
Position Paper

August 2015

Making CMU a success: key principles for the new securitisation framework

Introduction

AFME and its members strongly support efforts by the European Commission and all those involved in current efforts to develop a new EU framework for high-quality securitisation.

The Commission has said that "The development of a high-quality securitisation market constitutes a building block of the Capital Markets Union and contributes to the Commission's priority objective to support a return to sustainable growth and job creation" and "Securitisation is a crucial element of well-functioning financial markets. Soundly structured, securitisation can be an important channel for diversifying funding sources and allocating risk more efficiently within the EU financial system."

The seven years or so that have passed since the onset of the financial crisis have provided strong evidence of how well most European securitisations have performed, such that securitisation is now part of the solution, not part of the problem. A robust EU framework will help to reinforce this confidence in securitisation.

However, it is of critical importance that all of us – policymakers, regulators and all market participants – work together to get the new framework right. It must be successful.

In this paper, AFME highlights key principles that we urge policymakers to consider as the details of the new framework are being developed.

Key points

Securitisation is rich in detail, and AFME has already commented in detail on many aspects of the new proposals including the qualifying criteria for long-term securitisation, for short term securitisation (asset-backed commercial paper), capital, liquidity, disclosure and risk retention. We are happy to discuss our detailed responses with policymakers whenever required.

However, with so much detailed analysis available it is also important not to lose sight of certain key guiding principles, which we would urge all policymakers to prioritise and work towards when formulating the new framework.

- **The new framework must work for the bulk of the market to be successful.** It would be self-defeating if the new framework were so onerous in terms of its criteria and calibration that only a small part of the market could comply, or little benefit could be achieved by complying.
- **The new framework must make securitisation attractive for both issuers and investors.**
 - The market needs balanced regulations on capital that recognise the strong performance of European securitisation through and since the crisis, as well as the additional strengths of simple transparent and standardised securitisation ("STS").
 - Investors should not be forced to take risk on a high cliff-effect between capital requirements for STS and non-STS transactions.
 - Rules on significant risk transfer should be consistent across the EU, and which set requirements for bank originators that are appropriate and achievable, not hidden or impossible to meet.
 - The market needs a more level playing field with other fixed income instruments: for example, the liquidity treatment of qualifying securitisation in terms of haircuts, limits, etc., under the LCR should be much closer to that of covered bonds.
 - On disclosure, a more sensible balance needs to be struck, with proper recognition of the legitimate and reasonable commercial and confidentiality concerns of originators. We need a greater focus on quality of data and practical compliance, not ever-increasing and overlapping demands for more and more quantities of data required for diverse portals using diverse templates that are of little practical use to investors.
 - While investors should be expected to conduct thorough due diligence and appropriate stress testing prior to investing and also to monitor the ongoing underlying asset performance of their holdings, the regulation of this expectation should be balanced against the regulation of these requirements for investments in comparable products such as covered bonds, senior unsecured debt or even alternatives such as "whole loan" pools. An overbearing due diligence burden under regulation (and potentially pain of significant sanction) will simply lead to further shrinkage in the existing investor base and continue to deter new investors in favour of those other products.
 - On risk retention, we caution against further changes being made without consultation, particularly to the originator definition and the additional restriction. We urge the adoption of the principles-based approach recommended by the EBA in its Securitisation Risk Retention Opinion and Report of December 2014.

- **Policymakers should not seek to remove all risk from securitisation.** While of course the new framework should be prudent, it would be mistaken to seek to regulate away *all* risk (even if that were possible). Risk, sensibly managed and distributed, is an inevitable and healthy feature of all financial markets. It makes no more sense to seek to remove all risk from securitisation than to remove it from government bonds, covered bonds, corporate bonds or equities. Sensible risk-taking is what creates rewards for investors (returns) and issuers (risk-reduction) alike. Thus, the new framework's criteria should seek to validate existing best practice in terms of transparency and simplicity rather than imposing new requirements related to the riskiness of the underlying loans¹. Capital requirements for transactions meeting those criteria should be more in line with those for other high quality investments.
- **Prudential treatment of European securitisation should be considered in the context of its strong performance before, through and since the crisis².** European securitisations have performed well even *before* the *existing* framework of regulation was in place. So this should be the context in which new regulation is considered, and which should drive prudential treatment. As for credit ratings, downgrades have been contained, and many of these have been attributable to either new and tighter criteria, or downgrades in related sovereign ceilings - for which securitisation should not be held responsible.
- **Compliance with the new framework must be practical, quick and certain for issuers and investors.** Many of the fifty or so criteria proposed for STS remain vague and subject to regulatory interpretation³. The number of criteria should be reduced and replaced by a less detailed principles-based approach. Clarity, consistency and speed of obtaining the STS designation are key: we continue to believe that the best way to achieve this is for the authorities to appoint and regulate one or more independent, credible bodies to issue certifications under supervision while maintain obligations on investors to carry out their due diligence. If our preferred approach is not pursued, a self-certification regime with simpler criteria and a high liability hurdle may be a possible alternative. The criteria should be reviewed regularly to adapt to market evolutions, ensuring that standards are applied uniformly and regulating the conduct of the certifying bodies generally.

Conclusion

Time is of the essence: each month brings more news of European originators, structurers, underwriters or investors looking to exit the market as volumes have fallen to a level too low to justify the maintenance of staff, intellectual capital or technology. We urge all policymakers urgently to take steps to address the regulatory factors holding back the recovery of the securitisation market as soon as possible and in any event by the end of 2015.

¹ While riskiness of the underlying loans should generally not be part of STS criteria, there is a better case for such requirements in additional modules for specific purposes, such as HQLA eligibility.

² See Section 1.1.1 of the "EBA Report on Qualifying Securitisation" of July 2015.

³ We have commented, in private, in detail on the proposed criteria for both long- and short-term securitisations.

Annex: detailed supporting arguments

from AFME response to European Commission Green Paper May 2015

- Securitisation has performed well, in both credit and pricing terms. For many asset classes, credit losses through and since the crisis have been negligible and well within expectations. To the extent there have been shortcomings, these have been addressed both by regulation (for example, the Capital Requirements Directive/Regulation rules for risk retention or "skin in the game") and by positive and voluntary action and engagement by the industry itself (for example, the establishment of the Prime Collateralised Securities initiative).
- Securitisation is a critical tool in helping to build Capital Markets Union: prudently deployed and sensibly regulated, it can act as a bridge between the balance sheets of banks (and non-banks such as corporates) and the capital markets, enabling banks to de-leverage and divest risk and non-banks to diversify funding sources while providing investors with high quality fixed income securities at attractive yields, broadening and deepening our capital markets.
- Securitisation has not been treated on a level playing field with other forms of fixed income or other investment in recent years. The differential treatment in regulations affecting capital, liquidity, transparency and disclosure and derivatives, when compared with both covered bonds and direct investment in "whole loan" pools, are well known. These have no logical or intellectual justification, and while it can be argued that the risks of these different forms of investment may not be completely equivalent, the differential as it exists today is wholly disproportionate to any difference in risk inherent to the different instruments.
- It is essential to encourage non-bank investors to return to the market. With hindsight it can be seen that the pre-crisis securitisation market was overly dependent on direct or indirect bank funding (of one form or another). A rebuilt and sustainable market in Europe requires non-bank investors to be encouraged to return. Solvency II and the AIFMD regimes have precisely the opposite effect for insurance companies and AIFMs and we call for their urgent review.
- Securitisation must recover its function as a tool for risk transfer, not just providing funding. Because of its complexity, on a pure funding basis securitisation will normally be expensive compared with other forms of funding such as unsecured issuance and covered bonds. Securitisation can only compete meaningfully if its cost is compared with these competing products on a capital-adjusted basis, taking into account the saving in cost achieved by the freeing up of regulatory capital through the transfer of risk. While a single European framework for this exists in the form of the Significant Risk Transfer regime, many inconsistencies exist among different member states in its application despite guidelines already issued by the European authorities. These should be addressed urgently so that originators around Europe can assess the capital adjusted cost of securitisation on a uniform basis.
- Transparency and disclosure: securitisation as whole has been tarnished by stigma resulting from the shortcomings in disclosure that were prevalent in the run-up to the financial crisis in certain more complex structures which used securitisation techniques to create instruments that were opaque. It is important to distinguish these products, which (rightly) no longer exist due to both regulation and lack of investor demand, from the qualifying securitisation market where, as an asset-based form of borrowing, disclosure has always been extensive. This has always been what investors – rightly – have demanded. Disclosure in mainstream securitisation is more transparent than other forms of capital raising such as equity finance or unsecured borrowing, where investors have to rely on very high level financial statements rather than precise information on the assets supporting their investment. While the industry supports further improvements in the scope and accessibility of disclosure, there should be a single regime that is useful, easily accessible and carries minimal costs.

To quote Yves Mersch, Member of the Executive Board of the ECB, "Some creative thinking on how to present the information in an accessible manner may help preserve legal precision while avoiding information overload."

- Risk retention: this has always been a feature of the European qualifying securitisation market, which has not used (in any material sense) the "originate-to-distribute" business model which helped lead to the problems in the US sub-prime mortgage market. As a result, AFME members consider that the rules for risk retention should be applied to all securitisations, and not just to qualifying securitisations, although we support the application of a direct approach to qualifying securitisations. We also suggested in our response to the European Commission Green Paper consultation (answer to Question 3) certain adjustments to the risk retention regime to improve its functionality, following which we call for a period of stability in this area to help build certainty around the rules.

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