Briefing Paper
AFME Securitisation: Solvency II
October 2017

AFME welcomes the progress now being made to revisit the current Solvency II calibrations for the risk factors for investment by insurance companies in securitisations. This is particularly timely now that the regulations setting out a revised Securitisation Framework are being finalised. These harmonise existing sectoral legislation and create a new framework for “simple transparent and standardised” or “STS” securitisation, and adjust bank capital requirements to reflect these changes.

Reviving Europe’s securitisation markets is a key pillar of Capital Markets Union (“CMU”). It has been widely acknowledged that if securitisation is to play a meaningful role in CMU, by reducing reliance on Europe’s banks and increasing reliance on Europe’s capital markets, it must provide not just direct funding but also risk transfer, particularly for bank originators.

It is therefore essential for non-bank investors, such as insurance companies or asset managers investing on their behalf, to return to the securitisation market – particularly for investment in mezzanine and subordinated tranches. Many insurers left when the current – heavily prohibitive - calibrations came into effect. A revived securitisation market that relies only on bank investors, without participation by non-banks, will not deliver the full benefits of CMU and will be less financially stable.

Key components for rebuilding the market

There is now much evidence which shows that the credit and liquidity performance of most European securitisation through and since the crisis has been excellent: this can be seen from the data collected over the last ten years since the financial crisis. In addition, considerable additional regulation has been put in place over this period addressing inter alia alignment of interest, ensuring “skin in the game” and comprehensive disclosure, and reducing reliance on credit ratings - culminating in the new securitisation framework described above.

Prudential safeguards around European securitisation are already stronger than they ever have been and will be stronger still with the implementation of the STS framework. The key policy objective today must therefore be to make it attractive for insurers to return to the European securitisation market.

For this to happen the following adjustments to the existing regime are key:

- **Relative, as well as absolute, risk factors are critical**: insurance company investors have a choice of different asset classes in which they can invest. If they are to return to the European securitisation market, then the applicable risk factors should be set no higher than either those for bonds that have displayed similar levels of performance during the stress period of the sovereign crisis (such as covered or corporate bonds), or (where relevant, for example for residential mortgages) investment in “whole loan pools”.

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• Any “non-neutrality” premium should be reasonable, and deliver the above policy objective: the concept of a “non-neutrality” premium on capital for investment in the same assets after securitisation (compared with before) is present in the bank regulatory capital regime. To the extent it also forms part of the Solvency II regime, it should be set at a level which is lower than for banks: otherwise insurance companies simply will not return to the market.

• The current calibrations are much too high: this has been widely acknowledged. However, it is key that reductions in risk factors are made not just for senior tranches but also for subordinated tranches. Indeed, insurance company investors have a particularly important role to play at the mezzanine and junior level – this is where they can perform the function of absorbing risk from the banking system. It is therefore key that risk factors for subordinated tranches, particularly at the A / BBB rating level, are set at realistic levels. These are the most common ratings for subordinated tranches in European securitisation and if securitisation is to recover its function as a risk transfer tool it must be competitive for insurance companies to invest at these ratings. Current risk factor proposals for subordinated tranches remain extremely high in both absolute and relative terms.

• Cliff effects should be avoided: overly conservative calibrations can create significant cliff effects between:
  - senior and non-senior
  - different credit ratings, with progression down the credit spectrum
  - between securitisation and “whole loan pool” investment, and
  - between STS and non-STS

The table below illustrates how significant the cliff effects are in the current Solvency II regime:

<table>
<thead>
<tr>
<th>Credit quality step</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B and below</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Bonds</td>
<td>0.9%</td>
<td>1.1%</td>
<td>1.4%</td>
<td>2.5%</td>
<td>4.5%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Covered Bonds</td>
<td>0.7%</td>
<td>0.9%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Residential mortgage loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>e.g. 3% for life at LTV=80%</td>
</tr>
<tr>
<td>Current Securitisation Type 1</td>
<td>2.1%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Current non-senior securitisations Type 1</td>
<td>12.5%</td>
<td>13.4%</td>
<td>16.6%</td>
<td>19.7%</td>
<td>62%</td>
<td>100%</td>
</tr>
<tr>
<td>Current SII Type 2</td>
<td>11.6%</td>
<td>12.3%</td>
<td>15.2%</td>
<td>17.2%</td>
<td>77.5%</td>
<td>92.5%</td>
</tr>
<tr>
<td>Recalibrated SII Type 1 (Penaudin, Kulas, Giu)</td>
<td>9.1%</td>
<td>11.4%</td>
<td>14.2%</td>
<td>5.10%</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: BofA Merrill Lynch Global Research

• Non-STS securitisations are also key: risk factors for non-STS securitisations should also be revised. Non-STS securitisation products such as commercial mortgage-backed securities (“CMBS”) and collateralised loan obligations (“CLOs”) remain important and useful contributors to European economic growth; it is vital that investment in non-STS transactions remains viable. It is not under the current risk factor framework.

A more balanced possible approach

One example of a more balanced approach to the calibration of the risk factors is presented in the table below, adjusted for the various securitisation categories under Solvency II where Type 1 is equivalent to STS and Type 2 is equivalent to non-STS. The example calibration is based on the existing risk factors for both covered bonds (for senior STS) and corporate bonds (for non-senior STS and, with a shift of one credit quality step, for non-STS).
### Transitional and grandfathering measures

Clearly, the new calibrations will derive from the new STS regime but simply referring across to bank regulation may be problematic. For example, a link to the requirements set out in Article 243 of the revised CRR could suggest that the same additional criteria will be required of insurers as they are of banks.

The requirements under Article 243 (such as, inter alia, determination of risk weights of the underlying exposures) are derived from, and closely linked to, broader CRR concepts and matters that insurers are unlikely to be familiar with. Insurance companies, with their own regulatory regime, may have a difficulty integrating requirements designed for banks into their systems.

Rather than adopting a copy-paste approach from the CRR, appropriate additional metrics that are directly relevant for insurance undertakings should be used for Solvency II purposes.

### Next steps

AFME has also undertaken a survey of insurance company investors to ascertain the factors which influence their decisions to invest, and the results of this are attached.

### AFME Contacts

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<tbody>
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Solvency II Investor Survey Results – survey undertaken in September 2017

As the EU Securitisation Regulation and amendments to the CRR are being finalised, and given the acknowledgement that the insurance regulatory framework for securitisation should be compatible with the Securitisation Regulation, attention is turning to the revision of the current Solvency II calibrations for the risk factors for investment by insurance companies in securitisation. AFME welcomes the progress being made in this respect. In order to provide the views of the insurance investor community on the current treatment under Solvency II and the basis upon which investors would be prepared to invest in securitisation going forward, AFME conducted a survey of 33 buy side firms. The largest number of the respondents comprised insurance companies (49%), with a significant number of asset managers (39%) and a small proportion classified as ‘Other’ (12%). A large majority of the insurance company respondents were based in the EU27 (80%), with a smaller proportion based in the UK (20%). The asset managers were mainly operating globally (56%) and in the EU excluding the UK (39%), with a small number operating in the EU including the UK (5%).

The key findings of the survey are:

- 45% of respondents have either stopped investment or reduced investment in European securitisation, whereas only 15% have increased investment.
- Of those respondents that have stopped or reduced investment, by far the largest number say that this decision was due to the high Solvency II capital charges for securitisation.
- 79% of respondents not planning to invest in STS transactions with the current charges, would invest if the charges were reduced to equivalence with corporate bonds.

Summary of survey results

- 45% of respondents have either stopped investment or reduced investment in European securitisation, whereas only 15% have increased investment. This supports evidence from BAML (see Annex 1), that insurance companies have reduced their investment allocation to European securitisation in recent years.
• Of those respondents that have **stopped or reduced investment**, by far the largest number say that this decision was **due to the high Solvency II capital charges for securitisation**. The administrative burden of investing in securitisation has also played a significant role in the reduction of insurer investment in the asset class.

If you used to invest in European securitisation and have now stopped, or have reduced the amount that you invest, which of the following impacted this decision (select more than one option if appropriate)?

- Excessive administrative burden from regulation of the European securitisation market
- Public issuance has been too low
- Secondary market activity is not sufficient
- Securitisation transactions do not meet our matched maturity requirements
- Current Solvency II capital charges for securitisation are too high

**Current Solvency II capital charges for securitisation are too high**

<table>
<thead>
<tr>
<th>Option</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excessive administrative burden from regulation</td>
<td>12%</td>
</tr>
<tr>
<td>Public issuance has been too low</td>
<td>6%</td>
</tr>
<tr>
<td>Secondary market activity is not sufficient</td>
<td>3%</td>
</tr>
<tr>
<td>Securitisation transactions do not meet</td>
<td>1%</td>
</tr>
<tr>
<td>Matched maturity requirements</td>
<td>2%</td>
</tr>
</tbody>
</table>

• Of those respondents **not currently planning to invest in STS transactions** with the current capital charges, **79% would invest if the charges were reduced to equivalence with corporate bonds**. A further 7% would invest if the capital charges were reduced to the level of covered bonds.

If you are NOT planning to invest in STS transactions with the current Solvency II capital charges, would you invest in STS securitisation if the capital charges were reduced to equivalence with any of the following options?

- Corporate bond capital charges: 79%
- Covered bond capital charges: 7%
- Would not invest in STS securitisation even if capital charges were reduced: 14%

**Corporate bond capital charges: 79%**

**Covered bond capital charges: 7%**

**Would not invest in STS securitisation even if capital charges were reduced: 14%**

• Of those **investors that have withdrawn from the European securitisation market**, or have never invested in it, **72% of respondents said that they would invest if the STS capital charges were equivalent with corporate bonds**, and a further 21% if equivalent with covered bonds.

If you have withdrawn from the European securitisation market, or have never invested in it, do you believe that you would invest in STS transactions if the Solvency II capital charges are reduced to levels equivalent to those of corporate or covered bonds?

- Yes, if reduced to equivalence with corporates: 72%
- No, but yes if reduced to equivalence with covered bonds: 21%
- No, will not invest even if capital charges are reduced: 7%
• Of the respondents currently investing in securitisation, the majority are most likely to purchase tranches rated AA-BBB. This indicates that investor interest will be focused outside the senior STS category in the Solvency II regulations, as tranches rated AA-BBB are highly likely to be either non-senior STS or part of non-STS transactions.
Q7 - In what range is the size of your overall investment portfolio? For asset managers please state the size of the portfolio invested on behalf of insurance clients. (Euro equivalent)

Less than 250 million: 22%
250 - 500 million: 4%
500 million - 1 billion: 4%
1.5 billion - 5 billion: 13%
Greater than 10 billion: 48%

Q8 - If you invest in securitisation transactions, what is the current seniority/rating of the tranche that you are most likely to purchase?

Sub-Investment Grade (lower than BBB): 15%
Investment Grade (AA to BBB): 27%
Other Investment Grade: 58%

Q9 - If you invest in securitisation transactions, which of the following options, in the context of an asset/liability management strategy, best represents the risk that insurers are exposed to in terms of losses?

Losses due to defaults: 38%
Losses due to changes in market/spreads: 62%

Q10 - Are you planning to invest in STS transactions if the current Solvency II capital charges are maintained?

Yes, we will invest in STS transactions only: 12%
Yes, we will invest in STS and non-STS transactions: 47%
No, we will only invest in non-STS transactions: 13%
No, we will not invest in securitisation at all: 28%

Q11 - If you are planning to invest in STS transactions with the Solvency II capital charges maintained at their current level, which classes of STS securitisations would you look to invest in?

Diversified portfolio: 75%
Auto ABS: 0%
Other consumer ABS: 15%
RMBS: 10%

Q12 - If you are NOT planning to invest in STS transactions with the current Solvency II capital charges, would you invest in STS securitisation if the capital charges were reduced to equivalence with any of the following options?

Corporate bond capital charges: 75%
Covered bond capital charges: 7%
Would not invest in STS securitisation even if capital charges were reduced: 14%

Q13 - If you have withdrawn from the European securitisation market, or have never invested in it, do you believe that you would invest in STS transactions if the Solvency II capital charges are reduced to levels equivalent to those of corporate or covered bonds?

Yes, if reduced to equivalence with corporates: 72%
No, but yes if reduced to equivalence with covered bonds: 21%
No, will not invest even if capital charges are reduced: 7%

Q14 - If you answered Yes to the previous question, and lower Solvency II capital charges are adopted, how long do you think it will take you or your clients to be able to fully enter the market once the lower capital charges are implemented?

1-3 years: 31%
More than 3 years: 0%
Immediately: 31%
Up to 1 year: 38%
Q15 - If you invest in European securitisation, do you use internal models to calculate the capital requirements?

- Yes: 67%
- No: 33%

Q16 - If you do not currently use internal models, and assuming that Solvency II capital charges similar to corporate or covered bonds are adopted, would you develop an internal model for securitisation with the aim of reducing the capital requirements under the standard approach?

- Yes: 21%
- No: 79%

Q17 - Do you believe your local regulator would approve an internal model that significantly deviates from the standard approach?

- Yes: 15%
- No: 85%
Annex 1 – BAML data on insurance company asset allocation

BAML’s insurance equity research team provided data on the portfolios of the 27 largest listed insurers in the EU between 2011 and 2016. The data shows that in this period, the allocation of assets to securitisation (‘Structured Finance’ or ‘Structured’ in the below charts) has dropped from 5% to 3% of total fixed income holdings.

Chart 9: European Insurer asset allocation (1)

Source: BofA Merrill Lynch Global Research.

Chart 11: European Insurers’ Investment mix, 2016

Source: BofA Merrill Lynch Global Research.