Relaunching securitisation in the EU

1. The high stakes benefits of securitisation

A market expert opined that the value that securitisation can bring is extremely high. One of Europe's main challenges is the struggle to finance the digital and green transitions and the enhancement of euro area growth. The securitisation market can create significant additional funding capacity, but any changes to the regulatory framework need to be implemented in the right way.

An industry speaker agreed that securitisation will bring many opportunities. It will boost economic growth, help to bridge the pension protection gap and support economic growth. Given the need to finance both the digital and green transitions and increased defence expenditure, it makes perfect sense to use the benefits of securitisation to channel Europe's capital towards economic growth.

1.1 Easier access to credit, efficient risk allocation and improved transparency

An industry representative explained that the US mortgage backed securities (MBS) market funds 70% of mortgages, which frees up originators' balance sheets. These originators are then free to find new borrowers and expand access to credit. This funds more housing, which has knock on benefits on construction and household demand. Taking another example, collateralised loan obligations (CLOs) are securitisations of corporate loans which fund lending to small and medium sized enterprises (SMEs).

Secondly, securitised products help market functioning by helping to allocate risk. In a well functioning securitised products market, the different parts of the capital structure are allocated to the most appropriate pockets of risk. The senior tranches go to banks or pension funds; assets further down the capital structure are allocated to insurance companies; below investment grade, assets go to hedge funds and private equity. Securitised products also help market functioning through the transfer of risk. It is difficult to transfer assets when all banks want to be asset light, but this can be done using securitisation. Portfolios of assets can be transferred to banks for securitisation and transmission throughout the financial system.

Finally, securitisation increases the transparency in the economy. In a thriving securitisation market, there is monthly reporting on consumer loans, commercial property and SMEs, which would not exist if these assets were simply sitting on balance sheets. The trade in these assets also increases price transparency. The existence of a large number of participants thinking and talking about the drivers and pricing of credit risk is a significant benefit to regulators.

1.2 Securitisation is an essential tool for managing banks' funding needs and balance sheets

A regulator added that the ability to tranche liquid standardised assets decreases banks' cost of funding. In the German market, banks retain approximately 40% of their securitised positions for funding purposes. Secondly, securitisation frees up capital from the balance sheet. If 40% of a position is retained on the balance sheet, this effect is not significant. This effect is linked to supply and demand in the credit market, however. As the credit market is suffering from low demand and the banks are well capitalised, there is not currently a strong need to free up capital.

2. The main objective is to scale up the EU securitisation market

An industry representative explained that many financial institutions do not invest in the EU securitisation market because it is too small and too fragmented. Ultimately, the market needs to grow. One reason for the small market size is the onerous reporting requirements and loan level transparency. Transparency is welcome, but some of the templates used in the reporting process are excessively complex. There has to be a recalibration of the requirements. Currently, the requirements add cost and deter issuers from the market. The smaller investors' struggle to comply with the due diligence requirements makes them even less likely to invest in the EU. In the US, the insurers are substantial players in the securitisation market. Structured products comprise over 20% of insurers' balance sheets. In some private equity backed insurance companies, this number is even higher. However, the figure for EU insurers is less than 5% due to the higher capital requirements. For covered bonds the capital requirement is 5% to 7%; for non simple, transparent and standardised (STS) securitisations, it is 100%.

The regulatory framework is channelling the investment into covered bonds over securitisations. The EU should want structured products to be considered a top tier asset class. This does not happen due to stigma and the limited size of the market. In the US, market participants can allocate to anywhere in the world; in the EU, they can only allocate to assets that comply with EU regulations. This means the market is too small to drive investment, which means the required yield is significantly higher, which makes the market unattractive for investors. Frankly, US issuers do not comply with EU disclosure requirements because they do not have to. Allowing EU investors to invest in asset classes and structures that are approved in other jurisdictions will create a healthier market.

3. The main impediments to the proper functioning and development of the securitisation market

3.1 Information asymmetries have led to the stigmatisation of securitisation risk in the EU and a corresponding miscalibration of the regulatory framework

A regulator emphasised that securitisation is a very powerful and therefore very successful financial innovation, but it does pose some risks. These risks are typically linked to problems with the quality of underlying assets. Essentially, the principal issues are information asymmetry and incentivisation.

An industry speaker explained that there is still a stigma against securitisation. The issue with securitisation is really about the assets that are being securitised. The same applies to banks' balance sheets. If a balance sheet only contains poor quality loans, it will contribute to systemic risk. The EU securitisation market remains depressed for several reasons. First, two parts of the capital surcharge are incorrectly calibrated. The first is the p factor, which is designed to cover the additional risk created by the securitisation structure, such as model risk. The current weighting of the p factor is too high. Even though it was reduced in Capital Requirements Regulations 3 (CRR3), especially for STS output floor calculations, it should be reduced further. The second incorrectly calibrated element of the capital surcharge is the floors that are applied, especially on senior tranches.

The second key bottleneck is liquidity. Today, only AAA senior tranches of securitisations are eligible for the liquidity coverage ratio (LCR). They are treated as 2B high quality liquid assets (HQLA), which is less favourable than covered bonds, for instance. Finally, it is vital to bring investors back. Today, the insurers are experiencing punitive capital charges. This needs to be addressed to bring back investment.

An industry representative emphasised that the stigma of securitisation is only an issue in Europe. It is time for Europe to go beyond political statements and ideological convictions and look at the data. The data on securitisation in the EU does not suggest any reason for this stigma, barring a few products which no longer exist. Secondly, the excessive capital charges are a significant issue for banks as well as insurers. In academic terms, this issue is called non neutrality. The capital for securitisation is higher than the capital for the underlying, which does not make sense. Thirdly, the investor base is limited due to the non neutrality of regulatory capital and quirks in the European regulatory framework, which are preventing different parts of the market from participating in it. Europe introduced STS on the recommendation of the Basel Committee on Banking Supervision (BCBS), but the capital requirements are excessive.

The real market in Europe is very small. If volume is small, there is not enough frequency and continuous issuance for investors to justify the cost of setting up the business. The high barriers to entry for issuers and investors lead to complications with liquidity. Bank of America's research indicates that there is almost no difference in secondary market liquidity between STS ABS and prime benchmark covered bonds, although their regulatory treatment is materially different. Finally, there are unjustified discrepancies in the treatment of cash and synthetic securitisations. For unknown reasons, the reporting on synthetic securitisation does not show how many transactions are happening. There are also quirks in who is able to invest in what. For example, under the emergency legislation during Covid, insurance companies were prohibited from making unfunded investments in STS synthetics.

A market expert summarised that, although the EU has the safest and most highly regulated market in the world, some forms of securitisation are still being penalised. Not a single penny has been lost on a AAA tranche in 40 years, but these products are still not viewed as AAA instruments.

3.2 Inconsistencies in bank funding tools

A regulator explained that the German covered bond market is highly standardised and successful. The strength of this market means there is little room for securitised mortgages. A market expert remarked that, from the point of view of lending capacity, the difference between covered bonds and securitised products is that securitised products leave the balance sheet and thereby create room. A regulator commented that German banks consider covered bonds to be more attractive, which indicates that there is not a level playing field.

3.3 Fixing the regulatory framework, taking a risk based approach and monitoring macro risk

An official agreed that securitisation is an essential tool for allocating risk and an efficient capital market requires a broad variety of instruments. The regulation of securities is not perfect, however. The disclosure and due diligence requirements are excessively burdensome; there is the issue of liquidity; and the capital requirements in Solvency II and the Capital Requirements Regulation (CRR) are not correctly calibrated. There needs to be a risk based approach to securities regulation. The level of risk should determine the capital requirements that apply. It is also important to consider consumer protection and the macro risk that is associated with securitisation. If the whole framework is being recalibrated on a broad scale, the regulatory and supervisory community will need to monitor the market. Ultimately, the way forward is clear: the European regulatory authorities need to do more to free up the securitisation market.

A regulator stated that artificial incentivisation should not be used to make securitisation more attractive. In the end, capital and liquidity should still reflect economic risk. Any reduction in the requirements should not act as a subsidy. In some markets, there is not an exact substitution between covered bonds and securitisation. A market expert agreed that there should be no artificial incentives. The question for EU policymakers and industry participants is whether the regulatory framework is excessively strict.

An official added that there should be a holistic and horizontal approach to regulation. The capital requirements should reflect the risk of securitised assets, which currently is not always the case. Allowing investment funds regulated under the Alternative Investment Fund Managers Directive (AIFMD) to sponsor is one way to introduce more competition into the market. The due diligence requirements should be targeted and proportionate. Sophisticated investors should not be burdened or double burdened by the requirements. A specific way to make securitisation more attractive is the current proposal on the third party effects of assignment of claims conflict of law. This proposal clarifies what assignment of claims would apply, which would make the legal perspective much clearer.

3.4 The rules on disclosure must be simplified

A regulator emphasised that it is possible to make the regulatory framework more efficient. Regulation has generally become too complex, and this is also true for securitisation. The disclosure rules and some of the practical aspects around due diligence are extremely complex. Reducing this complexity would lower transaction costs and make securitisation more attractive without increasing risk.

A market expert agreed on the need to simplify templates and remove excessive administrative burdens. The European Central Bank (ECB) uses a template for banks that want to use securitised products in refinancing operations, yet ESMA requires banks to use a much more complicated template. Many market participants find this discrepancy somewhat strange.

An industry speaker agreed that some of the disclosure requirements are triggering significant additional cost. Simplifying the features of the originated loan will enable these instruments to be understood more easily, which should support a lower capital charge. The capital charge should be calibrated according to the tail risks. In the US, the market is much deeper because loan features are harmonised and there are state support mechanisms, such as Freddie Mac and Fannie Mae. There is investor appetite for securitised products if the risk return is appropriate.

3.5 Bringing stakeholders together will help to create an effective EU securitisation ecosystem

An industry speaker stated that the originating banks, the regulators and the investors need to work together to tackle these issues. An official noted that regulation is not able to build a market, but it can provide the ecosystem to enhance a market or even hinder the development of a growing market. From an academic perspective, the securitisation regulation has been an impediment to the market.

4. Success factors for an EU platform for safe securitisation assets

4.1 Determining the objectives and the business model

A regulator noted that greater standardisation and securitisation would also help to create deeper and more liquid markets, which is essential for capital markets union (CMU). In Germany there are some helpful market driven initiatives such as True Sale, but the creation of an EU platform would increase standardisation even further.

An industry representative commented that any platform similar to Fannie Mae and Freddie Mac would need to have a defined objective and be designed to provide safe assets.

A market expert agreed on the importance of establishing the objectives of any future platform. The small banks do not have the internal capacity to conduct tranching and selling. An EU platform could conduct these operations for smaller institutions. The difference of risk is another interesting benefit of such a platform. It could allow an institution to buy an instrument at a value that incorporates the risk, which may differ between countries, sell the lower tranches to the appropriate investors and then keep the AAA tranche on the balance sheet and resell its own securities.

An official (emphasised that public guarantees are not free money. There is risk being taken with taxpayers' money. Any public guarantee is highly likely to constitute a form of state aid, which means it will have to meet the public interest test. To pass this test, the guarantee will have to have a specific purpose, such as freeing up capital in SMEs, which will significantly limit the horizon of possibilities for the scheme. European state aid law will also limit the profits of the investors, the sponsors and the platform because the benefit of the guarantee must go to the SMEs. There are also significant fiscal challenges across Europe. The use of guarantees might increase debt levels and deficits, and guarantees are always a difficult issue in ratings negotiations. It might appear easier to work with the European Investment Fund (EIF) and European Investment Bank (EIB) on this endeavour, instead of national governments, but their funding is common debt. There will be a way forward, but it will not be an easy journey.

A market expert agreed that the way forward will not be easy. However, the governments in the US, Canada and Japan have never lost any money on their guarantees; on the contrary, these guarantees are a source of significant revenue.

An industry speaker agreed on the importance of defining the economic model for a theoretical European platform. It could be a public guarantee, or a mutual guarantee financed by fees. The selected option will have consequences on the economic model and who ultimately pays for it. The idea of a European platform appears to be a longer term project. Tackling the challenges in the securitisation market will require both regulatory reform and the development of a platform. These initiatives should be launched in parallel.

A market expert agreed that it is important to review the regulatory framework while also launching the platform initiative. The creation of an EU platform will require a state guarantee, which is a difficult political question. This is the biggest difference between the US and EU markets. In the US, there are entities sponsored by the federal government.

4.2 Solving the issues posed by the diversity of underlying assets

An industry representative explained that the platforms in Canada, Japan and the US work because there is a common product and a common legal framework. The EU countries have different legal frameworks and use many different products. It will be difficult to combine these into a common platform. It should be possible to address the issues with credit risk and loss sharing, perhaps using a form of insurance or fee, but the lack of cashflow predictability in the pools will likely lead to a significant demand for data, unless there is a bullet structure or guaranteed liquidity. It will not be impossible, but it is important to figure out the objectives and then determine how to achieve them. Another alternative would be to allow smaller banks and originators, possibly including non banks, to access country level platforms. This would reduce the barriers to entry and the cost of doing business. To deal with the issues with due diligence requirements and templates, the pre existing platforms for bank networks and national platforms and formats for SMEs should be exploited and leveraged.

4.3 Involving the EIF and EIB to leverage private capital

An industry representative stated that the remit of the EIF and EIB could be expanded to capture consumer and mortgage products. The establishment of a public private partnership (PPP), with the co participation of the EIB and EIF, could facilitate the use of private capital to magnify the effect of the risk transfer and liquidity and cash placement.