Securitisation reform to boost European competitiveness

Focussing on bank capital velocity and regulatory governance will expand bank-funded investment

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Top European policymakers, such as the ECB Governing Council and the Eurogroup, have argued in recent months that European Union countries need "massive private investments" to advance the climate agenda and generate higher productivity and competitiveness. Equity markets can play a role by providing EU corporates with the risk capacity to invest more. But debt will be necessary to finance most of the increase in capital investment. European banks will be central to intermediating surplus funds from European and international savers by providing the additional debt.

From a macroeconomic perspective, there is little mystery why private sector investment in Europe has fallen short of what central bankers and others believe is necessary to generate economic growth. The recovery in demand since the pandemic has been sluggish and the profitability of European firms has been too weak to generate a spontaneous increase in real investment by the private sector. Moreover, many believe that structural impediments to investment exist in Europe's financial markets. European debt markets function primarily through the region's banks, and the profitability of these banks lags behind that of international competitors.

How could European banks finance an upturn in investment-related lending? Bank liquidity and funding are in plentiful supply, but capital remains a constraint. Since new bank equity (beyond what is required by prudential regulation) is largely unavailable, how can banks rise to the challenge of financing additional investment?

If 'massive private investment' were to be financed by issuing covered bonds (CBs), European banks' balance sheets would have to be much larger and their equity larger. This appears simply infeasible to shareholders who would have to supply additional equity. It is, thus, natural that the ECB Governing Council and the Eurogroup have been focussing attention on the potential for expanding the securitisation market.

CBs are no substitute for securitisation, especially when banks are capital constrained. Indeed, bank financing raised through CBs or securitisation are fundamentally different. The credit risk of the loan pool covered by a CB remains on the issuing bank's balance sheet and CBs generate neither a transfer of credit risk nor a commensurate reduction in regulatory capital. This form of financing provides no capital relief.

In contrast, securitisation, when it satisfies the Significant Risk Transfer (SRT) requirements of regulators, shifts risk off the issuing bank's balance sheet, allowing a bank to redeploy its risk capacity by making new loans. This feature of securitisation may be labelled 'capital velocity', expressing the notion that securitisation permits a bank to deploy its risk capacity more than once. In contrast, CBs do not provide banks with 'capital velocity'.

On the other hand, both CBs and traditional (true sale) securitisations provide liquidity to the issuer. They share the feature that both permit one bank to provide secured funding to another. Reinforcing

1. The co-authors accept full responsibility for any errors or omissions. The views expressed are those of the authors and not necessarily those of their companies and institutions, or of those with whom the authors have had discussions, or of their companies. All authors can be contacted via LinkedIn.

secured lending channels among banks is important in generating robust funding flows without relying on intermediation by central banks. Before the 2011-2013 European Sovereign Debt Crisis, European banks operated a substantial unsecured interbank market with significant depth even at relatively long tenors. This unsecured interbank market dried up in the 2011-2013 crisis except for transactions at the very shortest tenors. While liquidity has returned, CBs and securitisation remain important mechanisms for making interbank funding more robust and reducing the burden that will fall on central banks if another crisis were to occur.

We believe that modest but key modifications to the regulatory rules on securitisation could boost 'capital velocity'. Real economy investment would increase if banks were able to optimise their balance sheets more effectively. Over the last decade, European regulators have made multiple attempts to adjust securitisation regulations to arrive at a smooth functioning and financially stable market. Success has been limited. We believe that the answer is not to dismantle the regulatory framework that has been developed but to make small, judiciously chosen adjustments to the rules aimed at better aligning regulatory rules with actual risk.

The political will to adapt rules to European needs has been evident in several past attempted reforms but clearly these have been insufficient to restore the market. Examples include (i) the European Parliament's introduction of the SME Supporting Factor, (ii) the European Commission's rewording of the standards to change the hierarchy of approaches for bank securitisation capital (reducing Europe's reliance on external ratings), (iii) the European Supervisory Authorities (ESAs) development of a synthetic simple, transparent and standardised (STS) securitisation framework.

The last of these measures is aimed at improving the 'capital velocity' of European banks and represents a success in the sense that volumes rose, and smaller banks participated. But it also represents a partial failure in that it introduced new investor fragmentation in the market. By not mentioning regulated and diversified European (re) insurers in the list of authorised guarantors, the rules prevent insurers from participating in the STS market on an unfunded basis (though they remain active in the shrinking non-STS segment).[2]

The adoption of a 0% risk-weighted requirement for Multilateral Development Banks (MDBs) as unfunded guarantors for STS has strengthened the roles of the European Investment Fund (EIF) in various European countries and of the European Bank for Reconstruction and Development (EBRD) in a growing number of CEE countries, where securitisation markets remain subdued. The greater role of these prominent institutions has helped to popularise the securitisation technique and reduced the post-GFC stigma attached to securitisation in those countries. The effect, however, has been to limit the mobilisation by the MDB resources of private money in these securitisation transactions to improve European competitiveness.

Overall, market data show that the traditional securitisation market in Europe is a shadow of its past self, with only the synthetic SRT market showing reasonable levels of activity. Can securitisation be mended, one may ask? We believe the answer is yes, but it will require that regulators make appropriate choices adapted to Europe's needs and then legislate and implement them. This should be done on a timescale that makes results visible in the data before the end of the next European Commission's mandate. The complexity of the process and the timescale constraints make reform in securitisation regulation a significant journey. Large steps could be taken early on by focusing on 'low hanging fruit'.

What competitiveness gains might be achieved by changing regulation and which changes would be most effective and easiest to implement? A straightforward and effective improvement in the securitisation rules would be the introduction of a risk-sensitive risk weight (RW) floor proportional to pool RWs. This would constitute a simple and easily implementable step, better aligning risk and regulatory RWs, and would be highly relevant for senior tranches. The securitisation RW floor currently equals a constant percentage of notional value. This makes no distinction between securitisations secured on risky versus safe pools. The distortionary effects of the current approach are clearly visible in the distribution of the existing market across different asset classes.

Designs for such a risk-sensitive RW floor were presented in a paper entitled "Rethinking the Securitisation Risk Weight Floor".[3] Our preferred option: for internal ratings-based approach (IRB) and standardised approach (SA) banks, a factor of proportionality of 10% applied to the underlying pool risk-weight under SA. Adopting this would provide stable capital requirements for senior

2. According to an IACPM survey, "in 2023, the 13 participating insurers protected more than €1 billion of SRT tranches mostly at mezzanine level and, as close to 90% of insurance protections are syndicated, each participant retained on average one third of the insured tranche, with an average size of insurance protection of €25 million after syndication. Insurers' appetite to protect SRT transactions continues to increase but is capped by their inability to access the growing EU STS market."

3. Duponcheele, Georges, Marc Fayémi, Jérémy Hermant, William Perraudin and Frédéric Zana (2024) "Rethinking the Securitisation Risk Weight Floor", May. https://www.riskcontrollimited.com/wp-content/uploads/2024/05/20240503-Rethinking-the-Securitisation-Risk-Weight-Floor-v61.pdf

tranches, unaffected by whether the IRB capital requirements or the SA Output Floor capital requirements apply.

In addition to adopting this simple change, we believe that reform of securitisation regulation would be more effective if changes in governance arrangements were adopted by the EU co-legislators. Specifically, the implementation of regulatory changes and the effectiveness of reforms would be enhanced if the following steps were taken.

a) Introduce mitigation techniques if unintended consequences from poorly framed regulation arise. The European Lamfalussy architecture of financial regulation and supervision has moved over time from a principles-based to a rules-based system, which brings rigidity when obvious reforms of regulation are needed. This would include the power to suspend unworkable rules until the next legislative or review cycle. Such tools exist in the US, but not in the EU or not in a way that can be used dynamically.

b) Regard securitisation as a balance sheet optimisation and 'capital velocity' instrument in regulation and, in this respect, quite different from CBs. Regulators could adapt their risk appetite for risk transfer more dynamically depending on whether greater or lesser risk transfer is desired at a macro or micro level.

c) Unify EU securitisation market supervision under the coordination of ESMA.[4] Important benefits can be achieved by having a single-entry point for market participants such as increasing supervisory convergence and reducing supervisory costs on an EU-wide basis. The Joint Committee of ESAs Securitisation Committee, which should receive enhanced decision-making powers could provide a second level of control of supervisory activities.

d) Develop regulatory rules in collaboration with capital market participants. There is currently no experts' group or stakeholder group at the level of the Joint Committee of the ESAs, which should receive enhanced decision-making powers to remove regulatory frictions in the demand and supply sides of the market. Several past episodes exemplify collaboration by regulators and market participants to achieve common goals (ECB Loan Level Initiative, European DataWarehouse). An efficient Capital Markets Union (CMU) depends on more such collaborative work.

e) Finally, in the long-term, 'smart' regulatory governance should foster innovations in the CMU. This would allow for a reduction in market fragmentation within the European Union, adapting and harmonising local jurisdictions to foster a truly pan-European market.

As the ECB Governing Council has pointed out much is at stake for the region. It is in everyone's interest that prudent changes in regulation to support the region's investment needs be identified and implemented. Now is the moment to rethink certain aspects of securitisation regulations which are highly material for European competitiveness. Mario Draghi, former ECB governor and Italian Prime Minister has recently said: "Rethinking our economic policies to increase productivity growth and competitiveness is essential to preserve Europe's unique social model." We believe that the concrete changes advocated here, (i) the adoption of a risk-sensitive RW floor, and (ii) changes in governance, would contribute to the objectives he expresses.

4. Currently, there are 48 distinct supervisory entities responsible for the supervision of securitisation transactions in the EU.