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# Securitisation as a key pillar of the UK Future Regulatory Framework

Policy priorities in response to H.M. Treasury's Call for Evidence for the review of the securitisation framework

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# Executive summary

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# The UK economy today faces two main challenges

- The Covid-19 recovery: the damage to the economic fabric and growth prospects caused by the pandemic will take time to repair

- The green transition: achieving targets will require enormous capital mobilisations

- The UK financial system needs to be well-equipped to react to these challenges:
  - Economic growth requires financing and capital, both from banks *and* institutional investors
  - New Basel rules will increase the cost of capital for banks, constraining lending
  - Volumes and ratios of non-performing loans will likely increase in the near future; while the financial system remained resilient during the pandemic it also benefited from significant government and central bank support
  - Continued over-reliance on bank financing makes advancing capital markets an increasingly urgent priority

- **Securitisation is uniquely placed to address these challenges through its ability to transfer risk while still enabling banks to continue to lend.**

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# Summary of recommendations

| | Issue | Solution |
|---|---|---|
| **Liquidity Coverage Ratio (LCR)** | • STS is not properly recognised under the LCR | • Adjust LCR to include all securitisation and better to reflect the quality of STS securitisation |
| **Capital for bank investors** | • Overly conservative capital treatment for bank investors under CRR | • Recalibrate CRR to reflect the real risk, level the playing field and reduce distortions |
| **Solvency II** | • Overly conservative capital treatment discourages insurers from taking longer-term mezzanine risk, and instead encourages direct purchase of illiquid portfolios of "whole loans" | • Recalibrate Solvency II to align more fairly with covered bonds and corporates and reduce cliff-effects |
| **Significant Risk Transfer (SRT)** | • SRT assessment process has in the past been slow, uncertain and inconsistent | • Continue the improvement in review procedures and feedback |
| **Disclosure requirements** | • ESMA disclosure templates remain challenging for originators with many compliance uncertainties. | • Adopt a more proportionate approach especially for private securitisations |
| **On-balance-sheet securitisation** | • EU framework introduced in March 2021; no UK equivalent at present. | • Introduce a UK equivalent of the new EU framework, but with a balanced approach for synthetic excess spread and simplified requirements for high-quality collateral |
| **Asset-backed commercial paper (ABCP)** | • Lack of central bank support and overly strict requirements for STS at ABCP Programme level have led to zero take-up | • Improve central bank support and LCR treatment |
| **ESG Securitisation** | • If well supported, ESG and green securitisation can make an important contribution to funding the transition to a more sustainable economy. | • Implement common standards and support the nascent market consistently with other financial products |
| **STS criteria** | • Excessive complexity has discouraged the issuance of new securitisations and prevented their use for certain asset classes (e.g. SME loans) | • Consider if streamlining is possible |

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# Regulatory imbalances should be addressed

While remaining prudent, the framework should:

- Make it easier and economically attractive for:
  - originators to undertake securitisations
  - investors to provide both funding and risk appetite for securitisation
- Treat securitisation proportionately compared with other fixed income products and "whole loan" investment
- Encourage the development of the ESG securitisation market while not imposing additional constraints

**The Final Report of the High-Level Forum on CMU provided well-targeted and prudent recommendations to adjust the securitisation framework. These should be implemented to their full extent.**

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# Key messages

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# The unique value of securitisation

- Securitisation is a powerful structuring technique which through risk transfer, credit and maturity tranching can create significant added value when distributed and held by institutions qualified to evaluate the customised cash flows.
- Securitisation can support financial stability as it:
  - facilitates the sharing of risks originated by banks and other originators in their services to the economy with expert institutional investors, thus reducing the risk concentration and promoting diversification
  - rebalances funding of the economy away from banks to capital markets
  - contributes to capital planning and absorption of upcoming pressure as capital requirements increase
  - helps to resolve NPE portfolios by removing them from banks' balance sheets, sharing risks with highly specialised investors in distressed debt markets
  - As noted in the Final Report of the High-Level Forum on CMU (June 2020): "Importantly, securitisation can play a key role in addressing the consequences of the Covid-19 crisis, by raising liquidity for banks, helping manage their balance sheet exposures, reducing the link between sovereigns and banks given the large volume of sovereign guaranteed loans, and eventually contributing to setting the post-pandemic [EU] economy."
- In particular, securitisation can also support corporate and SME financing by:
  - freeing up capital to generate new lending in the form of SME loans and leasing
  - providing essential and safe structured financing for trade receivables
  - providing capacity for lending to ESG projects such as mortgage loans financing energy-efficient houses, rooftop solar energy loans or SME loans for sustainable projects

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# Creating value - restoring the motivations for securitisation

- The reason why securitisation issuance has fallen significantly in the UK is that the economics no longer work for many potential issuers and investors.

- Due to excessive capital requirements, the capital-adjusted cost of funding for banks through securitisation is often too high.

- This lack of viability of securitisation for many banks constrains the UK financial system by restricting banks' ability to use their capital to support as much lending as possible. Without well-functioning securitisation, banks are forced either:

    - to stop lending after they have reached full balance sheet capacity, or
    - to sell loans as "whole" (unsecuritised) portfolios to third party investors: such portfolios are illiquid and may be sub-optimal in extracting the best value.

- For securitisation to be cost-effective, the cost of freeing up one unit of capital for issuers must be less than the return on equity which such unit of capital would earn were it invested in funding assets on the balance sheet.

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# The economics of securitisation are highly sensitive to the risk weights for retained tranches: SME example

## OBJECTIVE

Based on real-life assumptions, this case study illustrates whether a synthetic securitisation transaction on a SME portfolio is cost-effective for the issuer.

A securitisation is cost-effective when the cost of freeing up one unit of capital is less than the return on equity ("RoE") at which this unit of capital would be reinvested.

We make the assumption here that the RoE at which freed up capital would be reinvested is equal to the RoE of the portfolio when held on the balance sheet.

| ASSUMPTIONS[1] | |
|---|---|
| Turnover SME (M€) | 30 |
| Maturity pool (years) | 4 |
| PD pool | 1.77% |
| LGD pool | 34% |
| Fixed rate SME loans | 1.80% |
| Funding cost[2] | 0.35% |
| Expected loss | 0.60% |
| RW pool (SME)[3] | 75.0% |
| Required capital ratio[4] | 12% |
| Mezzanine spread | 9% |

TRANSACTION STRUCTURE

| | | | | Scenario 1 | Scenario 2 |
|---|---|---|---|---|---|
| | Detachment | Attachment | Thickness | Tranche RW | Tranche RW |
| Senior[5] | 100% | 8% | 92% | 15% | 7% |
| Mezzanine[6] | 8% | 1% | 7% | n/a | n/a |
| Junior[5] | 1% | 0% | 1% | 1250% | 1250% |

[1] *"Real-life" assumptions.*
[2] *Indicative figure for a 5-year senior CDS spread on an EU G-SIB.*
[3] *Conservative Average SME supporting factor based on CRR Article 501.*
[4] *Estimate of total CET1 requirements for an EU GSIB.*
[5] *Retained.*
[6] *Sold to investors.*

# Securitisation is not cost-effective at 15% risk weight for the senior tranche, but is cost-effective at 7%

## CALCULATIONS

### BEFORE securitisation

| | | |
|---|---|---|
| Net portfolio revenue | 0.85% | (i) = fixed rate - expected loss - funding costs |
| Capital required | 9.00% | (ii) = RW * required capital ratio |
| **Portfolio RoE** | **9.44%** | (iii) = (i) / (ii) |

### AFTER securitisation

| | Scenario 1 | Scenario 2 | |
|---|---|---|---|
| Cost of transaction | 0.63% | 0.63% | (iv) = mezzanine thickness * mezzanine spread paid to protection provider |
| Capital required on retained tranches | 3.16% | 2.27% | (v) = (senior tranche RW * thickness + junior tranche RW * thickness) * required capital ratio [assuming SRT recognition] |
| Capital "freed up" with transaction | 5.84% | 6.73% | (vi) = (ii) - (v) |
| **Cost of one unit of freed up capital** | **10.79%** | **9.36%** | (vii) = (iv) / (vi) |

## CONCLUSION

If the cost incurred to free up one unit of capital is greater than the RoE at which this unit of capital could be re-invested, the transaction is uneconomical.
Under current framework (15% RW floor on the senior tranche), the transaction is uneconomical, as in scenario 1.
It is economical with a 7% RW floor on the senior tranche, as in Scenario 2.

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# Securitisation maximises the efficiency of capital usage for banks

- Securitisation uniquely enables banks to transfer risk while still enabling them to continue to lend. It is the only fixed income instrument which can do this.

- Capital is only released if the strict rules to achieve "Significant Risk Transfer" and "Commensurate Risk Transfer" are achieved. These rules are supervised by the PRA.

- When SRT is achieved, the capital released can be redeployed to support new lending.

- Because capital is used more efficiently, this enables banks to continue to lend more, and to do so cost-effectively, to support important sectors of the economy such as SMEs which cannot afford wider spreads and have no direct access to the capital markets themselves.

- The next slides (14 and 16) provide worked examples illustrating how securitisation increases the efficiency of lending, both to support more lending and to make existing lending viable.

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# Securitisation with SRT increases efficiency of capital usage to support more lending, including to SMEs

Synthetic securitisation: senior tranche 100% retained; first loss tranche placed (with 5% retention).
Return on RWA before securitisation is above 1.50% internal hurdle for lending. Impact of tax excluded for simplification purposes.

| ASSUMPTIONS *Capital requirement for originator* | | BALANCE SHEET (€m) | *Explanation of formulae* | *Column A Pre-securitisation* | | *Column B Funding through securitisation* | | *Column C Additional lending now possible* | *Column D Total lending after securitisation (Column A + Column B)* |
|---|---|---|---|---|---|---|---|---|---|
| CET1 Target Ratio | 12.00% | Assets / total funding requirement | | 1,000.00 | | 1,000.00 | New lending supported by 66.30 of "freed up" capital→ | 736.67 | 1,736.67 |
| | | | | | Senior: | 135.00 | ← RW of senior (15%) * €900m | | |
| | | | | | 5% retention (of first loss): | 62.50 | ← RW of retention (1250%) * €5m | | |
| Risk retention | 5.00% | Total RWA | Assets (1,000) * RW (75%) = | 750.00 | | 197.50 | Assets (736.67) * RW (75%)→ | 552.50 | 750.00 |
| RW on retained senior tranche (€900m) | 15.00% | Total capital | CET1 Target Ratio (12%) * Total RWA = | 90.00 | | 23.70 | "Freed up" capital i.e. 90-23.70→ | 66.30 | 90.00 |
| *Funding cost for originator* | | | | | | | | | |
| Unsecured borrowing cost | 0.50% | PROFIT AND LOSS (€m) | | | | | | | |
| Coupon paid on first loss tranche | 8.00% | Asset income | Assets (1,000) * Yield (2.50%) = | 25.00 | | 25.00 | | 18.42 | 43.42 |
| | | | | | Senior tranche: | 4.38 | ← [1,000 - 100 - 23.70] * 0.5% | | |
| | | | | | Junior tranche: | 7.60 | ← [100 * 95% * 8%] | | |
| Cost of capital for originator | 10.00% | Debt funding cost | (Assets - Total Capital) * borrowing cost = | 4.55 | | 11.98 | | 3.35 | 15.33 |
| *Other assumptions* | | Capital cost | Total capital * cost of capital (10%) = | 9.00 | | 2.37 | | 6.63 | 9.00 |
| RW on underlying assets when held on b/s | 75.00% | Total cost | Capital-adjusted cost of funding = | 13.55 | | 14.35 | | 9.98 | 24.33 |
| Yield on underlying assets | 2.50% | Net income | Asset income minus total cost = | 11.45 | | 10.65 | | 8.43 | 19.08 |
| Deal size (€mm) | 1,000 | Return on capital | Net income divided by total capital = | 12.72% | | 44.93% | | 12.72% | 21.20% |
| Placed tranche thickness (€100m) | 10.00% | Return on RWA | Net income divided by total RWA = | 1.53% | | 5.39% | | 1.53% | 2.54% |

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# Securitisation helps the efficiency and profitability of the banking sector

- The preceding example (slide 14) shows how securitisation allows banks to use capital more efficiently, improving both return on capital (RoC) and return on risk-weighted assets (RoRWA).
- The return on capital through securitisation has increased from 12.72 % to 44.93 %. This is because less capital is required to support the same amount of assets. RoRWA also increases. See the green boxes at the bottom of Columns A and B.
- The amount of freed up capital – 66.30 in this example – can now be used to support 736.7 of new lending on the balance sheet: see Column C which uses the same calculations as Column A but on a different base: 736.67 instead of 1,000.
- Column D adds Columns B and C together and shows that the same total capital as was required pre-securitisation (90) is now being used to support 1,736.67 (rather than 1,000) of assets. RoC and RoRWA have also increased, compared with the pre-securitisation case (Column A).
- The following example (slide 14) shows the same analysis save for a change in the yield assumption (from 2.50% to 2.25%). Here, it is not viable for the bank to lend because the return on RoRWA is 1.19% which is below the bank's internal target yield of 1.50%. However, the greater efficiency of capital usage provided by securitisation enables the internal hurdle to be exceeded (1.97%), and for the bank to lend – for example to SMEs – when it would otherwise not be able to do so. See the green box at the bottom of Column D.

# Securitisation with SRT boosts internal lending hurdles for lenders, increasing the viability of low-margin business to, say, SMEs

Synthetic securitisation: senior tranche 100% retained; first loss tranche placed (with 5% retention).

Return on RWA before securitisation is below 1.50% internal hurdle for lending. Impact of tax excluded for simplification purposes.

| ASSUMPTIONS | | BALANCE SHEET (€m) | Explanation of formulae | Column A<br>Pre-securitisation | Column B<br>Funding through securitisation | | Column C<br>Additional lending now possible | Column D<br>Total lending after securitisation (Column B + Column C) |
|---|---|---|---|---|---|---|---|---|
| *Capital requirement for originator* | | | | | | | | |
| CET1 Target Ratio | 12.00% | Assets / total funding requirement | | 1,000.00 | 1,000.00 | New lending supported by 66.30 of "freed up" capital→ | 736.67 | 1,736.67 |
| | | | Senior: | | 135.00 | ← RW of senior (15%) * €900m | | |
| | | | 5% retention (of first loss): | | 62.50 | ← RW of retention (1250%) * €5m | | |
| Risk retention | 5.00% | Total RWA | Assets (1,000) * RW (75%) = | 750.00 | 197.50 | Assets (736.67) * RW (75%)→ | 552.50 | 750.00 |
| RW on retained senior tranche (€900m) | 15.00% | Total capital | CET1 Target Ratio (12%) * Total RWA = | 90.00 | 23.70 | "Freed up" capital i.e. 90-23.70→ | 66.30 | 90.00 |
| *Funding cost for originator* | | | | | | | | |
| Unsecured borrowing cost | 0.50% | PROFIT AND LOSS (€m) | | | | | | |
| Coupon paid on first loss tranche | 8.00% | Asset income | Assets (1,000) * Yield (2.50%) = | 22.50 | 22.50 | | 16.58 | 39.08 |
| | | | Senior tranche: | | 4.38 | ← [1,000 - 100 - 23.70] * 0.5% | | |
| | | | Junior tranche: | | 7.60 | ← [100 * 95% * 8%] | | |
| Cost of capital for originator | 10.00% | Debt funding cost | (Assets - Total Capital) * borrowing cost = | 4.55 | 11.98 | | 3.35 | 15.33 |
| *Other assumptions* | | Capital cost | Total capital * cost of capital (10%) = | 9.00 | 2.37 | | 6.63 | 9.00 |
| RW on underlying assets when held on b/s | 75.00% | Total cost | Capital-adjusted cost of funding = | 13.55 | 14.35 | | 9.98 | 24.33 |
| Yield on underlying assets | 2.25% | Net income | Asset income minus total cost = | 8.95 | 8.15 | | 6.59 | 14.74 |
| Deal size (€mm) | 1,000 | Return on capital | Net income divided by total capital = | 9.94% | 34.38% | | 9.94% | 16.38% |
| Placed tranche thickness (€100m) | 10.00% | Return on RWA | Net income divided by total RWA = | 1.19% | 4.13% | | 1.19% | 1.97% |

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# What securitisation does and does not do

| Does | Does not |
|---|---|
| **Reduce the concentration of risk in the banking sector and enable banks to customise much more effectively the risks they retain or sell.** Securitisation converts illiquid loans into liquid and transferable securities that can be sold to specialised investors and traded in secondary markets. As a result, securitisation removes credit risk from bank balance sheets, enabling banks to reallocate capital and strengthen their capital ratios. The credit and maturity tranching process creates both tranches with lower credit and mark to market risk and tranches with higher credit and mark to market risk. | **Eliminate risks from the financial system** Securitisation does not eliminate risks – it rather helps to distribute and diversify them in a more efficient manner to those investors who are well prepared to hold those risks. Subject to risk retention rules, well-managed and supervisor-approved credit risk transfer away from the banking sector through securitisation benefits the economy and the banking sector, enhances monetary and financial stability, and creates opportunities for fund managers to improve their investment returns. |
| **Provide direct and indirect benefits for SMEs** Securitisation can finance not just direct loans to SMEs, but also SMEs' working capital (in the form of trade receivables) and leases of crucial assets such as vehicles and manufacturing equipment. Synthetic securitisations of SME loans assisted by public guarantee schemes contribute to new SME lending. | **Supplant other financing options for SMEs, such as equity** SME lending attracts higher capital charges for banks as SME lending is inherently higher risk. Securitisation of SME loans enables banks better to manage capital allocated to SMEs and lend more. However it is not a substitute for equity for SMEs, rather a complementary tool. Securitisation can act as a bridge from bank balance sheets – where most SMEs currently obtain their funding – to the capital markets. |

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# What securitisation does and does not do

| Does | Does not |
|---|---|
| **Provide specialised investors with significantly improved choice in their portfolio mix**<br>The technique of credit and maturity tranching allows the cash flow from the underlying assets to be purchased by different types of investors with varying investment preferences. Securitisation thus provides investors with exposure to the real economy to improve their ability to fine tune risk and return, or create tranches with particular maturities or currencies.<br><br>Securitisation is a specialised product suitable for institutional investors who have the resources to understand the transaction structures and carry out all necessary due diligence. The introduction of STS criteria was intended to widen the investor pool by simplifying and standardising transactions based on common and transparent features. | **Reduce risk for holders of all tranches**<br>The technique of tranching cashflows facilitates the creation of higher or lower risk investments to meet different investors' appetites for risk and return, or particular maturities or currencies. Investors buying the senior tranche receive in priority the cash-flows from 100% of the portfolio, while those buying the non-senior tranches only get paid after all payments owed to the senior tranche are made. It makes no more sense to seek to remove all risk from securitisation than to remove it from government bonds, covered bonds, corporate bonds, consumer lending or equities. Responsible risk-taking is what creates rewards for investors (returns) and issuers (risk-reduction) alike.<br><br>The natural complexity of securitisation transactions does not mean that they are riskier products in the economic system. European securitisations have a solid track record and are the most highly regulated and transparent fixed income asset class. |
| **Provide an asset that meets liquidity needs**<br>In particular during market stress, securitisations that meet applicable eligibility criteria of the relevant central bank liquidity operations can provide investors and originators with immediate funding and increased liquidity in the primary/secondary markets. | **Serve as a panacea for financial sector needs**<br>Securitisation is only one of the options in the financing toolkit for originators and investors. It has proved itself as a viable option, including during times of market stress. |

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# Securitisation perceived risks & mitigants

**Note: Many of these perceived risks are not unique to securitisation; AFME does not believe all risk control measures noted below are proportionate to the risks of UK (and EU) securitisation**

| Risk | Mitigant | Reference |
|---|---|---|
| Misalignment of interests/risks between issuers and investors | • 5 % risk retention requirement | Art. 6 (SR) |
| Low quality underlying assets (poor underwriting or asset performance) | • Criteria for credit-granting, including ban on securitisation of self-certified residential mortgages<br>• Prohibition on adverse selection | Art.9 ( SR)<br><br>Art 6(2) (SR) |
| Complex and opaque structures | • Ban on re-securitisations (CDO-squared structures are no longer permitted in the EU) | Art. 8 (SR) |
| Investors not understanding the risks properly | • Comprehensive due diligence requirements<br>• Prohibition on selling securitisations to retail clients | Art. 5 (SR)<br>Art. 3 (SR)<br>PRIIPS, MiFID II product governance rules |
| Use of complex derivatives | • STS requirements relating to standardisation | Art 21(2) and (3) (SR)<br>Art 26c(2) and (3) (SR) |
| Information asymmetry; any disclosure which does not provide investors with sufficient information to evaluate their risk | • Highly demanding transparency regime unique among fixed income products – template-based loan-level and investor reporting and disclosure of all documents essential to understand the deal for public and private transactions | Art. 7 (SR) |

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# Securitisation perceived risks and mitigants

## Note: Many of these perceived risks are not unique to securitisation; AFME does not believe that all risk control measures noted below are proportionate to the risks of European securitisation

| Risk | Mitigant | Reference |
|---|---|---|
| Non-compliance, fraud, mis-selling. | • Third party verification of STS compliance<br>• Administrative sanctions and remedial measures<br>• Possibility for Member States to impose criminal sanctions | Art. 28 (SR)<br>Art. 32 (SR)<br>Art. 34 (SR) |
| Low-quality assets or sub-optimal structuring of transactions. | • Assets packaged in an STS securitisation must meet stringent lending, homogeneity and underwriting standards; non-STS securitisations are also highly regulated<br>• STS requirements relating to simplicity<br>• STS requirements relating to standardisation<br>• STS requirements relating to transparency | Art. 20 (SR)<br>Art. 21 (SR)<br>Art. 22 (SR)<br>Art. 26 (b, c, d, e) (SR) |
| Accumulation of risks in the financial system arising from securitisation. (AFME does not believe that securitisation, unique among various financial techniques, requires special macroprudential oversight.) | • Macroprudential oversight of the securitisation market<br>• Prudential balance sheet and leverage ratio benefits of securitisation for bank originators require compliance with stringent economic as well as documentary, structural and significant risk transfer requirements | Art. 31 (SR) |
| Mis-calibrated credit ratings. | • Reduced reliance on credit ratings and improved quality of ratings<br>• Various other requirements applying to CRAs | CRA Regulation |

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# Securitisation perceived risks and mitigants

## Note: Many of these perceived risks are not unique to securitisation; AFME does not believe that all risk control measures noted below are proportionate to the risks of European securitisation

| Risk | Mitigant | Reference |
| --- | --- | --- |
| Tranching lowers the credit risk on higher-rated tranches, and raises the credit risk on lower or unrated tranches. | • Capital charges for banks and insurance company investors are calibrated very conservatively based on the credit risks of the new securitisation tranches | CRR Art. 258-270<br>Solvency II Art. 178 |
| Maturity tranching lowers the price volatility/mark to market risk for tranches with shorter maturities or weighted average lives, and raises this risk for tranches with longer maturities or weighted average lives. | • For regulated investors such as insurers whose investments are subject to mark to market requirements, capital charges must fairly reflect the post-securitisation price volatility of tranches<br>• For other investors such as fund managers, investors receive sufficient data to mark their portfolios to market | Solvency II Art. 178 |

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# The European securitisation market remains subdued; heavy regulations constrain growth

- The securitisation market in the UK and EU was disrupted after the 2008 financial crisis and has not scaled up with the STS framework; STS has not delivered an expansion of securitisation beyond a few Member States
- Existing frequent issuers have made use of the STS label, which now represents a significant share of the market (for placed issuance)
- However, non-STS issuance still outweighs STS, and STS has not stimulated new issuers or investors
- Much of the actual use of the STS label has been to apply it retrospectively to existing financings - mainly performing consumer ABS term securitisations and private ABCP transactions.
- The harsh treatment of securitisation compared to other financial instruments, whole loan pools and other fixed income investments makes STS securitisation burdensome, unattractive and costly for many issuers and investors – the upcoming revision of the STS framework is vital to address these concerns
- The regulatory framework in the UK and EU is more stringent than in the US – despite the strong performance of European securitisation through and since the financial crisis
- The ability of US originators to transfer mortgages to government-sponsored entities such as Fannie Mae (which then engage in risk transfer techniques) will likely shield US originators from certain adverse changes in the risk-weighting of mortgages under Basel III, contributing to a disproportionate impact in the UK of those coming reforms

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# The quality of the STS label has not been recognised; the unlevel playing field remains

- The Securitisation Regulation introduced tough new requirements:
  - ➢ disclosure requirements which were not calibrated for the specific features of the securitisation market – particularly problematic for private transactions
  - ➢ due diligence requirements for investors which are excessive and go well beyond what is reasonably necessary for the high credit quality of many securitisations
  - ➢ over 100 criteria must be met to achieve the STS label
- The concept of "simple, transparent and standardised" securitisations is widely supported, but the tough new regime has created higher hurdles for both originators and investors, and not been properly recognised in capital and liquidity rules:
  - ➢ partial adjustments to Solvency 2 and bank capital calibrations have mostly focused on the very senior tranches but failed to address distortions for mezzanine and junior investment
  - liquidity treatment under the LCR has not improved with STS and has even deteriorated with the new CRR (only AAA rated ABS are now eligible)
  - ➢ while improving, Significant Risk Transfer, which is required in order for originator banks to achieve prudential balance sheet and leverage ratio benefits,_ remains a complex and challenging process
- The 2020-21 targeted initiatives on NPEs and on-balance-sheet securitisation were a step forward, but
- Some existing transactions were penalised by the new framework (e.g. UTP).
- Generally the institutional debate limited the potential for impact of some proposals, so these reforms should be revisited in the future review of the broad securitisation framework

# Summary of key hurdles and recommendations

| Issue | Remedy |
|---|---|
| **Liquidity Coverage Ratio (LCR)**<br>STS is not properly recognised under the LCR nor is securitisation liquidity appropriately calibrated compared with other fixed income instruments. | • Promote STS to Level 2A under LCR; restore eligibility at A not AAA; recalibrate haircuts<br>• Remove cap on residual maturity for ABS HQLA (at 5 year WAL)<br>• Allow AA equivalent ratings (as was the case in the past) |
| **Capital for bank investors**<br>Overly conservative capital treatment for bank investors under CRR, also for bank originators under new rules for STS on-balance-sheet securitisation (see below). | • Recalibrate the fixed parameters that are components of the *p* factor for SEC-IRBA with a floor of 0.1 and maximum of 0.3 for STS securitisations, and a lowered floor of 0.25 and maximum of 0.75 for non-STS securitisations.<br>• Introduce a *p* factor of 0.25 for SEC-SA for STS securitisations and 0.5 for non-STS securitisations, the latter achieving a level playing field with US regulations<br>• Re-introduce a 7% RW floor in all approaches, considering also SEC-ERBA, for STS securitisations (cash and synthetic) for originator or sponsor banks |
| **Significant Risk Transfer (SRT)**<br>The assessment process has in the past been slow, uncertain and inconsistent. | • Continue the improvement in review procedures demonstrated by the PRA in the last two years by improving response times, providing feedback on grey areas and striving for a more consistent application of the rules<br>• SRT assessment rulebook should be finalised with the aim of simplifying the process |
| **Solvency 2**<br>Overly conservative capital treatment discourages insurers from taking longer-term mezzanine risk, and instead encourages direct purchase of illiquid portfolios of "whole loans" | • Recalibrate risk factors to align with covered bonds for senior STS securitisations and with corporate bonds for non-senior STS. Reduce cliff effects between STS and non-STS and senior and non-senior traches. |

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# Summary of key hurdles and recommendations

| Issue | Remedy |
|---|---|
| **Securitisation of NPEs**<br>Amendments introduced under the CMRP did not go far enough to help the NPE securitisation market and did not consider all NPE categories which may thus be penalised (such as UTP). | • Remove the 100% RW floor under the SEC-IRBA and SEC-SA (the floor does not apply under the SEC-ERBA)<br>• Remove the 50% RW floor in Art.269a(6) and extend its application to institutional investors<br>• Extend favourable treatment (i.e. the 100% RW cap for qualifying traditional NPE securitisations) to lower discount transactions (from 50% NRPPD to 20% NRPPD) |
| **Disclosure requirements**<br>Disclosure templates remain challenging for originators with many compliance uncertainties. | • Apply a more proportionate approach for the supervision of template implementation<br>• Reassess the need for ESMA templates for private securitisations<br>• Implement specific, well-designed templates for synthetic securitisations |
| **On-balance-sheet securitisation**<br>Benefits of original EU proposals constrained by risk weighting of synthetic excess spread and the requirement for recourse to excessively high-quality collateral. Both will increase complexity, reduce efficiency and make the framework more expensive to use. | • Implement an equivalent framework in the UK<br>• But with a balanced approach to synthetic excess spread<br>• Clarify and simplify requirements for high-quality collateral |

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# Summary of key hurdles and recommendations

| Issue | Remedy |
|---|---|
| **ESG securitisation**<br>ESG and green securitisation can make an important contribution to funding the transition to a more sustainable economy. The market is nascent and requires support. | • Develop proportionate common standards for ESG securitisation<br>• Accommodate transitioning assets as currently there is limited availability of ESG underlying collateral<br>• Consider suitable incentives |
| **ABCP**<br>Lack of central bank support (in contrast to other types of commercial paper funding) led to severe market disruption in 2020. Overly strict requirements for STS at ABCP Programme level has led to zero take-up. | • The existing 5% "temporarily non-compliant exposures" limit in Article 26(1) SR should be increased to 50% and the remaining WAL in Article 26(2) increased to 5 years<br>• ABCP should be eligible under purchase and repo operations of the Bank of England.<br>• STS ABCP should be admitted to the HQLA buffer under LCR rules. |
| **Complex STS criteria**<br>Excessive complexity has discouraged the issuance of new securitisations and has also prevented the use of securitisation for certain asset classes (e.g. SME loans) | • Consider if requirements can be streamlined<br>• Allow for a flexible interpretation of criteria in practice |

# 1) Understanding securitisation: recalling the key functions

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# What is securitisation?

- There are three main types of securitisation: true sale/cash; on-balance sheet/synthetics; ABCP.
- The first type of securitisation is "true sale" or "cash" securitisation. This is the process of pooling together a large number of loans (such as mortgages, loans to purchase cars , loans to SMEs, or rooftop solar energy loans) held on the balance sheet of a bank or other financial institution (the "originator") and selling them to a newly created and legally separate entity (the "Securitisation Special Purpose Entity" or "SSPE").
- This SSPE finances the purchase of the loans by issuing bonds to investors. The loans generate cashflows (for example, monthly mortgage payments from homeowners), which are used to repay the investors. Investors have recourse only to the underlying securitised loans and have no claim on the originator for credit losses.
- This process converts otherwise illiquid loans into more liquid and tradeable securities.
- The second type securitisation is "on-balance-sheet" or "synthetic" securitisation: this is simpler, in that there is no "true sale" of assets and often no SSPE. Instead, the risk of an identified portfolio of assets is transferred by the purchase by the originator of a guarantee from a third-party investor, who promises to reimburse the originator should any of the assets default.
- A third type of securitisation is asset-backed commercial paper ("ABCP").

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# A traditional cash securitisation structure

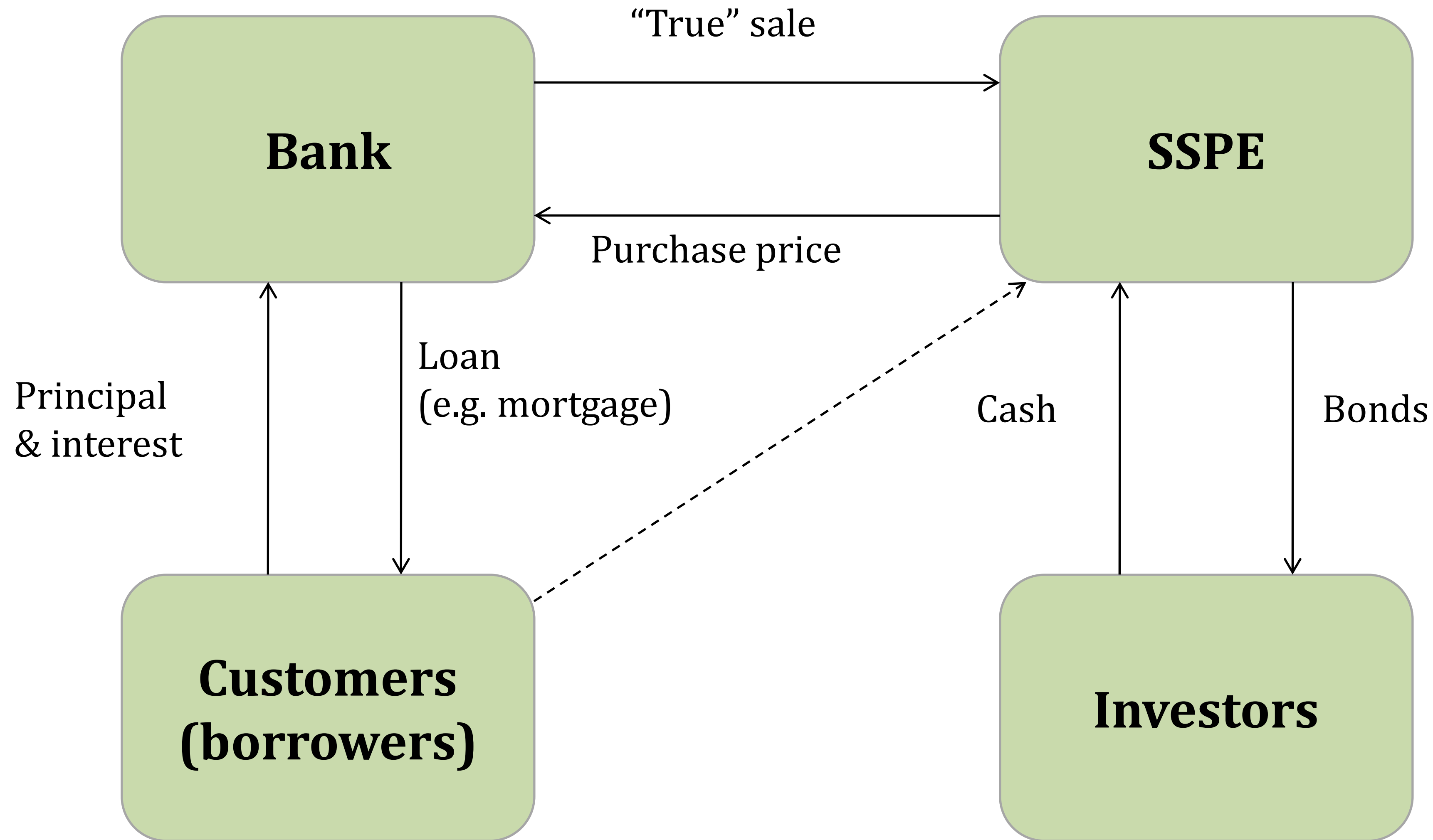
- The Originator (typically a bank) grants a loan (a mortgage in this example) to the Borrower, who in exchange pays principal and interest on the loan over time.

- As owner of the assets, the Originator pools the loans and sells them via a "true sale" to a Securitisation Special Purpose Entity (SSPE) which is a stand-alone entity, created exclusively to acquire and fund the pool.
- The SSPE pays a purchase price to the bank and finances this by issuing bonds or commercial paper to investors. The interest payments to investors are funded only by the cash flows generated by the pool of loans.

- Although the Borrower still makes his or her monthly payments to the Originator, who remains the servicer of the mortgages, the entitlement to the principal and interest is transferred to the SSPE via a ring-fenced (see dotted line) financial structure. This gives the investors recourse to the pool of mortgages, protecting them from the risk of default by the Originator. The investors have no recourse to the Originator for credit losses on the assets.

- If SRT is achieved, the bank may reduce the capital allocated to the assets according to the proportion of risk transferred to the investors. The capital released can then be used to support new lending. By law, the Originator retains 5% of the risk of the pool of loans.

# What is securitisation?



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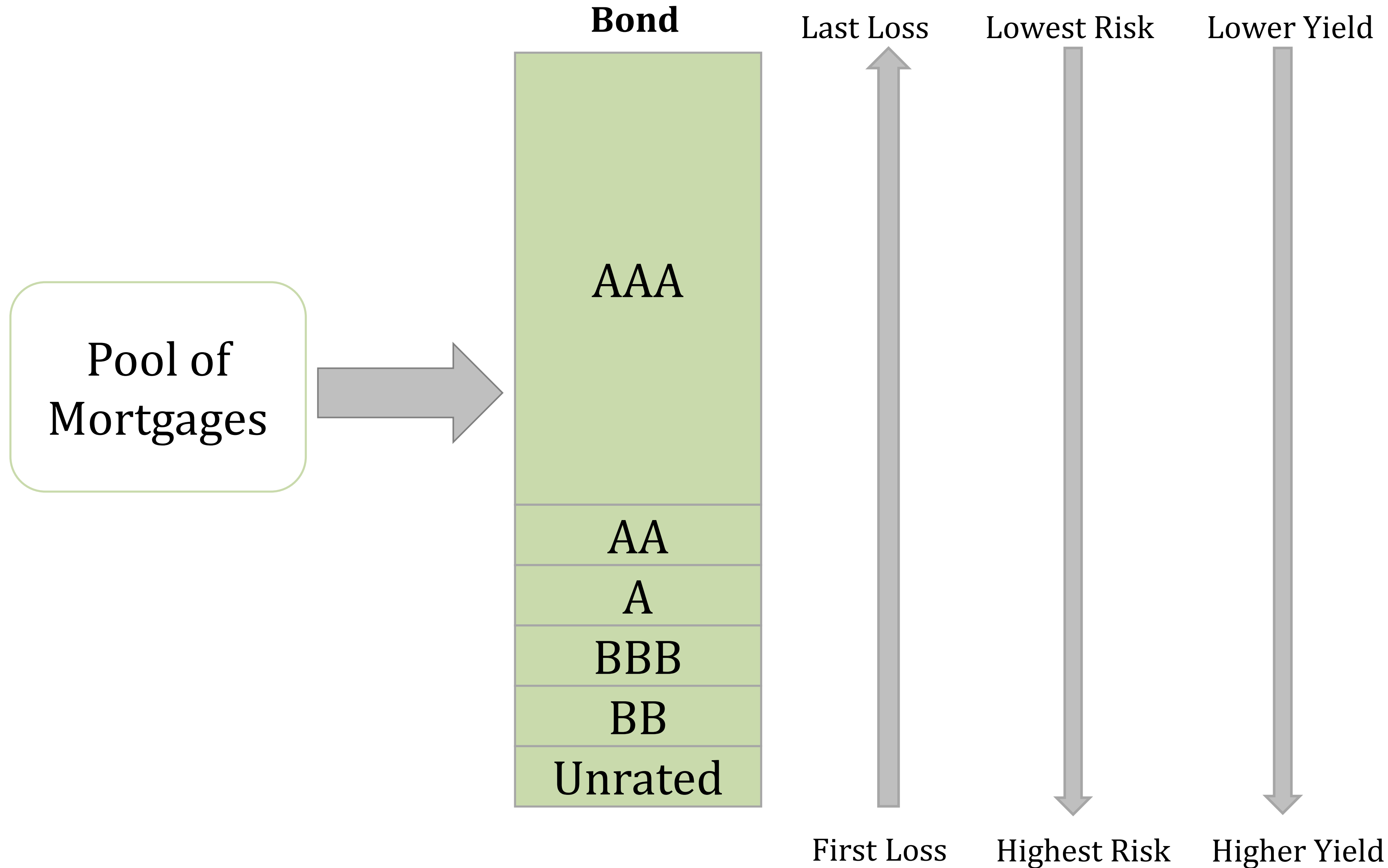
# Securitisation bond structures



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# Investors and structures

- Securitisations are bought by a range of investors – typically banks' treasury departments, asset managers, pension funds, public sector entities, insurance companies, large corporates and a range of investment funds
- Securitisation funding is typically floating rate (a spread over Euribor or Libor / SONIA)
- The investors receive regular payments, typically quarterly, passing through the interest and principal payments made by the underlying borrowers
- Securitisation funding is typically divided into tranches with different ratings: from senior tranches at AAA to mezzanine with lower ratings to unrated junior tranches
- The different tranches carry different levels of risk and yield, with lower-ranking tranches providing credit enhancement for the higher rated tranches
- Securitisation is not sold to retail investors - this is not permitted by the Sec Reg. The target market is professional institutional investors

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# "On-balance-sheet" or "synthetic" securitisation

- "On-balance-sheet" or “synthetic” securitisation is simpler than cash securitisation, in that there is no "true sale" of assets and often no SSPE.
- Instead, the risk of an identified portfolio of assets is transferred by the purchase by the originator of a guarantee on the assets from a third-party investor (which may be an SSPE which issues notes to investors like in a traditional securitisation), who makes payments to reimburse the originator should any of the assets default.
- Supervisors review such transactions to confirm if the requirements of the CRR to achieve significant risk transfer are met. If so, this increases banks' capacity to provide new loans.
- On-balance-sheet securitisation is especially helpful to securitisation of corporate and SME loans, which are both capital-intensive when held on balance sheet and more difficult to securitise in the cash markets. Without this mechanism banks would be more constrained in their capacity to lend and consequently SMEs and other corporate borrowers would be less able to obtain financing they need to develop their businesses.
- Whether executed in a traditional or “on-balance-sheet” structure, the purpose of securitisations is to finance real economy assets and manage risks. The relative importance of each of these two objectives – financing and risk transfer – varies depending on the type of securitisation undertaken.

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# Asset Backed Commercial Paper (ABCP)

- Asset-backed commercial paper (ABCP) is a short-term money-market security that is issued by an SSPE (also known as a "conduit"), which is set up by a sponsoring financial institution that provides liquidity lines to support the refinancing of maturing ABCP (full support is required for STS ABCP programmes). The maturity date of an ABCP is set at no more than 270 days and it is issued either on an interest-bearing or discount basis.

- ABCP financing is an important source of funding for the real economy including providing working capital for corporates by financing trade receivables, leases, auto loans to assist auto purchase and SME loans.

- Multi-seller conduits are managed by banks that finance assets purchased from different originator-sellers. The seller of each pool of assets retains a portion of credit risk of at least 5%, by law.

- Single-seller conduits are formed to purchase assets originated by a single originator-seller and/or its affiliates (e.g. loans originated by a specific auto manufacturer).

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# Simple, transparent and standardised (STS) securitisation

- The STS framework was introduced in the EU (originally) to restore investor confidence and support the recovery of the European securitisation markets which were damaged after the 2008 financial crisis when serious errors made in US sub-prime mortgage lending spread through the global financial system
- Most UK and EU securitisations have performed very well in both credit and liquidity terms, both through the 2008 financial crisis and since then, although investor confidence was damaged
- "Simple transparent and standardised" or "STS" securitisation is therefore a sub-set of all securitisations created by the Sec Reg. STS securitisations comply with strict criteria established by law
- The Sec Reg also defines universal legal requirements for all securitisations – not just STS securitisations – dealing with disclosure, due diligence and risk retention
- These rules seek to align interests of both originators and investors to ensure securitisation is sound and easier to analyse with defined, clear risks
- EU and UK institutional investors regulated under CRD/CRR, Solvency II, AIFMD, UCITS or IORP regimes are prohibited from investing in a securitisation (STS or non-STS) unless the relevant sponsor or originator retains a 5% interest in any securitisation

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# Public & private issuance

- Public issuance requires listing and an offering document compliant with the Prospectus Regulation; private issuance does not.
- Private markets exist in all fixed income products, not just securitisation.
- In securitisation, private markets comprise:
  - Asset-backed commercial paper
  - On-balance-sheet securitisations
  - Bank balance sheet funded securitisations (for example, warehouse lending to originators to fund ongoing origination)
- Private securitisations tend to have fewer investors and less public disclosure, but this does not mean that they carry more risk or are opaque to investors or supervisors.
- On the contrary, disclosure in private securitisations is often negotiated between the issuer and investor and can be both tailored and more extensive (because not disclosed to the public) than in public transactions; this enables investors to build a stronger relationship with the issuer, and lend more.
- Template-based disclosure for private securitisations fits poorly with the specific requirements of the market
- Supervisors can access all information available to investors (Art. 7 Sec Reg) in addition to supervisory reporting (e.g. CoRep) under prudential regulatory rules.

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# What are the motivations for using private transactions?

- There may be significant commercial and/or legal sensitivity with respect to the disclosure of the existence of the financing transaction, of information relating to the underlying assets and/or of the (often proprietary) underwriting or credit scoring techniques used to originate the assets in the first place.

- For corporates, disclosure of loan-level data for trade receivables securitisations could divulge the trading strategy, key clients and pricing information of a business to its competitors.

- Many corporate borrowers favour private transactions because they allow for efficient future amendment, extension and restructuring. This is because the investor will typically be a bank with whom the borrower has a close relationship. In certain circumstances, such transactions may operate to provide an important additional line of credit to businesses and are essentially viewed by the parties involved as private loans, the terms of which are determined through direct negotiation between such parties.

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# Securitisation brings important benefits to the real economy

- Direct funding for consumers, homeowners, autos, SMEs.
- Reduces risks and capital requirements while maintaining banks' capacity to lend and relationship with the borrower.
- Enables banks to match-fund assets with liabilities, reducing refinancing risk.
- Transforms illiquid assets into liquid, tradeable securities.
- Acts as a bridge from bank balance sheets to institutional investors, rebalancing funding away from banks and more to capital markets.
- Provides long-term investment opportunities for banks, insurance companies, funds and other types of institutional investor.
- Meets institutional investors' diverse requirements for risk and return in the form of a simple market instrument rather than an illiquid loan portfolio.

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# 2) The importance of securitisation in the current economic environment

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# Policymaker views

*Well-designed securitisation provides an effective tool for banks to free up their balance sheets and release capital. Hence, it could be an effective tool to redeploy capital and support small and mid-sized companies (SMEs), spur recovery from the pandemic crisis, and aid the transition towards a sustainable and digital economy. Moreover, the introduction of Basel 3 regulations in Europe will likely increase capital needs in the coming years and push banks to retain earnings for building up additional capital buffers, or deleverage by shrinking credit portfolios. A well-functioning securitisation market can help banks comply with new rules.*

**European Stability Mechanism, July 2021**

*Securitisation allows banks to transfer parts of the risks associated with their lending to other investors and can therefore broaden companies' investment bases and funding conditions. While the new European framework for simple, transparent and standardised securitisation (finalised in 2017) has dealt with the weaknesses and excesses that contributed to the financial crisis of 2008, it has not proven fully effective in reviving the much-reformed EU markets. A review should be conducted to explore how existing rules could be improved. This could include options for facilitating the securitisation of impaired assets.*

**Luis de Guindos, Vice-President of the ECB, and Fabio Panetta and Isabel Schnabel, Members of the Executive Board of the ECB, September 2020**

*When used properly, [securitisation] becomes a vital medicine for a stronger recovery after the COVID-19 pandemic. It creates new investment opportunities and more scope for banks to issue fresh loans to households and SMEs.*

**Othmar Karas MEP, December 2020**

*A market for prudently designed ABS has the potential to improve the efficiency of resource allocation in the economy and to allow for better risk sharing. It does so by transforming relatively illiquid assets into more liquid securities. These can then be sold to investors, thereby allowing originators to obtain funding and, potentially, transfer part of the underlying risk, while investors in such securities can diversify their portfolios in terms of risk and return. This can lead to lower costs of capital, higher economic growth and a broader distribution of risk.*

**European Central Bank and Bank of England, April 2014**

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# How securitisation can help manage the Covid-19 recovery

- Economic recovery post Covid-19 will demand large-scale mobilisations of capital at a time of great uncertainty and financial stress.
- The Covid-19 pandemic has diverted resources, and risks slowing the financing of the green transition via organic capital growth – capital and savings in corporates/SMEs have been largely used to stay afloat.
- Funding can only come from:
  - government programmes;
  - bank loans;
  - capital markets.
- All three are important but all have limitations:
  - Public authorities have already provided unprecedented support via various programmes;
  - Capital markets must play a greater role; however, it will take time to develop a stronger equity culture and greater capital markets capacity;
  - Banks will remain the main source of funding for most businesses, but they in turn are also constrained due to economic headwinds, regulatory constraints and increasing capital requirements.

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# How securitisation can help manage the Covid-19 recovery (cont.)

- Throughout most of 2020, supported by public intervention, banks were more willing to lend and interest rates were in decline.
- However in Q3/4 2020 banks had, on aggregate, started to tighten credit standards to companies. A further tightening of credit conditions is expected in the medium term.
- Likely increased financial distress across the corporate sector is not yet reflected in NPE ratios. Once public support measures expire, it is possible that more businesses will default, leading to higher NPEs and insolvencies.
- Higher NPE ratios risk becoming a distraction from new lending, and can act as a drag on bank profitability and put pressure on capital ratios.
- Securitisation can help banks to:
  - Deploy capital most efficiently to generate new lending ;
  - Facilitate capital planning and absorb upcoming pressure as capital requirements increase;
  - Resolve existing NPE portfolios by removing them from balance sheets (albeit at a cost).

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# How can securitisation support transition to a sustainable economy?

- The economic recovery is an opportunity to incentivise and accelerate this transition and to encourage business models to restructure in line with sustainability objectives.
- This will require vast investment from all sectors of economy. Bank balance sheets are capital-constrained. Securitisation, through its unique ability to transfer risk while maintaining lending, delivers more efficient capital management.
- Securitisation can help to increase banks' capacity for lending to sustainable projects such as mortgage loans financing energy-efficient houses, rooftop solar energy loans or SME loans for sustainable projects.
- It also allows capital market investors to contribute to specific sustainable projects and activities at their preferred level of risk.
- Although the green securitisation market is at an early stage of development, investor demand is increasing and issuance is growing in recent years, with EUR 603* millions of green securitisation issued as at FY 2020.

** Source: AFME Quarterly ESG Data Report Q4 2020*

# 3) The UK and EU securitisation market

# The post-Global Financial Crisis (GFC) credit performance of securitisation is excellent

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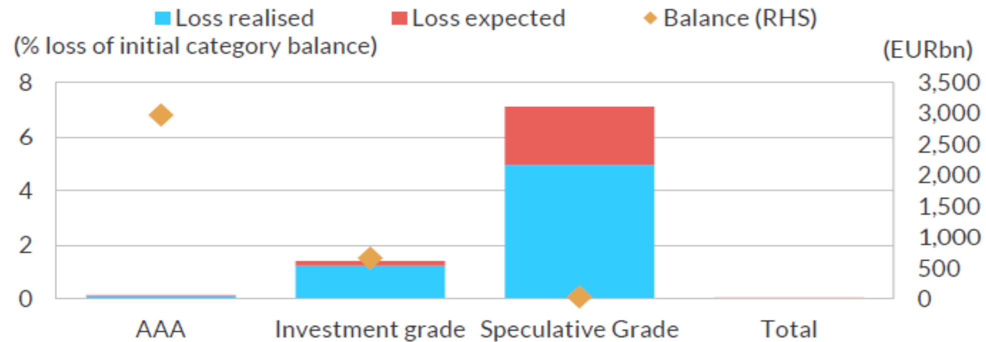
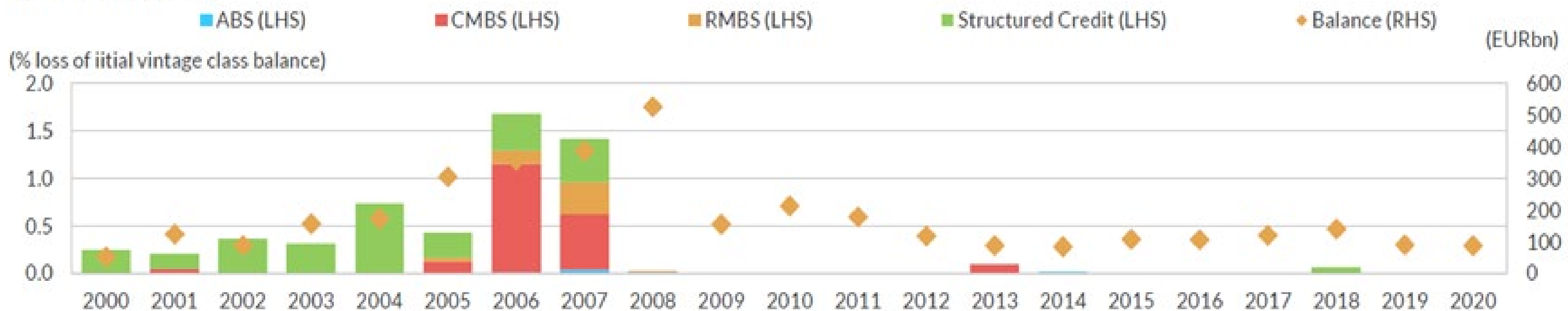
**Losses over the last 20 years have been concentrated in low-rated tranches (originally rated "CCCsf" or below).**
**Very few senior tranches, which predominate, have suffered losses.**




***Source**: Fitch Ratings: "Global Structured Finance Losses: 2000-2020 Issuance", March 2021*

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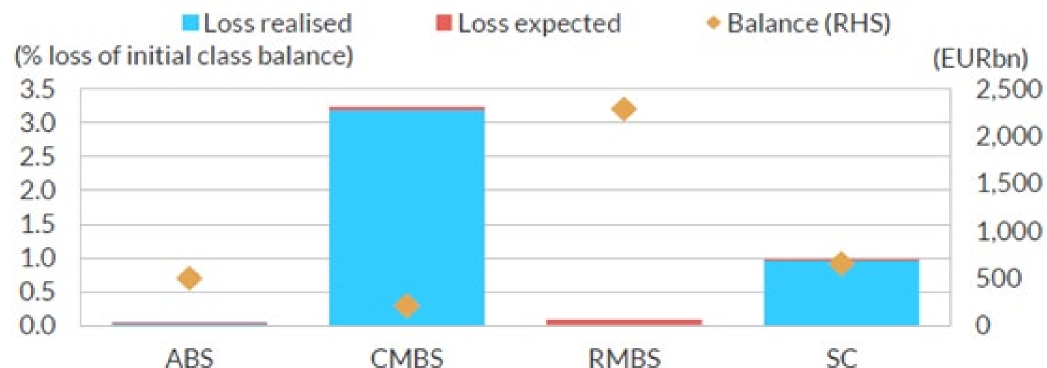
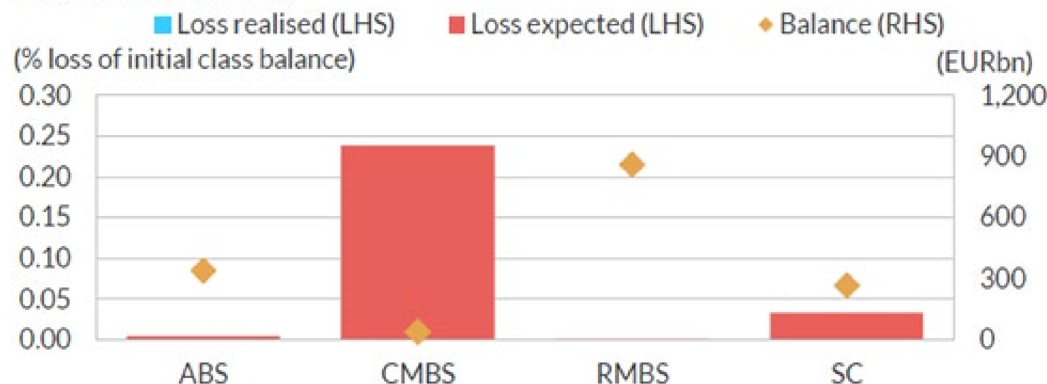
# Losses from the financial crisis were concentrated in CMBS and CDOs, which are excluded from STS

**Commercial Mortgage Backed Securities (CMBS) and Collateralised Loan Obligations(CLOs) were excluded from the STS framework.**




**In EMEA post-GFC, RMBS bore minimal losses.**
**Further, all expected losses (0.0007%) relate to tranches originally rated 'CCCsf' or below.**

***Source**: Fitch Ratings: "Global Structured Finance Losses: 2000-2020 Issuance", March 2021*

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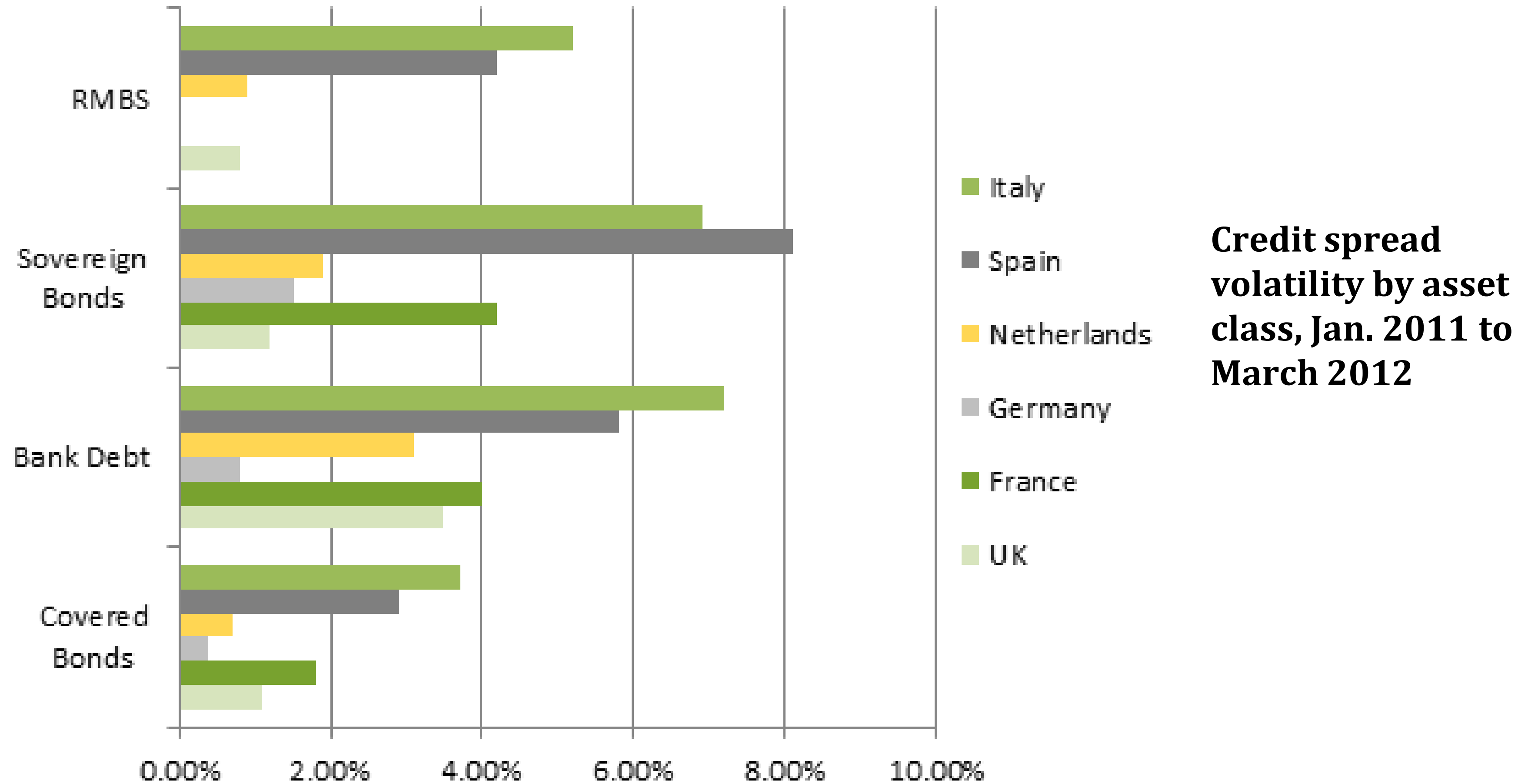
# During the "Eurozone crisis" securitisation spreads were less volatile than sovereigns and banks, and close to covered bonds




**Credit spread volatility by asset class, Jan. 2011 to March 2012**

***Source**: Bank of America*

# Credit performance across European structured finance sectors held strong in 2020

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**European Structured Finance Transition And Default Summary**

| | | --2020-- | | | | | --One-year average-- | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Ratings (no.) | Stable (%) | Upgrades (%) | Downgrades (%)* | Defaults (%) | Defaults (no.) | Stable (%) | Upgrades (%) | Downgrades (%)* | Defaults (%) |
| Overall | 3,266 | 91.5 | 4.8 | 3.6 | 0.2 | 8 | 77.7 | 7.8 | 14.5 | 1.0 |
| **Subsector** | | | | | | | | | | |
| Europe RMBS prime | 639 | 88.4 | 9.9 | 1.7 | 0.0 | 0 | 82.2 | 6.6 | 11.2 | 0.4 |
| Europe RMBS nonconforming | 556 | 93.7 | 5.6 | 0.7 | 0.0 | 0 | 76.0 | 11.0 | 13.1 | 0.1 |
| Europe RMBS other | 252 | 91.7 | 7.9 | 0.4 | 0.0 | 0 | 79.0 | 10.2 | 10.9 | 0.1 |
| Europe structured credit CLO | 881 | 96.0 | 1.0 | 3.0 | 0.1 | 1 | 74.4 | 15.3 | 10.3 | 0.2 |
| Europe structured credit SF CDO | 41 | 82.9 | 14.6 | 2.4 | 2.4 | 1 | 67.6 | 6.1 | 26.3 | 5.1 |
| Europe structured credit other | 274 | 92.3 | 2.6 | 5.1 | 0.0 | 0 | 74.8 | 6.6 | 18.6 | 1.4 |
| Europe CMBS | 195 | 81.0 | 0.5 | 18.5 | 3.1 | 6 | 74.4 | 3.6 | 22.0 | 3.0 |
| Europe ABS auto | 192 | 94.3 | 5.7 | 0.0 | 0.0 | 0 | 91.1 | 6.2 | 2.7 | 0.2 |
| Europe ABS nontraditional | 62 | 82.3 | 0.0 | 17.7 | 0.0 | 0 | 81.8 | 2.6 | 15.6 | 0.8 |
| Europe ABS consumer | 59 | 94.9 | 3.4 | 1.7 | 0.0 | 0 | 87.5 | 6.4 | 6.1 | 0.1 |
| Europe ABS credit card | 44 | 88.6 | 11.4 | 0.0 | 0.0 | 0 | 95.6 | 2.0 | 2.4 | 0.0 |
| Europe ABS other | 50 | 92.0 | 6.0 | 2.0 | 0.0 | 0 | 87.0 | 4.5 | 8.5 | 0.0 |
| Europe single-name synthetics | 21 | 42.9 | 0.0 | 57.1 | 0.0 | 0 | 81.8 | 3.7 | 14.5 | 0.5 |

***Source**: S&P Global "2020 Annual Global Structured Finance Default And Rating Transition Study", 13 May 2021 (Table 7)*

- The average change in credit quality remained positive at the end of 2020
- The annual default rate for European structured finance fell to 0.2% in 2020, remaining well below the one-year average of 1%
- The downgrade rate increased to 3.6%, but this is well below the one-year average of 14.5%.
- Almost every European securitisation subsector reported upgrades. Within European ABS, upgrades were the highest in the credit card subsector, where the upgrade rate was 11.4% in 2020, well above the one-year average of 2%.

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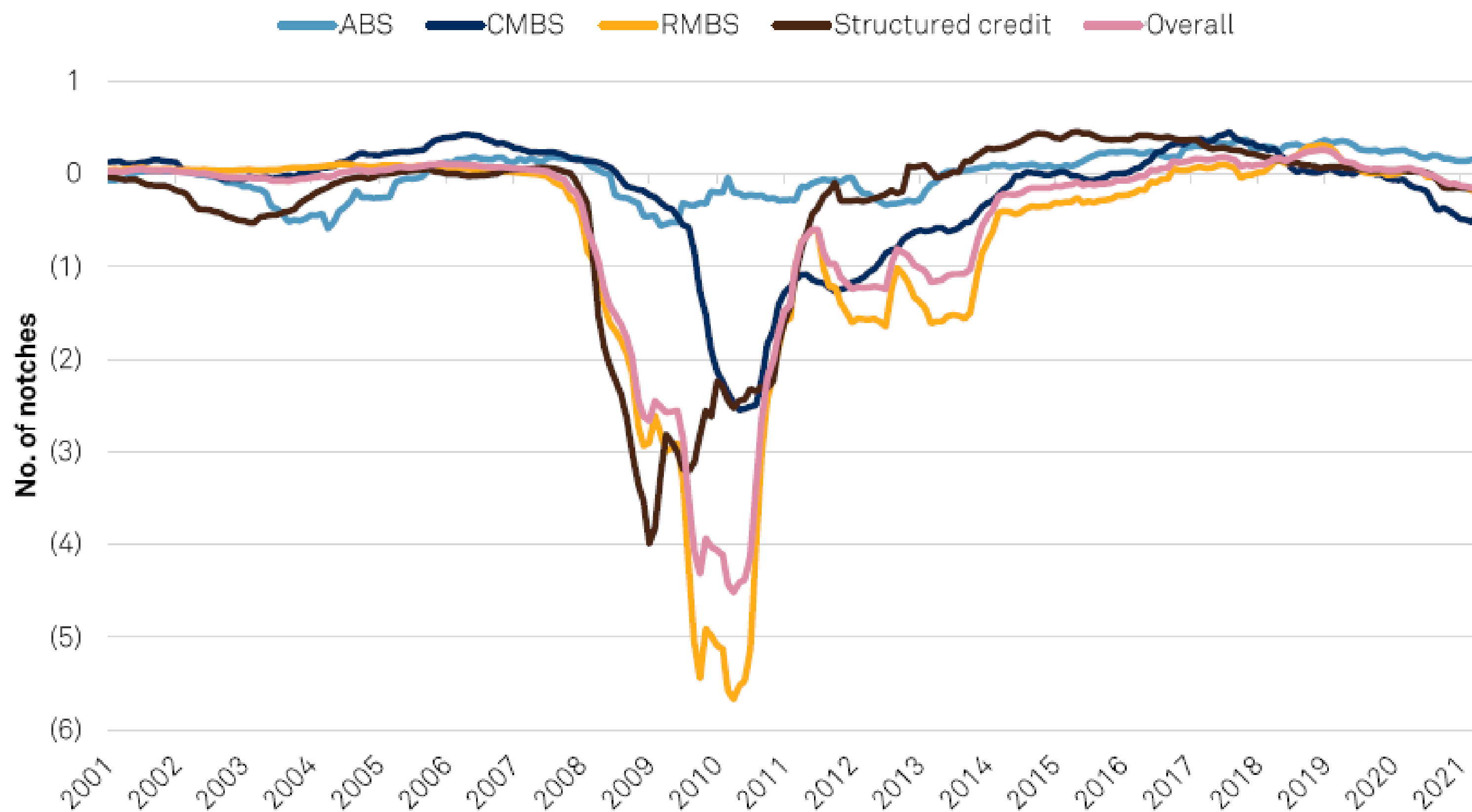
# Compared with past periods of stress, ratings performance through the pandemic has been benign




- Although net ratings migration for global structured finance securities has turned negative through the pandemic, the scale of rating decline has been limited, averaging only 0.1 notches.
- Ratings have been significantly more stable than in past periods of stress.
- The CMBS sector has seen the most severe downward ratings migration, averaging 0.5 notches, given some exposure to sectors most affected by lockdown restrictions, such as retail and hotels.
- The ABS sector has continued to see net positive rating movements, helped by the effects of policy support on consumer credit performance.

*Chart shows the average rating movement over the previous 12 months in terms of rating notches. Securities whose ratings migrated to 'NR' over the 12-month period are classified based on their rating prior to 'NR'. Excludes covered bonds. Source: S&P Global Ratings.*

***Source:** S&P Global Ratings*

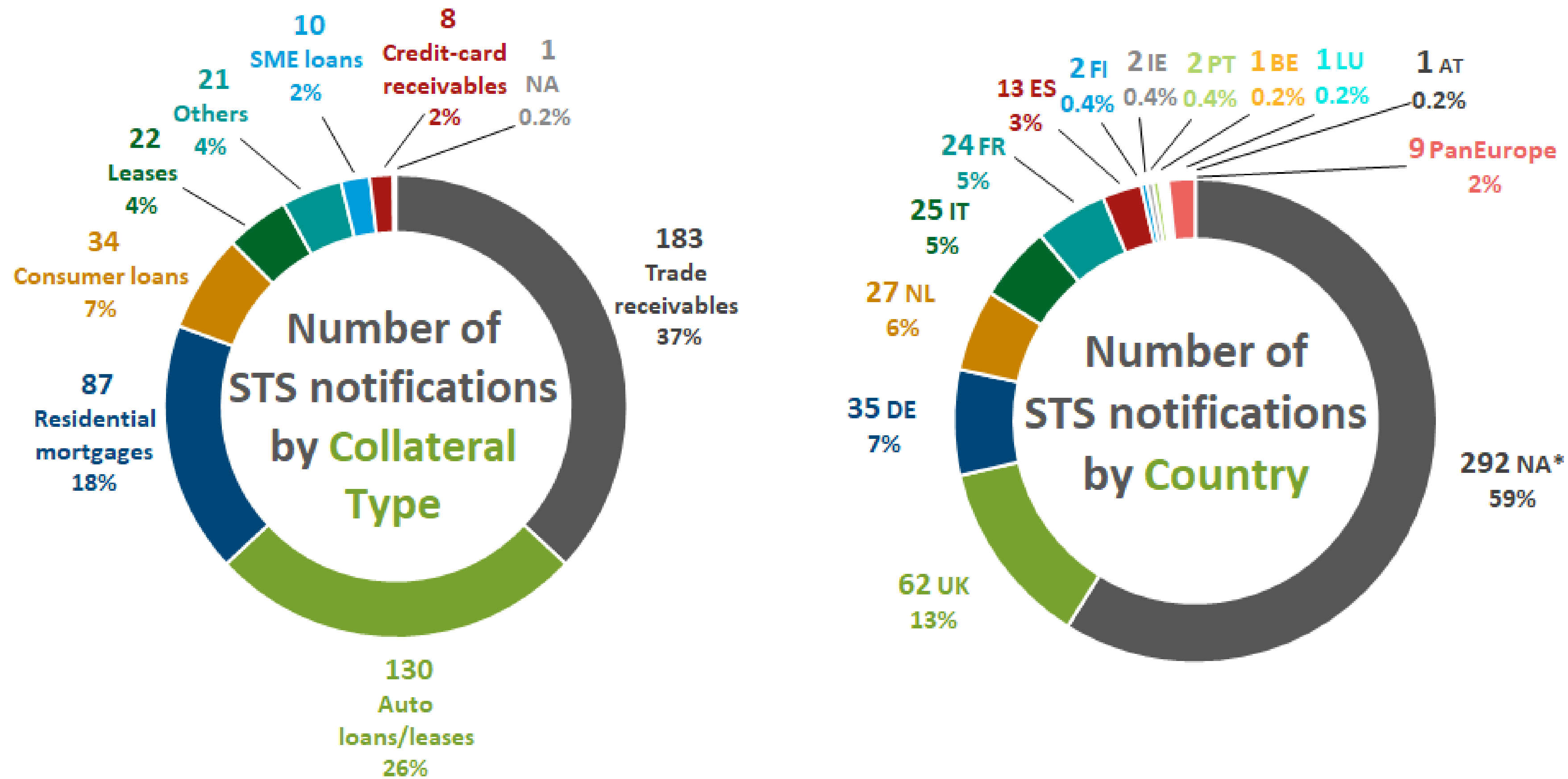
# Issuance volumes have remained low since the GFC, and 2020 issuance was the lowest since 2013

Issuance has not scaled up since the introduction of STS.
It is therefore critical to improve the framework to make it more attractive for issuers and investors.

| Values in EUR bn | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 H1 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| RMBS | 358.4 | 598.4 | 226.0 | 266.3 | 223.2 | 137.4 | 64.9 | 110.8 | 102.0 | 120.5 | 119.0 | 113.7 | 104.1 | 80.6 | 32.0 |
| ABS | 36.8 | 68.3 | 54.5 | 32.0 | 74.6 | 53.1 | 72.1 | 48.0 | 66.6 | 70.9 | 52.9 | 67.4 | 48.4 | 70.4 | 30.9 |
| CLO | 62.1 | 94.5 | 47.4 | 28.5 | 9.6 | 13.5 | 9.2 | 14.8 | 14.2 | 21.7 | 49.2 | 51.9 | 39.5 | 22.1 | 14.7 |
| CMBS | 52.5 | 10.2 | 29.1 | 7.1 | 3.8 | 5.0 | 8.8 | 6.3 | 6.0 | 3.7 | 0.9 | 5.8 | 5.8 | 2.4 | 3.7 |
| SME | 77.3 | 47.3 | 65.1 | 39.7 | 62.4 | 45.2 | 20.2 | 33.3 | 27.1 | 19.9 | 14.1 | 29.5 | 23.0 | 7.5 | 2.0 |
| WBS* | 7.9 | 0.0 | 1.8 | 4.5 | 3.2 | 3.7 | 5.4 | 3.7 | 0.8 | 2.9 | 0.0 | 0.6 | 0.0 | | |
| CORP* | | | | | | | | | | | | | | 11.7 | 1.9 |
| **Total European** | **594.9** | **818.7** | **423.9** | **378.0** | **376.8** | **257.8** | **180.8** | **217.0** | **216.6** | **239.5** | **236.0** | **268.8** | **220.8** | **194.7** | **85.2** |
| Placed (% of Total) | 70% | 13% | 6% | 24% | 24% | 34% | 42% | 36% | 38% | 41% | 47% | 50% | 54% | 42% | 66% |

***Source**: AFME Q2 2021 Securitisation Data Snapshot, SIFMA, BofA. Chart includes both placed and retained issuance volumes. *Due to change in source of securitisation issuance data, AFME does not report WBS volumes from 2020, CORP (Corporate) issuance volumes reported thereafter.*

# 496 STS issues to date: 292 private, 204 public




While there are 292 private STS notifications and 204 public ones on the ESMA website, most private ABCP STS notifications are for the same transactions where there is a "club" of banks involved, each notifying separately as a sponsor of their conduit. We estimate the actual number of STS trade receivables transactions to be less than 40% of what is shown by the ESMA website, i.e. 73 transactions instead of 183. We believe the majority of STS notifications are for public deals, and there has been no "rush to private securitisation" as implied in the Joint ESAs Report.

***Source:*** *ESMA. Data as of June 2021. *Country not available for 292 notifications for STS-notified private transactions.*

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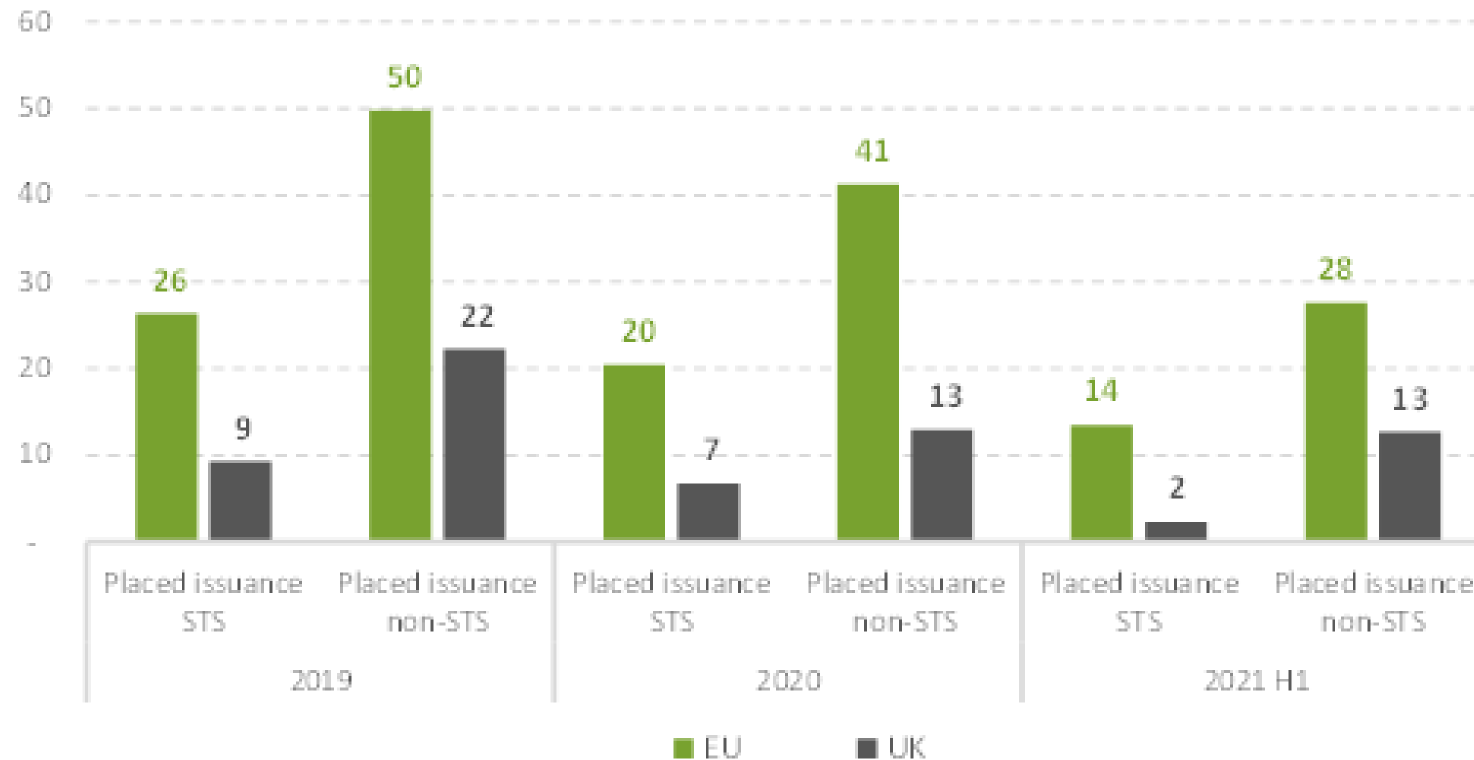
# Non-STS continues to outrank STS issuance in the EU and UK

- More than twice as much non-STS as STS securitisation has been issued in EU+UK in 2019, 2020 and 2021 YtD.




***Source:*** *Bank of America*

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# Why has there not been more STS issuance?

- While there has been frequent use of the STS label, much of this is applying the label to existing transactions, especially ABCP transactions (which tend to be private)
- For issuers, the STS requirements burdensome
- For investors:
  - ➢ the more sophisticated do not need (nor have they ever needed) STS other than as an additional check which they regard as interesting but not essential
  - ➢ the less sophisticated face the same due diligence obligations and credit work, which they prefer to deploy in return for higher-yielding non-STS transactions
  - ➢ regulated investors (CRR, Solvency II) face capital disincentives compared with other fixed income products, even after the lower charge for STS

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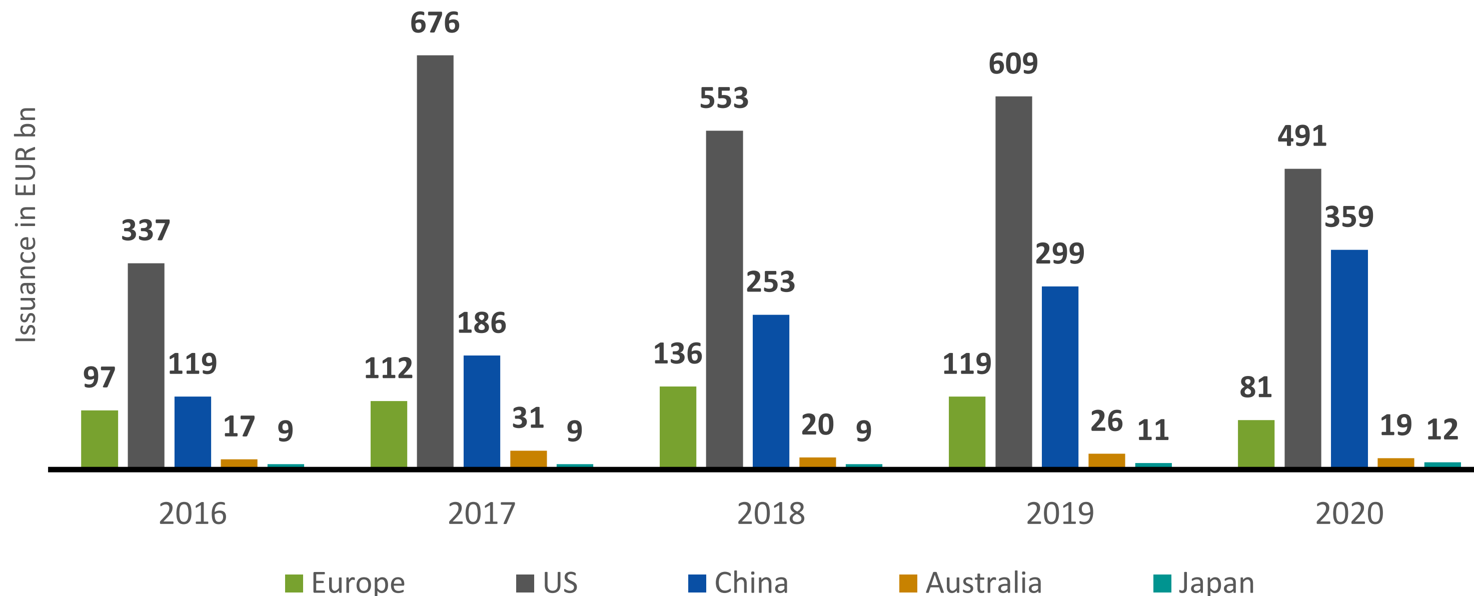
# How significant is European issuance globally?

- In Europe, more than half of securitisation transactions are “retained” by the originator to be used as ECB-eligible collateral for funding. Retained issuance does not represent true investor demand, but is central bank funding.
- Retained issuance is not a feature of the US market.
- Further, when comparing Europe to the US, the comparison should exclude the government-sponsored enterprises (Fannie Mae, etc., the "GSEs"). The US GSEs are guaranteed by the US government.
- On this basis, US issuance varies between 3 and 6 times EU+UK issuance.
- China issuance is growing fast.




***Source:*** *AFME Securitisation Data Report Q4 2020, SIFMA. US volumes include ABS, CDO and non-agency RMBS and CMBS*

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# 4) The regulatory framework for securitisation

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# Regulatory reforms related to securitisation between 2009 and 2014

| Regulatory Initiative | Issue description and key points to note |
|---|---|
| • CRD II: retention requirement (5%), disclosure and investor due diligence requirements, and significant credit risk transfer. | • Introduced a risk retention requirement.<br>• Imposed new and extensive due diligence obligations on banks and transaction level disclosure on new securitisations issued on, or from, 1 January 2011.<br>• Included a new definition and rules on significant risk transfer for an originator to treat securitised assets as having been moved off its regulatory balance sheet. |
| • Basel 2.5: Revised securitisation framework and further strengthening of trading book regime<br>• CRD III – new rules on re-securitisations and capital requirements for trading book exposures | • Introduced a definition of "re-securitisation".<br>• Trading book positions that are not in a correlation trading book, and are securitisation or re-securitisation products, have a standard charge applied to them similar to the banking book charge (rather than the trading book). The main result of this is that the capital charge for securitisations and re-securitisations has gone up considerably. Higher collateral haircuts for securitisation in repo transactions. Higher RWA for securitisation liquidity facilities and self-guaranteed exposures. |
| • Basel Securitisation Framework: revision of the capital requirements | • Increased regulatory capital charges for securitisation positions for investing institutions.<br>• Changes to risk-weight methodologies. |
| • Solvency II: revision of the capital requirements | • Introduced risk-based capital requirements for securitisation positions for insurance and reinsurance undertakings.<br>• Lowered capital requirements for "high quality" securitisations. |
| • Basel III: new liquidity standards, including the liquidity coverage ratio (LCR) requirement<br>• Corresponding EU CRR implementing measures | • New LCR requirements for institutions: certain covered bonds may be eligible as Level 2A High Quality Liquid Assets (HQLA), whilst only a limited universe of securitised assets may be eligible as Level 2B HQLA, at the discretion of national authorities and subject to a higher haircut. |

***Source:*** *EBA Discussion Paper on simple standard and transparent securitisations, 2014.*

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# Regulatory reforms related to securitisation between 2009 and 2014

| Regulatory Initiative | Issue description and key points to note |
|---|---|
| EU CRR, Alternative Investment Fund Managers Directive, Solvency II Directive: risk retention and due diligence requirements | • CRR introduced recast of CRD2 risk retention, investor due diligence and disclosure regime for CRR firms.<br>• Amendments to AIFMD and Solvency II regimes created new investor due diligence requirements, including a prohibition on investing in a securitisation unless the relevant originator or sponsor is compliant with 5% risk retention and sufficient information is made available for the requisite due diligence to be undertaken. Due diligence provisions also required certain qualitative assessments to be undertaken with respect to certain credit granting, risk management and asset administration policies and procedures of the originator and sponsor.<br>• Under the CRR and Solvency II, penal capital charges may be applied to the relevant securitisation position(s) if a national supervisor determines that the requirements have not been complied with, and that the investor has been negligent or omitted to undertake the required action; “corrective action in the best interests of investors” is required under the AIFMD regime in case of non-compliance. |
| • Basel standards on large exposures<br>• EU CRR: large exposure requirements | • BCBS supervisory framework for measuring and controlling large exposures including treatment for securitisation exposures.<br>• EBA final RTS on large exposures specifies: (a) the conditions and methodologies to determine the overall exposure of an institution to a client/group of connected clients, in respect of exposures through transactions with underlying assets; (b) the conditions under which the structure of transactions with underlying assets does not constitute an additional exposure. |
| EU Regulation on structural measures improving the resilience of EU credit institutions: separation of certain trading activities | • Separated certain "risky" trading activities from the core credit institution.<br>• Applied large exposure limits also to the core credit institution in respect of its exposures to certain financial entities, including certain securitisation vehicles, which may operate to further restrict activities in connection with securitisations. |

***Source:*** *EBA Discussion Paper on simple standard and transparent securitisations, 2014.*

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# Regulatory reforms related to securitisation between 2009 and 2014

| Regulatory Initiative | Issue description and key points to note |
|---|---|
| EU Capital Requirements Regulation, Art. 395 CRR. | • Required the EC to assess, by the end of 2015, the appropriateness and impact of imposing limits on institution exposures to shadow banking entities which carry out banking activities outside a regulated framework. Limits on exposures to certain securitisation vehicles may impact securitisation. |
| EU CRA Regulation: disclosure requirements on structured finance instruments and double rating and small CRA requirements. | • The related ESMA RTS specified:<br>(a) the information that the issuer/originator/sponsor of a structured finance instrument must publish;<br>(b) frequency at which this information is updated;<br>(c) template-based loan-level and investor reporting.<br>• Applied a phase-in approach to private and bilateral structured finance instruments.<br>• Required at least two credit rating agencies and must also consider the appointment of a 'small' CRA (with less than 10% market share). |
| EU EMIR regulation: bilateral margining requirements and central clearing requirements | • Proposed a two-way margin posting requirement also on derivative transactions entered into by the securitisation vehicle, provided that exposure thresholds and other conditions are met.<br>• Proposed a central clearing requirement also on interest rate derivative transactions entered into by the securitisation vehicle, provided that certain conditions are met. |

***Source:*** *EBA Discussion Paper on simple standard and transparent securitisations, 2014.*

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# Securitisation Regulation & subsequent reforms (2017-2021)

| | |
|---|---|
| **EU Securitisation Regulation** | • Recast the main provisions applicable to securitisation in sectoral legislation (see previous slides) in a new, harmonised securitisation regime applicable to all institutional investors.<br>• Introduced the STS label , setting out detailed criteria to meet the STS standard.<br>• Introduced severe penalties for culpable non-compliance applied to originators, sponsors, original lenders and issuers. |
| **Solvency II (Delegated Regulation 2018/1221)** | • Modified the stress factors and introduced a new distinction between senior STS, non-senior STS, non-STS and re-securitisations. |
| **LCR (Delegated Regulation 2018/1620)** | • Clarification that only STS labelled exposures can count as high-quality liquid assets (HQLA) in banks' calculation of their liquidity coverage ratio (LCR) if certain conditions are met.<br>• No improvement to reflect the introduction of the STS securitisation standard – the applicable classifications remained unchanged. |
| **March 2021 Capital Markets Recovery Package (not onshored) - NPE securitisations and a STS framework for on-balance-sheet securitisations** | • For securitisations of NPEs, introduced special risk retention regime, adjusted application of credit granting standards and adjusted capital requirements.<br>• Extended the STS securitisation framework to on-balance-sheet (synthetic) securitisations.<br>• Included mandates to develop a sustainable securitisation framework.<br>• Further amended third country SSPE restrictions. |

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# The Sec Reg is comprehensive and prudent

| **Requirement** | **Cash STS (residential mortgages, auto loans and leases, consumer finance, SME loans)** | **Cash non-STS (commercial mortgages, CLOs, NPEs)** | **On-balance sheet STS** | **On-balance sheet non-STS** |
|---|---|---|---|---|
| Due diligence | √ | √ | √ | √ |
| Risk retention | √ | √ | √ | √ |
| Transparency | √ | √ | √ | √ |
| No re-securitisations | √ | √ | √ | √ |
| Third country SSPE restriction | √ | √ | √ | √ |
| Over 100 criteria to meet the STS label, including:<br>• Sound criteria for credit granting<br>• Homogeneous assets<br>• No self-certification<br>• Not in default<br>• At least one payment<br>• Self-liquidating<br>• Fully hedged, no complex derivatives<br>• Credit triggers<br>• Servicer expertise<br>• Verification of pool data<br>• Cash flow model available | √ | While some criteria apply to all securitisations, not all of these are required for non-STS securitisations | √ | While some criteria apply to all securitisation, not all of these are required for non-STS securitisations |

# 5) Recommendations for the securitisation framework review

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# For securitisation to reach its full potential, barriers must be overcome

- The strength and benefits of the STS standard have not been reflected in the prudential framework
- Biases are embedded in prudential regulation
  - STS is not appropriately recognised in the LCR
  - Continuing conservative capital requirements for bank and insurance investors
  - Challenges in achieving Significant Risk Transfer
  - Unlevel playing field with comparable financial instruments in capital and liquidity treatment
- Highly complex regulatory framework
  - Need to simplify certain STS rules which do not add to investor protection but create hurdles for issuers
  - Disclosure remains a major and increasing source of tension and concern:
    - Public versus private, especially following the May 2021 Joint ESAs Report
    - Effect of the templates and repository thresholds for public issues
    - Jurisdictional scope

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# The LCR treatment remains disproportionately harsh for securitisation

| | Eligibility | Maximum share | Minimum haircut |
|---|---|---|---|
| **EU Covered bonds CQS 1** | Level 1 | 70% | 7% |
| **EU Covered bonds CQS 2 (and non EU covered bonds CQS1)** | Level 2A | 40% | 15% |
| **Unrated covered bonds** | Level 2B | 15% | 30% |
| **STS securitisations** | Level 2B, CQS 1 and senior only | 15% | 25%-35% |
| **Non-STS securitisations** | Not eligible. No grandfathering for existing LCR-compliant deals | | |

- Introduction of STS standard failed to promote STS senior tranches from Level 2B to Level 2A.
- It also failed to carry over the previous reference to the Standardised Approach (SA), limiting LCR eligibility to "AAA" ratings only. Previously, CQS 1 under the SA allowed ratings from AAA to AA.
- Haircut for AA- rated STS compliant securitisation compared to AA- rated covered bond of extreme high quality is 3.5 to 5 times higher.
- For the same type of securitisation, the haircut compared to high quality covered bonds is 1.7 to 2.3 times higher.
- Whilst the market for covered bonds is considered to be larger and more liquid, such significant differences in treatment are in our view not justified.
- To facilitate a deeper and broader capital market for securitisations, haircuts for LCR qualifying securitisations should be improved and aligned more closely with those of covered bonds of equivalent credit quality.

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# Relative capital treatment and disclosure required under Solvency II and CRR

| Solvency II / Standardised / 5yr exposure | AAA | AA | A | BBB | BB | B | Below | Mandatory Disclosure |
|---|---|---|---|---|---|---|---|---|
| Corporate Bonds and Loans | 4.5% | 5.5% | 7.0% | 12.5% | 22.5% | 37.5% | 37.5% | Fin statements reporting |
| Covered Bonds | 3.5% | 4.5% | 7.0% | 12.5% | 22.5% | 37.5% | 37.5% | Aggregate pool data |
| Residential mortgage loans (for life) | 3% at LTV=80% | | | | | | | None |
| STS securitisation senior tranche | 5.0% | 6.0% | 8.0% | 14.0% | 28.0% | 47.0% | 47.0% | Loan-by-loan data |
| STS securitisation non-senior tranches | 14.0% | 17.0% | 23.0% | 39.5% | 79.0% | 133.5% | 133.5% | Loan-by-loan data |
| Non-STS securitisation tranche | 62.5% | 67.0% | 83.0% | 98.5% | 410.0% | 500.0% | 500.0% | Loan-by-loan data |
| | | | | | | | | |
| CRR @ 8% /SA using ECAI ratings and for securitisation positions SEC-ERBA / 5yr exposure | AAA | AA | A | BBB | BB | B | CCC | Mandatory Disclosure |
| Banks | 1.6% | 4.0% | 4.0% | 8.0% | 8.0% | 12.0% | 12.0% | Fin statements reporting |
| Corporates | 1.6% | 4.0% | 8.0% | 8.0% | 12.0% | 12.0% | 12.0% | Fin statements reporting |
| Covered Bonds | 0.8% | 1.6% | 1.6% | 4.0% | 4.0% | 8.0% | 8.0% | Aggregate pool data |
| Qualifying Residential mortgage loans | 2.8% | | | | | | | None |
| SME loans qualifying as regulatory retail | 6.0% | | | | | | | None |
| STS securitisation senior tranche | 0.8% | 1.6% | 3.2% | 5.2% | 12.4% | 24.4% | 36.4% | Loan-by-loan data |
| STS securitisation non-senior tranche | 3.2% | 5.6% | 10.8% | 20.4% | 52.4% | 75.6% | 100.0% | Loan-by-loan data |
| Non-STS securitisation senior tranche | 1.6% | 3.2% | 5.2% | 8.4% | 14.4% | 27.2% | 40.4% | Loan-by-loan data |
| Non-STS securitisation non-senior tranche | 5.6% | 9.6% | 14.4% | 24.8% | 60.8% | 100.0% | 100.0% | Loan-by-loan data |

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# Bank capital – Basel III finalisation will put further pressure on bank balance sheets

- Impact studies on the finalisation of Basel III have not properly addressed the introduction of the new securitisation framework and the unintended effects of the application of an IRB output floor based on Standard RWA.
- A reduction of the *p* factor is urgent, as it could partially offset the future additional negative impact of the output floor on securitised exposures.
- When simulating the impact on own-account securitisation structures covering IRB portfolios, one can observe that, though they are efficiently structured to release RWA under the SEC-IRBA, they are inefficient or even worsen the effects of the output floor. This is due to the conservative calibration of the SEC-SA, which was designed before the introduction of the output floor by the finalisation of Basel III.
- It is important that RWA inflation due to the introduction of IRB input floors and the SA output floors on securitised pools is not magnified further by the non-neutrality of the securitisation risk weight functions, and hence a re-calibration of the SEC-IRBA and SEC-SA formulae should be undertaken. For example, adjustment of the *p*-factor for SEC-SA to 0.5 for non-STS and to 0.25 for STS (this would align to the US SSFA formula) and an appropriate adjustment to the *p*-factor for SEC-IRBA

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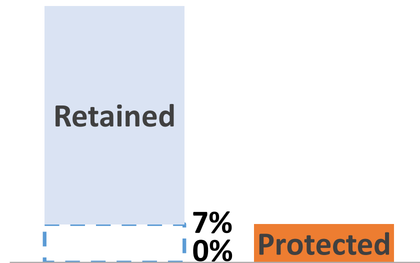
# Basel III finalisation output floor severely threatens the efficiency of securitisation transactions



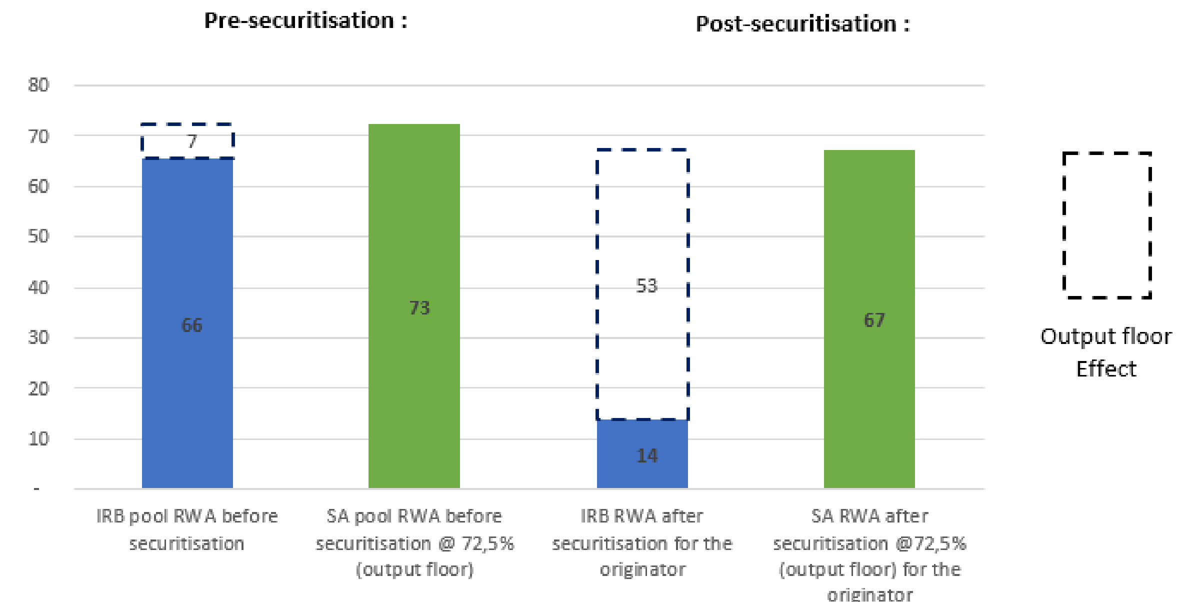

- Consider a synthetic securitisation structure where a bank buys credit protection on the first loss with an attachment/detachment point of 0%/7%
- The underlying portfolio has the following characteristics:
  - Number of loans: 400
  - Probability of default: 0.5% and Loss Given Default: 40%
  - Maturity: 2.5 years

**BEFORE SECURITISATION:**

- IRBA RW of the portfolio is 66%
- SA RW being 100%, the output floor would be biting: 72.5 – 66 = **6.5pp**

**AFTER SECURITISATION**:

- Retained senior tranche (93% thick) would receive a 15% RW under SEC-IRBA (application of the 15% floor for non-STS transactions)
  - Protection covers 1.2 times the sum of the Expected Loss (EL) and Unexpected Loss (UL), making the retained tranche virtually risk-free
- However, the application of the output floor on the same tranche would be very penalising:
  - RW on the retained senior tranche is 100% (floored to the pool's RW) i.e., a 67% floor (=72.5% *100% *93%)
- **To neutralise the impact of the output floor, the credit enhancement would have to reach 17%!**



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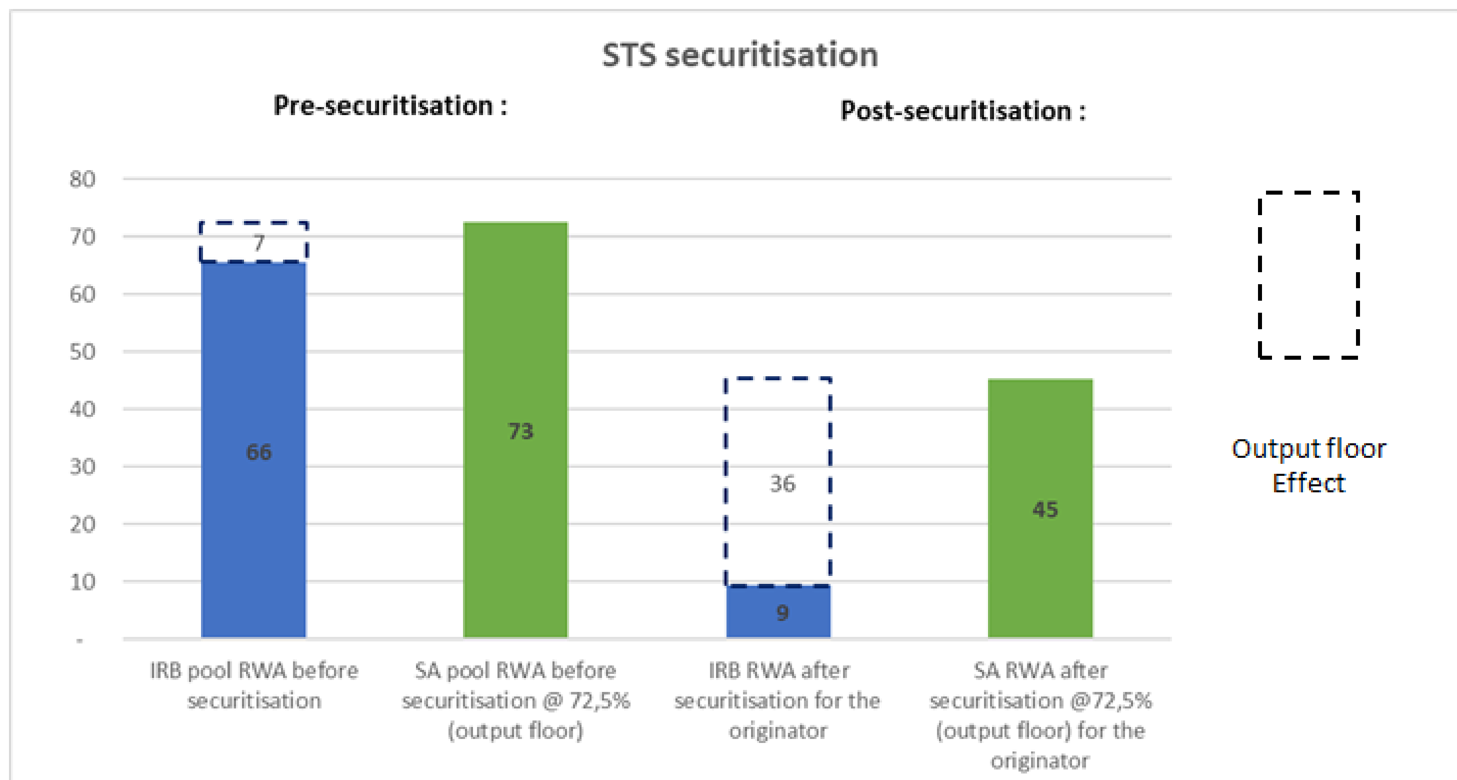
# Even for STS, the Basel III output floor severely threatens transaction efficiency




**Consider the same structure, that would benefit from the STS label.**

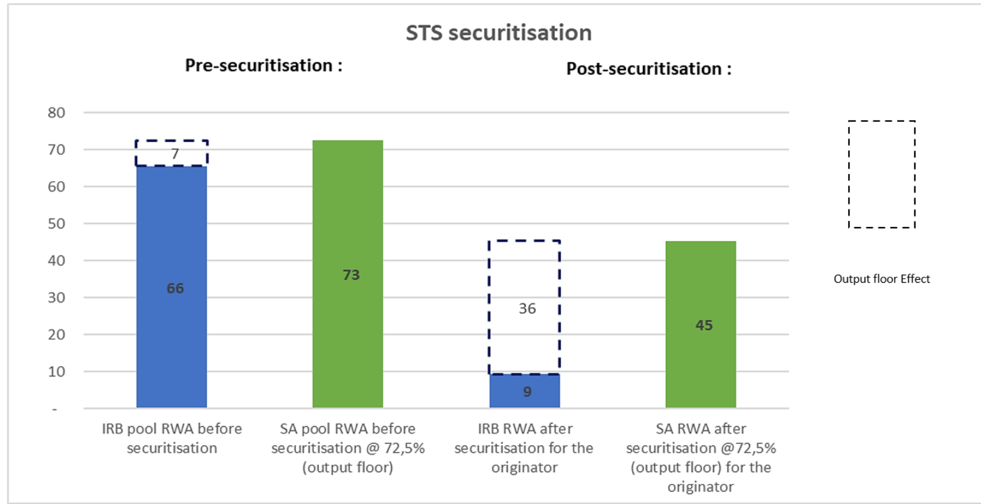
**BEFORE SECURITISATION:**

- IRBA RW of the portfolio is 66%
- SA RW being 100%, the output floor would be biting: 72.5 – 66 = **6.5pp**

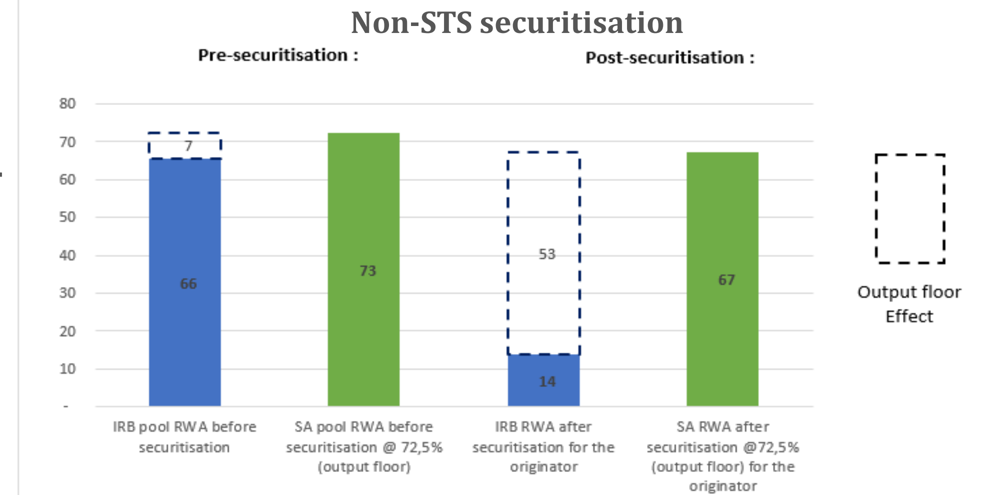
**AFTER SECURITISATION**:

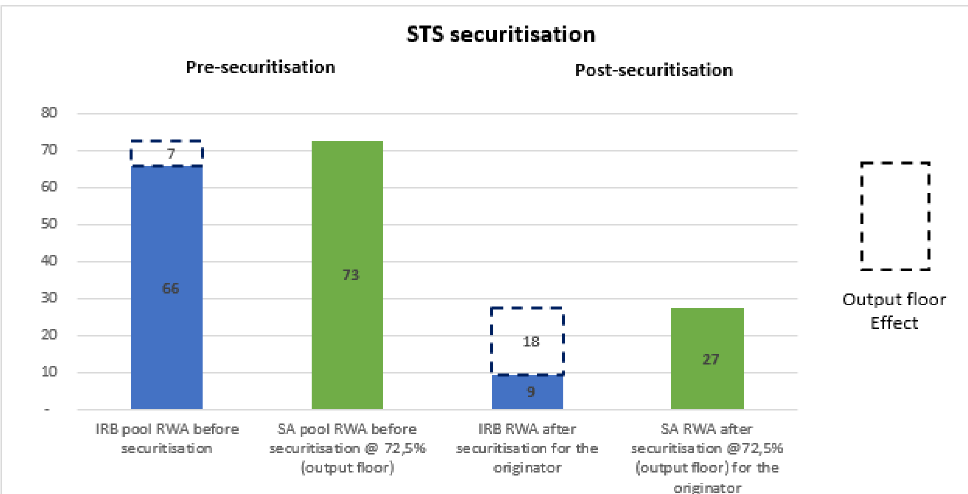
- Retained senior tranche (93% thick) risk-weighted at 10% under SEC-IRBA (application of the 10% floor for STS transactions)
  - Protection covers 1.2 times the sum of the Expected Loss (EL) and Unexpected Loss (UL), making the retained tranche virtually risk-free
- However, the application of the output floor to the same tranche is very penalising:
  - RW on the retained senior tranche is 67%, i.e. a 45% floor (72.5%*67%*93%)
- **To neutralise the impact of the output floor, the credit enhancement would have to reach 11.2%!**

# Impact of the reduced *p* parameter on the SEC-SA and the output floor

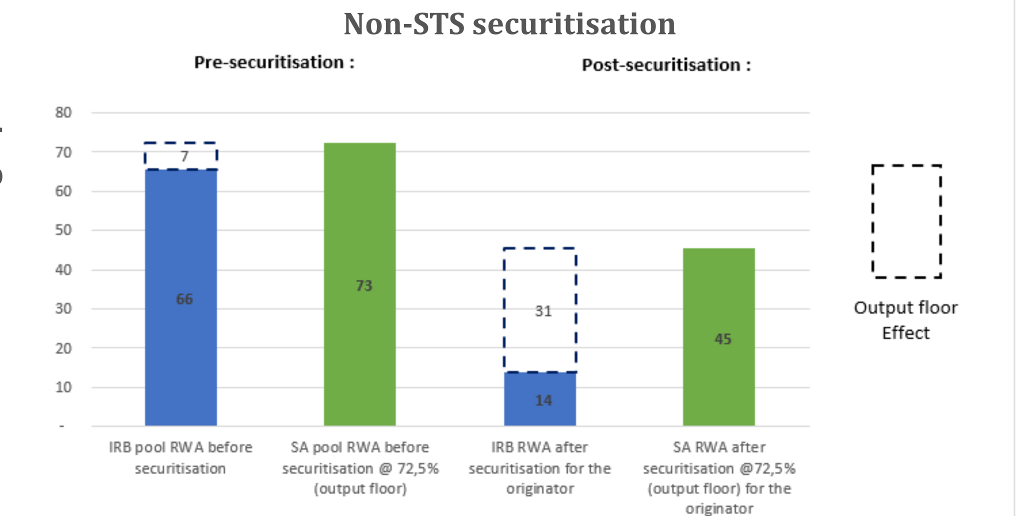



Applying a *p* parameter under SEC-SA from 0.5 to 0.25 to STS securitisation will reduce the output floor effect by half.




Applying a *p* parameter under SEC-SA from 1 to 0.5 to non-STS securitisation will reduce the output floor effect by 44%.



# CRR framework for bank investors in securitisation remains excessively conservative

- Review the CRR calibration and consider the recommendations of High-level Forum on CMU for Articles 259-264 of the CRR, in particular:
  - recalibrate the fixed parameters that are components of the *p* factor for SEC-IRBA with a floor of 0.1 and maximum of 0.3 for STS securitisations, and a lowered floor of 0.25 and maximum of 0.75 for non-STS securitisations.
  - introduce a *p* factor of 0.25 for SEC-SA for STS securitisations and 0.5 for non-STS securitisations, the latter achieving a level playing field with US regulations
  - re-introduce a 7% RW floor in all approaches, considering also SEC-ERBA, for STS securitisations (cash and synthetic) for originator or sponsor banks

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# The US approach to the *p*-factor gives it a competitive edge over the UK and EU

| "*p* factor" | | UK and EU | US |
|---|---|---|---|
| **SEC SA (Art. 261-262)** | Current | 1 for non-STS<br>0.5 for STS | 0.5 for all transactions |
| | **Proposed** | **0.5 for non-STS**<br>**0.25 for STS** | |
| **SEC IRBA (Art. 259-260)** | Current | Floor of 0.3 for STS and non-STS<br>And max ranging from 0.75 for STS to 1.5 for low risk mortgage pools for non-STS | The SFA is still in use. While the *p*-factor is not an explicit input in the SFA formula, implicitly it is close to 0. |
| | **Proposed** | **For non-STS lower floor of 0.25 and lower max of 0.75**<br>**For STS, lower floor of 0.1 and lower max of 0.3** | |

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# The Significant Risk Transfer (SRT) process

- The need for certainty:
  - Timing – we ask that the PRA provide formal or informal feedback within one month of submission, prior to execution, to indicate either:
    - SRT may be recognised (or "no objection" to recognition of SRT);
    - SRT may not be recognised; or
    - more information/discussions required (in case of transactions involving novel or non-standard features only)
    - We note that in its SRT Report of 2020 the EBA has proposed a harmonised timetable albeit with a longer time-line. We consider that timeline as too long, introducing execution uncertainty, in particular the proposal for NCAs to unilaterally 'stop the clock' and extend up to a 5-month pre-notification
  - In line with the EBA's SRT Report, if a transaction achieves SRT, that treatment should continue unless (broadly) the transaction is amended
- There should be a dual approach to the approval process:
  - Streamlined process for simple and/or repeat transactions - with provisional non-objection pre-execution.
  - Alternative process for transactions incorporating novel or non-standard features – pre-notification period should remain as no greater than 3 months without further extensions.
- Greater feedback and dialogue pre- and post-execution in line with the EBA's SRT Report.
  - In line with the EBA's SRT Report, post-execution application for recognition of SRT should be permitted where the originator has not initially sought SRT for the transaction

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# High cliff effects in Solvency 2 discourage investment by insurance companies

| | AAA | AA | A | BBB | BB | B and below |
|---|---|---|---|---|---|---|
| Credit quality step | 0 | 1 | 2 | 3 | 4 | 5 and 6 |
| Corporate Bonds | 0.90% | 1.10% | 1.40% | 2.50% | 4.50% | 7.50% |
| Covered Bonds | 0.70% | 0.90% | - | - | - | - |
| Residential mortgage loans | e.g. 3% for life at LTV=80% | | | | | |
| Senior STS securitisation position | 1.00% | 1.20% | 1.60% | 2.80% | 5.60% | 9.40% |
| Non-Senior STS securitisation position | 2.80% | 3.40% | 4.60% | 7.90% | 15.80% | 26.70% |
| Other securitisation (non-STS) positions | 12.50% | 13.40% | 16.60% | 19.70% | 82.00% | 100.00% |
| Cliff STS senior securitisation vs. Corporate Bonds | 0.10% | 0.10% | 0.20% | 0.30% | 1.10% | 1.90% |
| Cliff STS senior securitisation vs. Covered Bonds | 0.30% | 0.30% | | | | |
| Cliff STS non-senior securitisation vs. Corporate bonds | 1.90% | 2.30% | 3.20% | 5.40% | 11.30% | 19.20% |
| Cliff non-STS securitisation vs. Corporate Bonds | 11.60% | 12.30% | 15.20% | 17.20% | 77.50% | 92.50% |
| Re-securitisation position | 33.00% | 40.00% | 51.00% | 91.00% | 100.00% | 100.00% |
| Cliff Re-securitisation vs. Corporate Bonds | 32.10% | 38.90% | 49.60% | 88.50% | 95.50% | 92.50% |

source: Bank of America Merrill Lynch

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# Insurance capital treatment / Solvency II

- **The treatment of non-senior STS tranches:** while the capital calibrations for senior STS tranches have been set to levels which are comparable to corporates, the calibrations of non-senior STS tranches remain disproportionately high, creating strong disincentives for potential investors.
- **The treatment of non-STS securitisations:** these today carry very high charges as Type 2 securitisations. Many non-STS securitisations have an important role to play in funding the real economy and today's extremely high calibrations are not justified
- **Whole loan pool investment remains much more generously treated than even STS securitisation:** a whole loan mortgage pool (unrated, long duration, illiquid with no credit enhancement, where investors will suffer the first and every subsequent loss made on loans in the pool) will carry a capital charge of 3% for a 30-year life at 80% LTV. A 5 year senior AAA rated STS RMBS (rated, medium duration, liquid, credit-enhanced, protected from first loss) will incur a capital charge of around 5% for the senior tranche and much higher for the non-senior tranche. This disparity of treatment is unjustified from a prudential perspective and creates an unlevel playing field to the disadvantage of STS securitisation (a fortiori non-STS securitisation).
- **We therefore recommend that the calibration of risk factors for securitisations should be reviewed:** a more risk-sensitive approach would be to align the capital treatment of securitisation with the capital treatment of covered bonds for senior STS securitisations and with corporate bonds for non-senior STS and, with a shift of one credit quality step, for non-STS. We believe this revised approach would more appropriately reflect the true economic risk of such investments.

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# Recent amendments do not go far enough to help the securitisation of NPEs

- The amendments to the CRR did not take full account of the recommendations of the EBA Opinion on NPEs from 2019, opting instead to follow the Basel approach that does not take account of the European market needs.
- The 100% risk-weight floor in Article 269a(2) CRR should be removed. It only applies to SEC-IRBA and SEC-SA methods. It is perverse to treat SEC-ERBA better and thereby encourage reliance on CRAs. Many NPE portfolios will not be rated and SEC-IRBA and SEC-SA are both conservatively calibrated already.
- Similarly, the floor of 50% in Article 269a(6) should be removed and the application of Article 269a(6) should be extended to institutional investors. The purpose of this is to re-align the regulations to EBA's Opinion and hence allow investors to use the look-through approach taking into consideration the non-refundable purchase price discount (NRPPD) as an off-set to the portfolio's LGD.
- There is no rationale for limiting the ability to take account of the credit enhancing qualities of NRPPD to those situations where the NRPPD is at least 50%. The benefits of Article 269a(5) should be extended to NPE securitisations with any level of NRPPD, in particular in UTP transactions where NRPPD <50%.
- In the SR, the definition of "NPE securitisation" is too uncertain when it comes to the times market participants will have to measure the 90% level. The words "or any other relevant reason" should be deleted from the end of Article 2(25).
- The due diligence requirements appear accidentally to have been made more onerous, by adding Article 5(1)(f) without exempting investors from the need to comply with Article 5(1)(a)/(b). This should be adjusted to match the "derogation" approach taken in Article 9(1).

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# Disclosure – template implementation

- A more proportionate approach is required for the supervision of template implementation.

- Day-to-day supervision and enforcement of applicable legislation should be undertaken in a proportionate and risk-based manner, taking into account the type and extent of information already being disclosed by reporting entities.

- The application of the same disclosure requirements to private as to public securitisations and to both traditional and on-balance-sheet securitisations is a flawed interpretation of the Level 1 text and has created significant and entirely unnecessary difficulties for both issuers and investors in some sectors.

- We recommend right-sizing the disclosure requirements and re-assessing the need for templates for private securitisations.

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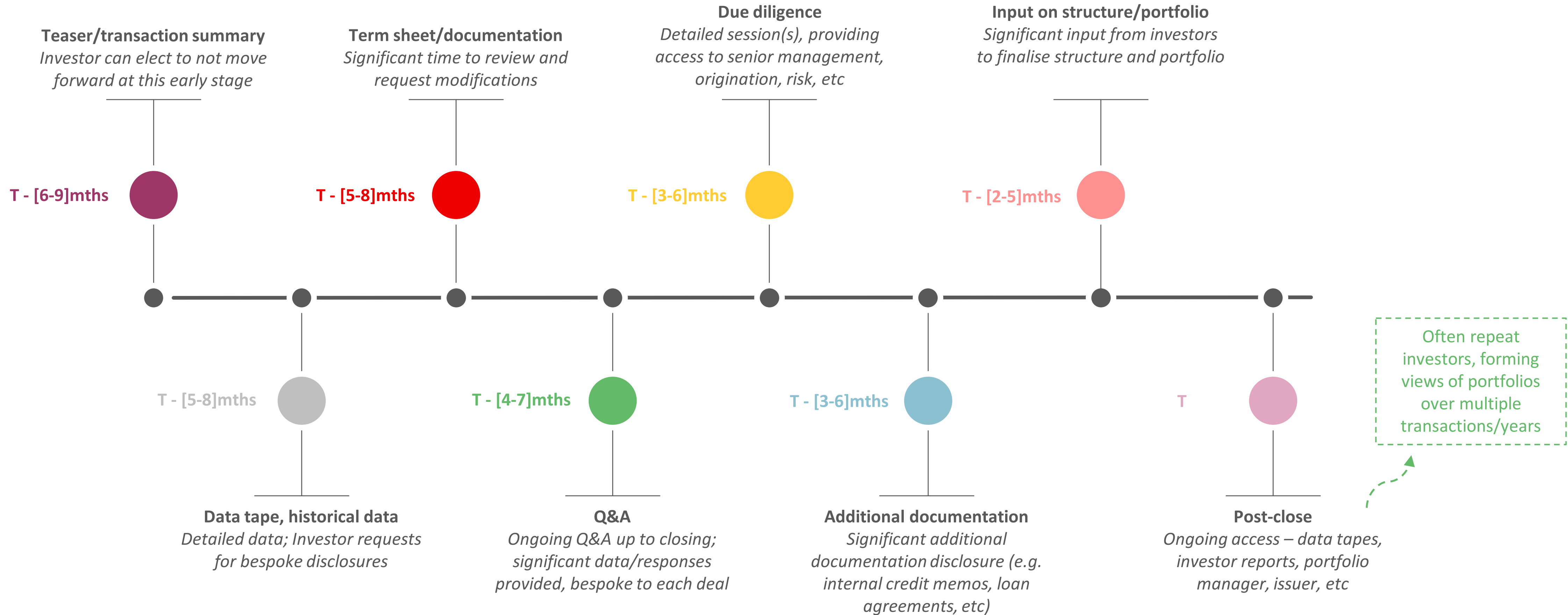
# Private Securitisations – Disclosure Timeline

**Significant ongoing disclosure to investors throughout structuring process, above and beyond the requirements of Article 7**



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# On-balance-sheet (synthetic) securitisation

- We welcomed the recent adoption of an STS framework for on-balance-sheet securitisations in the EU and would urge the UK to adopt a similar framework
- However, the benefits of the original EU proposals were constrained by too high a risk-weight for senior tranches, risk weighting of synthetic excess spread and the requirement for recourse to excessively high-quality collateral.
- These will increase complexity, reduce efficiency and make the framework more expensive.
- The risk weighting of synthetic excess spread also risks undermining the economic viability of future transactions, and may also impact the level of participation in them for certain supra-national institutions when acting as Protection Seller.
- There should be a more balanced approach to synthetic excess spread in the development of Level 2 technical standards.
- The requirement for the investor to have recourse to high-quality collateral to secure repayment of their investment goes beyond existing market standards and is not required by the vast majority of investors; it will add cost and complexity to transactions. These requirements in the Level 1 Regulation should be clarified and simplified at the earliest opportunity.

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# Key factors to support future growth in ESG Securitisation

- Common proportionate standards for ESG securitisation (so that additional burdens do not discourage the development of the market).

- The availability of sufficiently large pools of assets to support ESG securitisation:
  - the market will only grow if there is engagement with transitioning assets and room in the market is made for them; today, there is only limited availability of ESG collateral.

- Sensible ongoing due diligence and disclosure requirements, which are in line with the existing high standard of disclosure requirements under the Sec Reg – see AFME's 2021 discussion paper on ESG disclosure and due diligence practices.

- Need for political support and financial or regulatory incentives to promote the development of the ESG securitisation market:
  - We welcome the UK Treasury appointment of a Green Technical Advisory Group (GTAG) which is considering whether and how to onshore the EU technical screening criteria as well as international alignment issues.
  - We believe that it is important that any UK "taxonomy" recognises international standards as sustainability is a global issue.

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# ABCP Programmes should be included in collateral frameworks

- In the Sec Reg:
  - the existing 5% "temporarily non-compliant exposures" limit in Article 26(1) of the Securitisation Regulation should be modified to "50% non-compliant exposures"; and
  - the remaining weighted average life limit of the underlying exposures in Article 26(2) should be increased to 5 years.
- ABCP should be made eligible under purchase and repo operations of the Bank of England.
- STS ABCP should be admitted to the HQLA buffer under LCR rules.
- Programme-wide STS - eligible third country assets provision should be revised to include US and Canadian assets.

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# Appendix 1: the UK and EU compared with the US

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# The securitisation landscape in the UK and EU is fundamentally different from the US

- European banks fund virtually 100% of their mortgage portfolios on balance sheet using:
  - Retail funding
  - MREL eligible liabilities
  - Covered bonds
  - Securitisation
- The extraordinary monetary policy conditions prevailing over the last several years, and the disproportionate central bank support given to other fixed income instruments, has made securitisation uncompetitive as a pure funding tool such that many issuers who used securitisation placed with investors to fund their assets now no longer do so.
- We therefore saw a rise of retained transactions. It is much easier and cheaper today, and has been for some time, for issuers to issue, or issue and retain for placement with the central bank, both covered bonds and securitisations. As a result, the investor base for securitisation has shrunk.
- The terms of central bank financing favour covered bonds (a dual recourse instrument) over securitisation.

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# Key features of the US securitisation market

- Bigger, broader, deeper capital markets with many more non-bank investors and large pools of experienced institutional investor money tapping more comparable transactions with easier due diligence.
- Similar underwriting standards across the country, common law, unified capital markets rules leading to greater homogeneity and the ability to generate larger, homogeneous portfolios from across the US.
- Covered bonds are entirely absent.
- US government support: "Government sponsored entities" (GSEs) such as "Fannie Mae" purchase around 80% of the mortgages originated by US banks.
- Very little risk transfer is undertaken by US banks because of their ability to sell new mortgages to the GSEs.
- GSEs themselves actively make use of risk transfer techniques to support their capital positions.

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# Appendix 2: securitisation and covered bonds: understanding their different functions

# Securitisation and covered bonds respond to different needs of issuers and investors

- Covered bonds are a traditional source of funding in some countries where securitisation is not yet developed.
- Covered bonds are limited to certain asset classes such as mortgages and public sector assets. Investors have "dual recourse": to both the originator and the assets. As a result , covered bonds do not provide any capital benefits to banks, only funding.
- However, only securitisation can provide capital relief benefits to originating banks to support continued lending.
- There is a prudential limit to the extent to which banks can safely issue covered bonds and create security over their assets, beyond which they subordinate their unsecured creditors (i.e. savers and depositors) in the event of the bank's insolvency.
- There is a natural limit for investors too: covered bonds (because of dual recourse) carry full exposure to the bank name, so investors quickly come up against single name limits – whereas with securitisation the exposure is to the bankruptcy-remote cashflows of the assets themselves, with only limited name exposure.
- Covered bonds mainly have bullet maturities which require issuers to address refinancing risk, whereas most securitisations are self-liquidating and repay principal over their lives (amortising structures).

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# Securitisation and covered bonds respond to different needs of issuers and investors

| | Mortgage Covered Bonds | RMBS |
|---|---|---|
| Recourse | • Full priority recourse to Sponsor/Seller & covered pool second | • Recourse to assets, no recourse to Seller |
| Asset Side Requirements | • Overcollateralisation | • Retention of 5% economic interest to comply with CRD |
| Linkage | • Linkage to jurisdiction & strongly tied to Sponsor/Seller | • Linkage to country & sovereign risk |
| Funding Profile | • Potential to match fund but exposure to repayment rates remains | • Match funding of underlying mortgage portfolio cashflows |
| Downgrade Risk | • Exposure to covered bond Issuer's rating | • Ratings linked to collateral, counterparty risk mitigated |
| Test Type | • Periodic asset coverage test | • Non-asset triggers & pay out events (for master trusts) |
| Encumbrance | • Asset encumbrance limit provided by law | • Marginal encumbrance limited to 5% retention requirement |
| Contingent Liquidity | • Ratings contingent costs on swaps & cash reserves (not clear) | • Solutions to minimise swap counterparty risks/costs exist |
| Investors | • Investor base will primarily focus on credit quality of issuer | • Generally does not cannibalise credit lines for sponsor / originator |
| Effect of Breach | • Cross default; stop to issuances; replenishment obligation | • Non-asset trigger payout (for master trusts) |
| Inter-creditor Issues | • Potentially | • Limited |
| Capital release | • No impact – banks must hold capital against mortgage pool | • Capital can be released |
| Underwriting Validation | • Asset Monitor / Rating agency validation only | • Rating Agency & STS validation |
| "Wrong Way" Risk | • Issuer must encumber additional notional if house prices decline | • Risk borne by investors |

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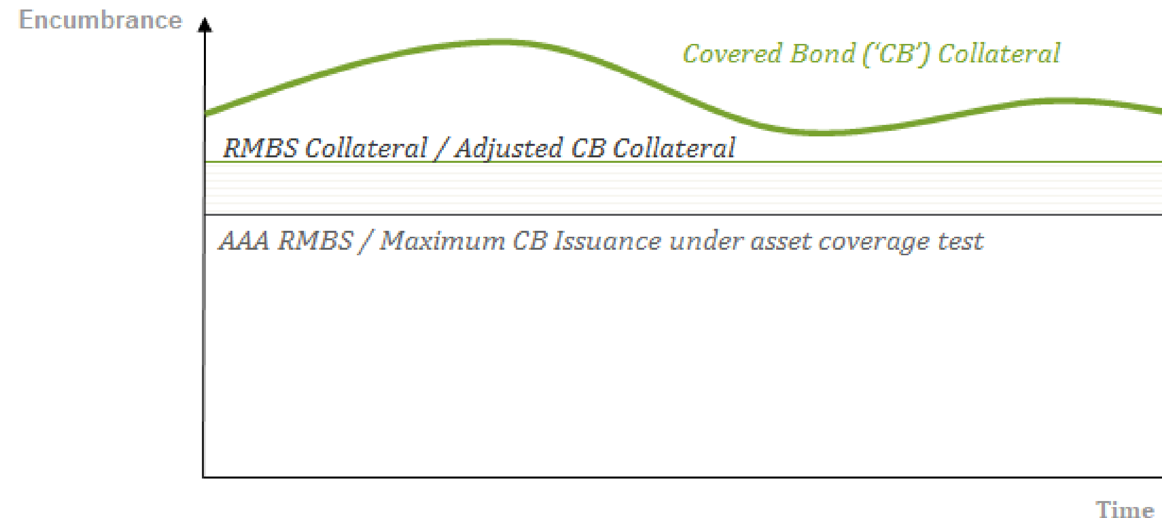
# Comparison: securitisation and covered bonds

| | Covered Bonds | Securitisation |
|---|---|---|
| Diversification from unsecured Investor base / de-linkage | ✓ | ✓ ✓ |
| Collateral Efficiency | ✓ | ✓ ✓ |
| Lengthens the maturity profile | ✓ ✓ | ✓ |
| Pricing and relative value (headline margin) | ✓ ✓ | ✓ |
| Provides matched funding | ✓ | ✓ ✓ |
| Provides capital release | | ✓ ✓ |

✓ ✓ = very attractive; ✓ = satisfactory

# Collateral Efficiency – a growing part of the equation

- Asset encumbrance is not free but carries an opportunity cost because of stable funding requirements as they relate to encumbered and unencumbered mortgages




**Typical excess collateral usage:**

- Prime RMBS: approximately 10%, fixed from closing date
- Covered Bond: approximately 20% potentially rising to approximately 40% under stress

- For RMBS, the level of collateral (asset side) and the level of funding (liability side) is locked in on the day of closing and investors carry all mark to market risk on both sides as well as the rating agency criteria change risk
- For publicly placed covered bonds, house price and portfolio performance deterioration (asset side) will require additional over-collateralisation. Hence, this asset side mark-to-market is borne by the issuer

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