove unnecessary barriers to issuance in the securitisation market.

4. Securitisation should be expanded to counter the currently unfavourable cost benefit ratio of securitisation in the EU

A regulator agreed that there is a need to finance the green and digital transitions. Securitisation is a valuable risk management and capital management tool. In this context, it is important to mention insurance linked notes (ILNs) and the insurance sector. ILNs are a form of reinsurance which can be used to manage risk and reduce risk-based capital requirements. The idea of pooling risk and assets makes complete sense. There have been problems in the past, but the risks have been addressed by regulation. However, there has not been widespread uptake of securitisation over the past few years. There are some positive signs in the SRT and simple, transparent, and standardised (STS) categories.

Ultimately, this is a question of supply and demand. Looking at supply, the question for financial institutions is whether securitised products are sufficiently attractive. In Germany, there is a strong mortgage covered bond market. It is not a surprise that securitisation is not popular in real estate because covered bonds are working well. During quantitative easing, it was important to have collateral on balance sheets, but currently quantitative tightening is being undertaken. 60% of bank securitisation was retained. There is a directly link to monetary policy here. The current process of quantitative tightening is certainly not driving the supply side of securitisation. On the demand side, there are many other alternative products to invest in. The outlook on real estate is not currently very positive. It is not reasonable to expect that originate to distribute (OTD) models will have positive results.

This raises the question of whether any changes to regulation are decisive to change market dynamics. The poor development of the securitisation market can partly be explained by looking at the alternatives in some markets. Securitisation has potential as a risk management tool and it should be part of CMU to make progress, even if securitisation markets will not change completely over the short term.

4.1 Not everyone agrees on the merit of adjusting securitisation regulation in the insurance sector

A regulator observed that there is little appetite for securitisation from the insurance sector. Insurance companies indicate that the alternatives are easier to manage. The complexity of investing in securitisation is an issue. Firms must match assets with liabilities and there are also better alternatives in terms of the risk return profile. However, securitisation does have potential. European Insurance and Occupational Pensions Authority (EIOPA) and the Commission are working on securitisation. After analysing a large amount of data, it was determined that the volatility in the market did not justify recalibrating the capital requirements related to securitisation. In the insurance industry, many institutions use internal models rather than the standard formula. The big players justify their lack of appetite by citing the risk return profile and the difficulties of managing asset liability consistency. EIOPA believes that the specific needs of the insurance industry need to be understood before uptake will increase. There has been a constantly low level of investment since the advent of Solvency II. Even when the capital requirements for other classes of investment were eased, the level of investment did not increase. There does not seem to be a correlation between capital requirements and investment appetite.

The manufacturers of securitised products need to have greater engagement with the European insurance sector. At present, there is little appetite for securitisation. Firms do not discuss the regulatory framework as an important factor. EIOPA runs public consultations and is in constant dialogue with firms. When the EIOPA board discussed the Commission's recent advice about recalibration, regulation was not highlighted as an issue. EIOPA will continue to look at securitisation with an open mind, however. It has no bias or stigma against securitisation. EIOPA will continue to look at evidence from the market. It is for insurance companies to invest if they consider securitisation to be convenient.

An industry representative asserted that it is vital to bring insurers back into the market. Between 10% and 30% of all US securitisation is sold to insurers; in Europe, the figure is 2%. In 2010, securitisation made up 10% of insurers' assets under management; today, it makes up 3%. The largest insurers made this change to their balance sheets two years before the introduction of Solvency II. Clearly, regulation does have an impact. When the regulatory capital requirements for senior tranches of SRT were reduced, synthetic securitisation increased rapidly.

A regulator stated that regulation is not holding back investment in securitised products. There are simply better alternatives in terms of risk return profile, liability matching and complexity.

4.2 Key actions to expand securitisation: increasing transparency, developing common standards, fostering innovation, and raising awareness

An industry speaker considered that it is important to consider how to expand securitisation. The regulatory framework is sufficiently robust and transparent. There is a need for bolder actions and a broader strategy. The public and private sectors need to work jointly on increasing transparency and raising awareness. Securitisation is still perceived as opaque and risky, although there is considerable transparency and robust risk management. The public and private sectors also need to develop and support the adoption of common standards. There have been some great successes in the US. In particular, the government sponsored agencies such as Fannie Mae and Freddie Mac have had a positive impact on mortgage financing.

The private sector needs to continue to innovate. There has been innovation in asset classes. Traditionally, there has been asset backed security (ABS) issuance in auto and car loans, but more recently there has been innovation around equipment, aviation, renewable energy, data centres and music royalties. This will grow the market, diversify the issuer base, and create opportunities for investors. Most of that innovation has been in the US. Europe should seek to innovate in ESG related asset classes. ESG asset related securitisation levels are only 1.5% in Europe. In the US, the figure is 30%.

4.3 Adjustments to regulation could focus on increasing market efficiency and simplifying the reporting and due diligence requirements

A regulator emphasised that the UK's Financial Conduct Authority (FCA) continues to support the regulation that was put in place after the global financial crisis. however, now is an appropriate time to look again at whether regulation could be improved and help ensure securitisation markets work effectively – recognising that regulation is not the only factor influencing market activity. The aim of the FCA's initial consultation on securitisation was to start a conversation about change and see whether the regulation could be tweaked allow the market to work more efficiently. For example, questions were asked about reporting template, how they apply to private versus public securitisations and whether the obligations for private securitisations could be reduced. There was a discussion about making due-diligence requirements more principles based, including when investors are buying overseas securitisations. The consultation also made proposals for adjusting the securitisation market for non performing loans (NPLs) The FCA has received a considerable amount of feedback on issues that fell outside of the initial consultation which will be picked up in a second consultation in 2024.

An industry representative noted that, while regulatory capital has a major impact, it is not the only issue. The other requirements are also important. The European Central Bank (ECB) recently published a paper showing that the reporting requirements for securitisation contain 8,400 lines of text. No other asset class in Europe has this level of reporting. There are six different reporting requirements in Europe within the prudential requirements. This level of complexity must be reduced.

4.4 The regulatory burden should be consistent across asset classes

An industry representative highlighted the importance of realigning the regulatory framework across asset classes and introducing greater transparency to the market. At present, the due diligence requirements are excessively onerous. As an example, 5 billion of asset backed securities were sold within two and a half weeks during the UK pension fund crisis. Almost 90% of these assets were purchased by US asset managers. The European banks could not react to the market dislocation in a timely manner due to the due diligence requirements. They bought the appreciated asset backed securities, which were sold at a profit by the American asset managers.

A regulator agreed that there is a need to reduce complexity and drive down the cost of securitisation as a tool. Indeed, it might not be necessary to recalibrate the capital requirements as the current framework functions well. It might be possible to move to a system of state guarantees, similar to what exists in the US, but this is a decision to be made at the political level. The next step should be to reduce the level of complexity in the sector.

The Chair emphasised that securitisation is important because private risk sharing will be an absolute necessity in the years to come.