RELAUNCHING SECURITISATION IN THE EU

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Revitalizing Europe's securitization market: a key pillar for the new Commission's CMU agenda

The European Union faces a critical need to bolster its capital markets to support substantial investments related to the green and digital transitions, while facing the challenge of an aging population. A key element of this strategy is revitalizing the securitisation market, which has suffered significant setbacks over the past decade.

The securitisation market's revival is indeed crucial for the EU's economic strategy, particularly in light of the additional €1 trillion needed annually to meet investment demands. This figure encompasses the green transition, which alone requires €700 billion per year, and the digital transition, which could demand up to €125 billion annually. The EU's underdeveloped capital markets present a significant hurdle, with European companies facing higher capital costs and often turning to the U.S. for fundraising.

Indeed, despite its importance, the European securitisation market has seen a dramatic decline over the past 15 years. From 2007 to 2022, annual issuance volumes fell from €407 billion to €157 billion, a 61% decrease. The market for publicly placed issuances shrank even more drastically, by 80%, indicating a severe liquidity crisis. In contrast, the U.S. securitisation market has bounced back robustly, underscoring a stark regulatory disparity.

This decline is largely due to the EU's stringent regulatory and prudential requirements. These were put in place after the GFC as an urgent response to the toxic origination practices developed in the US market. In the following years, the European framework for securitisation has been strongly reinforced, making it one of the safest in the world : e.g. Europe has prohibited potentially harmful practices like re-securitisation and securitisation without retention; and at the initiative of the ECB, a Data Warehouse has been created allowing an unchallenged level of transparency. But the very restrictive framework has been kept, imposing excessive burdens that hinder market growth. To address this, several critical adjustments are proposed.

Firstly, reforming the prudential frameworks is essential. This includes adjusting capital requirements for insurers and for banks, in order to align them with the risk of the underlying assets, and extending eligibility for liquidity buffers to banks, making securitised assets more attractive. Simplifying transparency rules to facilitate the issuance and acquisition of these assets will also enhance market liquidity.

Moreover, the development of a European securitisation platform is paramount. Such a platform would foster the emergence of a reference market, deep and liquid. It would standardize and massify demand, providing transparency and cost-sharing benefits for smaller banks. Beyond enhancing the securitisation market, this platform would create a new common safe asset, improving the efficiency and depth of European markets.

The guarantee provided by the platform should exclude any transfers between Member States and commitments of budgetary resources, instead being priced proportionally to the risk taken by the guarantor. Targeting homogeneous and low-risk asset classes, such as residential loans, would further ensure the platform's stability and efficacy.

By implementing these measures, the EU can not only revitalize its securitisation market but also significantly enhance its capital markets' capacity to finance crucial investments. This approach could transform European financial markets, making them more competitive and resilient in the face of global challenges. The inefficiency of the current market structure not only hampers growth but also risks marginalizing European financial actors on the global stage. Revitalizing the securitisation market through regulatory adjustments and the establishment of a securitisation platform will be a decisive step in overcoming these challenges. By aligning more closely with global standards and practices, Europe can unlock the potential of its capital markets, ensuring they play a pivotal role in financing the continent's future.

The EU's focus on revitalizing securitisation is not just a technical adjustment but also a strategic imperative.

The EU's focus on revitalizing securitisation is not just a technical adjustment but also a strategic imperative. It addresses both immediate financial needs and long-term economic goals. By fostering a robust, integrated market, Europe can secure the investments necessary for sustainable growth and maintain its competitive edge in the global economy.

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EU CMU and securitisation: competition needed

Securitization is important piece of puzzle for functioning and deep capital market and it is generally agreed that more securitization is needed in the EU. The benefits of securitization on the financial market have been repeatedly enumerated and described; I would like to emphasise the positive implication that securitization has on further financing SME, where other financing through capital market on individual basis might not be economically viable. Also, when SMEs are finance through the capital market, they are still financed mostly locally. Securitization could be the right tool to enhance cross-border financing and, consequently, the CMU. For the deepening and functioning of CMU we need well-functioning securitization market, which unfortunately is still not fully in place in the EU when compared with size of securitization market of other jurisdictions.

The securitization market in the EU is underperforming, even though some of it might be due to the market development, some of it is a result of the EU prudential financial regulation and still persisting negative connotation of the securitization in the EU. Noyer's report highlighted the EU's more cautious approach to prudential regulation for insurers and banks compared to other jurisdictions, which has unfortunately curtailed full development of the securitization market in the EU.

Further steps should be taken to revive the market, to provide more investment opportunities and bring more competition to the securitization market without introducing undue risk to the EU financial market. This should be done by elevating and further calibrating the prudential treatment of securitization for credit institutions and insurers as well as further assessing capital treatment for both STS and non-STS securitizations. The current framework has an overly conservative default rate assumption for a product that has demonstrated a low default rate, even during crises. We need to be careful in cutting down the requirements, however we might have doused the market a little too much in the past.

EU securitisation market needs diversified participants and rules that are more proportionate.

The requirements on due diligence and transparency should be more proportionate and differentiated as they are too stringent for sophisticated investors as well as issuers of securitization, such as alternative investment fund managers ("AIFMs"). The current due diligent requirements create administrative burden that might have discouraged from investing in securitization. Our goal should be enhancing capital market, thus incentivise qualified investors to invest in variety of instrument, which includes securitization, and not deter if from it. There are duplicative layers of due diligence between sector legislation and the securitization regulation. For further efficient market, the compliance cost while investing in securitization should be lowered and mentioned barriers removed. Also further investing opportunities like investing in third countries securitization should not be thus limited.

The revised AIFMD recognises AIFs as loan originators, requiring them to retain 5 % of originated loans. This requirement seems to be inspired by retention provisions of the securitization regulation that now should reflect this shift in AIFMD rules and allow the AIFM to act as sponsors of securitization, which is so far limited by securitization regulation to credit institutions and investment firms. Market data illustrate that AIFMs have been creditors to the institutional investors through CLO and top CLO managers are already AIFMs. While allowing them to sponsor securitization they would be less limited in their investment strategies, which in the end would allow further competition at securitization market and thus investment opportunities. The recent review of AIFMD has brought enough safeguards for AIFM and UCITS managers to become sponsors of the securitization.

The CLOs are on the rise in the EU, which illustrates further role the capital market plays in financing the market, yet they are considered ineligible for STS criteria for actively managed nature of them. These instruments have showed strong track records and lower default rated to other securitization products and thus they should not be disadvantaged on the securitization market. Also the application of STS label need to be made less burdensome and limit the steps the qualifying investors must undertake in order to apply more preferential treatment.

The CMU topic has been discussed over a decade and we have securitization regulation applicable for five years now, we should learn from the comparison with other jurisdiction as well from further development of the market and take steps to make market more effective.

KAUSTUB SAMANT

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Securitisation: this time it must be different

In an increasingly geopolitical world, size matters. Economically speaking, the world is getting bigger while Europe is getting smaller. Nowhere is this truer than in the comparative size of the European vs. other global securitisation markets. While many global markets have grown since the global financial crisis, the European market has collapsed. Rule-makers have attempted to establish securitisation reform in Europe for over a decade but with limited success. Only now does the urgency of the situation seem to be registering. Fortunately, help might be on the way. EU policymakers are preparing their third attempt at shaking up financial markets through the Capital Markets Union (CMU). They see the urgent need to reinvigorate Europe's lagging securitisation markets.

At PGIM, we welcome policymakers' focus on the securitisation markets. As a global asset manager with US $1.34tn in total assets under management (as of 1 August 2024), we are active in securitised markets for European and non-European clients. Along with our role as a top 10 CLO issuer in Europe and the United States, this gives us a unique insight into the impact of regulations across securitisation markets.

We feel that the EU has been excessively and unnecessarily risk-averse in its regulation of securitisation to the detriment of individuals and businesses who lose out on affordable financing. Pension funds, insurance companies and other institutional investors are missing out on investible opportunities and reliable return on investment.

EU investors are often limited in what they can invest in outside the EU due to the granular and onerous transparency requirements for securitisation investments. While this detailed reporting may create a cottage industry for third party data providers, it creates significant cost and provides little or no value for investors. US issuers, for example, already provide detailed loan-level data coupled with historical performance that is sufficient for sophisticated investors to produce a risk assessment. Because this information is not being provided in a specific template, it should not prevent EU investors from participating in these markets. We welcome the European Securities and Markets Authority's (ESMA) recent consultation on the revision of the securitisation disclosure framework. Hopefully this will result in lessening the burden on issuers, thereby encouraging non-US issuers to issue securities compliant with the EU regulation.

Risk retention in certain markets is also optional. Broadly syndicated CLOs - or mortgage-backed securities backed by high quality mortgage loans in the US - often do not require risk retention. Despite these types of securities complying with local risk retention requirements, EU investors are prohibited from investing in these assets. Addressing such cross-border investment barriers is critical to sharpening European investors' competitive edge.

Political momentum behind securitisation reform today gives hope that this time could be different.

The ability for UCITS to invest in securitisation is also hampered by regulation. UCITS are inhibited by the strict limit on acquiring no more than 10% of the debt securities by a single issuing body. This may make sense for corporate debt securities, but securitisation issuances are often much smaller but naturally diversified. Ironically, this requirement works against overall diversification of UCITS and puts them at a disadvantage to funds in other jurisdictions.

From an issuer perspective, the framework for Simple, Transparent, and Standardised (STS) Securitisation could be doing much more to re-energise the market. The scope for the STS is too narrow and includes a blanket ban on 'actively managed' structures. This excludes even AAA-rated tranches of collateralised loan obligations (CLOs). These instruments have never defaulted since their invention in the late 1980s. Reforming the STS label to qualify transactions where CLO active management occurs, with the right safeguards in place, would unlock an important channel of growth finance to European companies including SMEs.

Risk-based capital requirements for insurers should also be reviewed to increase their participation in the securitised markets. Asset profiles of many securitised products are a natural fit for insurance liabilities. Yet in 2022, only 12 per cent of EU insurers invested in securitised products, largely due to onerous capital requirements.

These are well-known shortcomings with the EU's regulatory framework, but risk aversion and inertia have resulted in a standstill for too long. The current political momentum behind securitisation reform gives hope that this time could be different. Anxious about under-investment, we have heard policymakers describe today as a 'now or never' moment for CMU. We look forward to actions being taken to boost Europe's competitiveness.

FRANÇOISE GILLES
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Securitisation: another brick for the CMU

In 2024, EU leaders called for a "new European competitiveness deal," focusing on enhancing the capital markets union and revitalizing the securitisation market through regulatory and prudential changes, recognizing its potential to drive EU growth, which is essential for supporting both the climate and the digital transitions.

As such, securitisation has been staged as one of the pillars for relaunching the Capital Market Union as (i) it enhances credit systems by promoting disintermediation, (ii) gives some air to banks' balance sheet hence provides additional financing capacity and (iii) increases the velocity of European banks thereby boosting their competitiveness relative to their American counterparts. On the other side of the Atlantic, the securitisation market is indeed frequently regarded as a benchmark due to its significantly larger outstanding amount compared to the European market. For instance, pre-Great Financial Crisis, Europe used to have a decent securitisation market, but in 2023, the US issued €1.3 trillion in securitized assets, compared to just €213 billion across the EU's 27 Member States. Such vast disparity is largely due to the extensive securitisation of residential real estate loans in the US, supported by government-sponsored entities like Fannie Mae and Freddie Mac.

For the European Union, the main goal is to achieve scale and liquidity in order to establish a successful securitisation market that provides the necessary financing for high technology innovation, renewable energy infrastructure, and burgeoning businesses. So, what do we need to do to catch up with the most dynamic markets? In my view, lifting the barriers that prevent Europe from achieving similar dynamism requires a comprehensive approach that addresses multiple factors within the ecosystem.

As an institutional investor, we engage in a diverse range of asset investments, including securitisation, on behalf of our clients. As such, our strategic asset allocation is guided by the pursuit of sufficient diversification, attractive yields, and the consideration of associated capital charges. While the decreasing volumes experienced since the Great Financial Crisis have also been driven by the uncompetitive return (in relative terms) of these assets, the issue of capital charges has garnered political attention. It notably translated in the recent review of the Solvency II Directive, in prompting a request for the European Commission to assess the appropriateness of existing calibrations for investments in securitisation. While the potential changes will only impact standard formula users, as internal model allow for a more granular approach, it seems crucial to engage all interested parties to reach scale and build a deep and liquid market. Only a nuanced and comprehensive approach will appropriately account for these risks without imposing undue pressure on capital charge requirements. Only such balanced strategy will help ensure the regulatory framework governing securitisation in Europe remains effective and relevant, fostering a healthier and more competitive financial landscape.

Need of a comprehensive approach that addresses multiple factors.

It is also important to give all the credit it deserves to the STS (simple transparent and standardised) reform: it has definitely restored confidence by creating a safer environment. However, the relative value problem on securitisation is also driven by due diligence cost notably for STS assets, and for highly rated assets, the complexity of the framework is not balanced by higher premium. Additionally, regulatory discrepancies across jurisdictions limit a global market approach and hinder portfolio construction. In Europe, the burden on investors—including proof of due diligence and monitoring of retention—is excessively high and should be borne by issuers, as it is the case in the US.

Therefore, to unlock the full potential of the European securitisation market, a balanced regulatory approach is essential. This approach should support both issuers and investors by ensuring that the market is competitive and attractive. Key strategic adjustments should include aligning regulatory requirements, if evidenced by the European Commission assessment, reducing excessive capital charges, streamlining due diligence processes, fostering a vibrant and resilient securitisation market capable of meeting Europe's financial and developmental needs. Ultimately, a holistic strategy that addresses these multifaceted challenges will pave the way for sustainable economic growth and innovation, enabling Europe to match the dynamism seen in the US securitisation market.

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A new chance for securitisation in Europe?

Securitisation is a critical tool for relaunching the capital markets union, and contributing to the financing of the European economy, as it has been underlined in many reports and statements since the beginning of the year.

Securitisation is a technique that shares out primarily the credit exposure of a portfolio into several bonds, the "tranches", with different seniorities to match with various investor needs. It is a way to provide alternative sources of funding for economic actors and corporates, complementary to traditional bank loans and bond financing. It can provide stable financing of the Working Capital, by securitisation of commercial or financial receivables. It is also a way to refinance portfolios of operational assets (automotive, renewable energies, ...), and can be a mean of diversification of medium/long-term financing sources through secured financing.

In addition to granting diversity of funding sources, securitisation can also be used by lenders to help managing their capital needs and alleviate their balance sheet and, for banking institutions, RWAs by making use of Significant Risk transfer mechanism (SRT), especially in the context of the negative impact of CRR3/CRD6 that will increase their capital requirements. These SRT transactions are generally private, most often carried out "synthetically" (guarantee-type format, without funding transfers).

The European securitisation market has significantly declined over the last years, as a stigma remains that is rationally no longer relevant. Indeed, since the financial crisis of 2007/2008, the regulatory framework for securitisation has been significantly strengthened in Europe with namely the ban on re-securitisations, the retention policy, transparency procedures, providing a much more secure framework than 15 years ago.

However, some rules seem no longer appropriate to the current challenges and should significantly evolve so that this market can resume significantly in Europe, while remaining properly supervised and transparent for investors.

The main impediments for relaunching the public cash market are dealing with the following:

- Market liquidity is one of the main bottlenecks: only AAA senior tranches from STS operations are eligible at level 2B of HQLA assets for the calculation of the Liquidity Coverage Ratio (LCR), which is a real problem for granting sufficient liquidity to this kind of assets, also in comparison with similar assets such as covered bonds. We would recommend allowing AA ratings and promoting STS to level 2A in order to reinforce the market liquidity.
- Capital surcharge stemming from current risk weighting parameters (p-factors, floors), that doesn't ensure capital neutrality and make securitization abnormally more expensive compared to the underlying assets.
- Streamlining the issuance related process and costs, including on reporting and disclosure, could improve the cost and operational burden on originators' side, stimulating issuers' appetite.
- Adaptation of regulatory burden on due diligence for investors, in order to introduce more proportionality in these obligations, would help improve liquidity on cash market;
- Last but not least, it is critical to get investors back. In this regard, improving capital charges for insurers is essential, as very punitive capital charges for securitisation currently act as a disincentive for insurers.

The industry welcomes the European Commission initiative to launch a consultation at next autumn, which will be an opportunity to address the above impediments. The stake is not a sole question of capital markets, but also of building a Savings and Investment Union, targeting a balance between investors and issuers expectations, and restoring competitiveness through a return on investment that is properly proportionate to the risks.

- In this regard, the recalibration of capital requirements for banking and insurance sector is a strong expectation from investors overall. The case of the senior tranches which bear the lowest risk is speaking. They are comparable to the covered bonds which are correlated to the credit quality of the issuer, but remain less competitive for banks and insurers.

The stake is to build a Savings and Investment Union, meeting issuers and investors' expectations.

- When it comes to SRT securitization, these transactions are dedicated to sophisticated and knowledgeable investors in capacity of properly assessing and bearing higher level of risk and then getting higher return. The time-to-market is critical in the process of originating and getting these transactions approved.

At the end, Europe needs to take into account the competitive landscape with the US, the UK and other jurisdictions to make sure that an investor, whatever his profile, is in a position to have an equivalent risk / return for the same quality of assets, comparing to other jurisdictions.

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Securitisation: who comes first - the issuer or the investor?

The recent efforts to revive the EU securitisation market have not led to discernible positive results; it remains far short of its potential to finance EU economic growth, dual transition and strategic autonomy.

One reason is political: despite the fact that EU securitisation did not experience the problems associated with US subprime mortgage crisis during GFC, reference to securitisation stigma persists in EU public discourse. Another reason is economic: the EU regulatory framework does not establish a level playing field among financial markets (e.g. securitisation, whole loans, covered bonds, credit funds, corporate credit) and introduces high barriers to entry to both securitisation issuers and investors (e.g. disproportionate disclosure and due diligence requirements, structuring and rating requirements, liquidity constraints, etc.), thus limiting issuers mostly to large banks and non-bank financial institutions (with limited sources of funding), and investors - to large asset managers and large insurers.

Issuers of securitisation compare the all-in cost of securitisation with that of other available funding sources. For banks, funding mortgages (be they residential or commercial) via covered bonds is much cheaper than that of securitisation; the former are favoured in repo and LCR eligibility, require only one rating to be eligible vs. two for securitisation, disclose only aggregate cover pool data vs. loan-by-loan data for securitisation and the syndication process is expedited on limited due diligence and programmatic issuance. All this translates into, say, one-hour launch-to-price execution for covered bonds vs at least one-week launch-to-price execution for securitisation, with all costs and execution risks that this entails.

From investor perspective, the infrastructure required by regulation is more prescriptive and costlier than that for any other investment, regardless of risks. The sunk cost can be economically justified only by large scale investor participation. Besides, investors consider their investments on a spread and nominal-yield basis, and on a risk-adjusted return and return-on-regulatory-capital basis. Most EU securitisation market sectors offer higher spreads, nominal yields and risk-adjusted returns than most other fixed income instruments, but the return on regulatory capital (especially for insurers) is often much lower (for both STS and non-STS) than for other comparable fixed income instruments. To illustrate: a German senior prime quality real estate loan had a risk-adjusted spread of 150bps in 3Q24 which delivered a RAROC of 11% for an insurer and 38% for a bank, both using SA capital calculation. In comparison, a AAA tranche of a non-STS securitisation of such loans had a similar risk-adjusted spread but delivered a RAROC of 3% and 81%, respectively. 75%-LTV housing loan delivered RAROC of 83% and 102% for insurers and banks, while the AAA-rated tranche of STS RMBS backed by such loans delivered 6.6% and 47.5%, and AAA-rated covered bond backed by a cover pool of such loans delivered 2% and 11 %, while a single-A rated corporate bond delivered 8% and 9%, respectively. The result change with yield and EL adjustments, but the differential magnitude remains and informs investors' preference for one investment over another.

Naturally, investors also consider the liquidity of their investments and assess it with different metrics (e.g. bid-ask spread, turnover ratios, eligibility for repo, LCR). These eligibility criteria apply only to banks, but they are also used as reference points for liquidity by non-banks. By these metrics, parts of the securitisation market compare favourably with parts of the broader fixed income market (i.e. STS auto ABS and prime RMBS with covered bonds and large corporates), but the quantitative aspects of eligibility among them differ materially. To illustrate, using Guideline EU 2016/65 of the ECB: the valuation haircut applied to a AAA-rated prime STS RMBS (Cat V), eligible credit claims and legislative covered bonds (Cat II), with comparable life of 3-to-5 years, are 7%, 8% and 2.5%, respectively. The notional value of the haircuts may change from time to time, but the size of differential seems to remain untouched.

Both issuers and investors care about the cost of securitisation.

To fully understand the need for its revival, EU securitisation should not be viewed only in the context of bank financing and risk transfer. It can be viewed as an asset-based financing technique with wide application in the financing of large and small corporates (e.g. SME loans on a pooled basis), infrastructure (e.g. utilities), sustainability (e.g. solar panels), digitalisation (e.g. data centers), etc. and applied by non-banks, private credit, non-financial corporates, etc. along with its use by the banks. To revive the EU securitisation the artificially high barriers to entry should be lowered by recalibrating and rescaling capital under CRR and Solvency II, due diligence and disclosure requirements, and also LCR and repo eligibility.