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Finance for Europe

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By email to valdis.dombrovskis@ec.europa.eu

Mr Valdis Dombrovskis
Executive Vice-President for An Economy that Works for People
European Commission
1049 Brussels

Dear Vice President,

Challenges facing Europe's banks: solutions through securitisation

As a new decade begins and the new mandate of the Commission begins to accelerate, we felt it was an appropriate time to write to you with our reflections on the first full year of operation of the new framework for securitisation set out in Regulation 2017/2402 (the "Securitisation Regulation"), which came into force on 1st January 2019. Especially as these first experiences have not been delivering the desired results from a Capital Markets Union perspective.

Securitisation offers banks both a diversified funding source and a method to transfer credit risk, thereby safely freeing-up capital that can be used to generate new lending to the real economy. In the process, it both improves bank capital efficiency and meets the needs of investors outside the banking system, such as insurance companies and asset managers, by enabling them to gain exposure to real economy consumer and corporate assets.

The aim of Capital Markets Union, of which the Securitisation Regulation was and remains an important part, was to rebalance the funding of the European economy to make it less dependent on bank finance through greater utilisation of capital markets. Securitisation is the only way to reduce banks' balance sheets while maintaining their capacity to lend to borrowers that do not have their own access to capital markets.

Further action is required to reach the required level of ambition

Yet, despite the best intentions of all involved and the good progress that has been achieved in many areas, the potential of the STS framework and the ambition to have a safe and vibrant European securitisation market is so far not being fulfilled. We believe that one of the important reasons for this is an excessively complex regulatory framework and an overly conservative treatment of securitisation for regulated investors. The unmatched transparency and oversight of "simple transparent and standardised" or "STS" securitisations, relative to all other asset classes, has not been recognised in associated regulations setting out capital and liquidity treatment.

Full year 2019 issuance of securitisation was down by 15% year-on-year, reversing the (small) positive growth trend for the first time in five years. Issuance in sectors potentially eligible for the STS label is down and market participants believe most STS issues to date would have taken place anyway. EU securitisation markets now rank third in placed issuance after the US and China, and ahead only of Japan and Australia. Given the size of the UK securitisation markets, Brexit has further altered the league tables leaving the US and China as the two dominant securitisation markets globally; some investors are already re-considering their portfolio allocations to reflect this.

In summary, an urgent review is needed

While issuers and investors have adopted STS securitisation driven by regulatory necessity, it has driven neither increased issuance nor the increased investor demand that is essential for healthy growth. It has certainly not been transformative. Looking into the future, STS securitisation issuance is likely to continue to be constrained, especially because of disproportionate capital and liquidity treatment and the very burdensome (and in some cases excessive) disclosure requirements.

Further, the forthcoming Basel rules will result in significantly increased capital requirements for Europe's banks, without demonstrated evidence of greater risk, further damaging profitability. In particular, in the context of incorporating Basel III rules into CRR 3, there should be consideration of the interaction of the Output Floor with SRT requirements. Likewise, LGD input floors will remove risk sensitivity and will undermine the ability to size adequately first loss tranches. The need for securitisation as a key tool to release financing capital for the real economy has therefore never been greater.

A call to review and amend the securitisation regime

AFME very much supports the conclusions on the Deepening of the Capital Markets Union adopted by the Council of the European Union in December 2019 in calling for a review and amendment of the securitisation regime to facilitate cross-border capital flows.

We therefore believe it is vital to make certain adjustments to the new framework because:

- The costs of STS securitisation are high, the benefits are limited and do not appropriately recognise the high quality of the STS standard;
- A better-functioning process for achieving significant risk transfer is required in order to allow Europe's banks to mitigate the otherwise damaging effect of the new Basel rules; and

- Recent discussions about a new framework for STS for synthetic securitisation are welcome, but such a framework should be implemented swiftly and allow an element of capital relief for originators.

We believe that the review scheduled to be finalised by 1st January 2022 should be brought forward into 2020 and that the upcoming CRR 3 legislative package could be a vehicle to implement urgently some justified technical adjustments which will stimulate the market.

We list in Appendix 1 some of the required adjustments. Some will require a review of primary legislation, but others could be undertaken in the near-term and effected through secondary legislation. These alone can have a positive and material impact on the market and we urge their implementation as quickly as possible.

My colleagues at AFME and our members would highly appreciate discussing our proposals and comments further with you and your colleagues as soon as the virus permits.

Yours sincerely,

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Appendix 1

The new securitisation framework has so far not fulfilled its potential or delivered material benefits due to an excessively complex and conservative regulatory treatment that does not adequately recognise the solidity of the STS framework and the performance of EU securitisation both before and after the financial crisis. We set out below key hurdles and remedies which take two forms: embedded biases in existing regulations, and unjustifiably strict requirements and interpretations which have created unintended consequences. We also include a third section on future development of the securitisation framework.

Our members believe that the top priorities for reviving the markets are:

- A more generous treatment of STS securitisations under the LCR regime
- Re-calibration of the securitization prudential capital for banks and insurance companies
- Improvements in the SRT process
- Proportionate approach for the supervision of ESMA template implementation
- Provide capital relief for STS synthetic transactions
- Establishment of a framework for ESG securitisation

Key hurdles and remedies: embedded regulatory biases

Issue	Remedy	Benefit
The benefits of the STS standard have not been reflected in regulation governing bank liquidity ratios, where an unlevel playing field persists with	A more generous treatment is required: eligibility levels should be re-examined, as well as applicable haircuts. This can be achieved by	To the extent that STS has had a positive impact, it has supported the demand from bank treasury investors for whom LCR-eligibility is important. A more generous LCR regime would promote growth in bank treasury participation which is very likely to create a virtuous circle of increasing volume, secondary market liquidity and 'normalisation' of securitisation that will in turn

other fixed income instruments.	amending the relevant Delegated Regulation.	encourage non-bank investors to return the market. Adjustments to the regime can be made which will still be prudent with the ECB collateral eligibility rules.
The prudential capital framework for bank and insurance company investors in securitisation remains excessively conservative compared to other comparable investments.	Reviewing the CRR calibration of the p factor for the SEC-IRBA especially for retail assets and of the p factor for SEC-SA to take into account both the STS framework and the calibration used by US banks for the SSFA (p factor of 0.5 with no STS requirement). Broaden the scope of CRR Article 270 beyond SMEs to other asset classes such as corporates and retail exposures.	CRR re-calibration benefits include • Reviving the European Securitisation market • Encouraging banks to provide senior financing to originator clients for the benefit of the real economy • Ensuring a level playing field with US market • Allowing banks to share risk with capital markets and institutional investors which is at the core of the CMU project
	Weighted Average Maturity (WAM): methodology should be consistent for cash and synthetic deals; prepayments should be recognised. EBA expected to publish guidelines soon.	WAM: final guidelines appropriately framed will further boost investment both directly by banks (at senior and senior mezzanine levels) and indirectly by non-banks.
	Risk Factors under Solvency II should incentivise	Solvency II: revised capital charges for STS securitisations in Solvency II will enable the recovery of a non-bank investor base

	investment in longer-term mezzanine risk and should not incentivise the purchase of illiquid loan portfolios over liquid high- quality securitisation bonds; the relevant Delegated Regulation should be adjusted to level the playing field and remove this distortion.	that has shrunk considerably in recent years, providing additional funding for the real economy, risk transfer possibilities for banks and the removal of distortions currently existing in the framework such as that highlighted alongside.
Improvements are needed in the process for achieving significant risk transfer (SRT) transactions, for both performing and non-performing exposures (see also below re Article 9(3)). It is key to finalise the outcome from the EBA 2017 Discussion Paper including in particular clarification of the use of excess spread and addressing the anomalies in the CRT tests.	Good progress is being made in discussions between AFME and ECB-SSM. COM should encourage and support the existing and improving dialogue among ECB, EBA and JSTs so that greater clarity and practical results can be achieved. The objective of the SRT process should be limited to preventing regulatory arbitrage. There should be more clarity on the structural features allowed including time calls in synthetic deals and excess spread in cash deals.	The SRT assessment is at the core of the securitisation issuance decision-making process as it provides an instrument for banks to transfer and therefore manage both their risk appetite and profile. The cost of doing this is much more viable if such risk transfer is recognised by supervisors and results in a commensurate reduction of the capital charge of the securitised loans. Improvements in the SRT assessment process will therefore ease the process of risk transfer for banks, enabling additional lending to the real economy, including to SMEs.

	The process for STS and/or repeat transactions should be streamlined.	

Key hurdles and remedies: interpretation and application of the Securitisation Regulation

Issue	Remedy	Benefit
Disclosure: securitisation market participants have faced major difficulties in achieving the new standard because of very substantial additional information required to be made available. Some securitisation market participants are expected to face significant difficulties in achieving full compliance with this new standard immediately upon application. This is particularly pressing for less sophisticated issuers, and in particular for corporates who rely upon private securitisation to finance trade receivables – an important source of funding for the real economy.	At a minimum, the Joint Committee of ESAs should confirm that competent authorities "should generally apply their supervisory powers in their day-to-day supervision and enforcement of applicable legislation in a proportionate and risk-based manner, taking into account the type and extent of information already being disclosed by reporting entities." See AFME Briefing Paper of November 2019, previously submitted to COM and the ESAs. Realistic thresholds and tolerance for the use of No Data options should form part of this approach and will assist compliance by market participants. Lastly, we continue to believe strongly that the application of the same disclosure	A balanced, practical approach will avoid the risk, in the most acute cases, of fire sales, and the withdrawal of funding. Failure to adopt such an approach risks highly negative outcomes which will damage the appetite of borrowers, especially corporates, to undertake securitisations.

Achieving complete compliance across all market sectors and asset classes within a few months is not achievable as a practical matter.	requirements to private as to public securitisations is a deeply flawed interpretation of the Level 1 text and has created significant and entirely unnecessary difficulties for both issuers and investors in some sectors. Right-sizing the disclosure requirements and re-assessing the need for ESMA templates for private securitisations is key.	
Uncertainties surrounding the potential scope of application of Article 7 and the interpretation of the requirements of Article 5.(1)(e) are creating difficulties for relevant European "institutional investors" seeking to invest in third country (non-EU) securitisations. This is because disclosure of asset level data is either not required or is not market practice in many cases in such third countries, which makes it	As an interim measure the Joint Committee of ESAs (and/or the European Commission) should provide guidance to ease the difficulties and to give more clarity on the interpretation of the relevant provisions; ultimately, however, a clear policy for third country securitisations should be prepared for Level 1 remedy.	By setting out the regulatory expectations for the relevant European "institutional investors" with regard to their due diligence obligations when verifying and monitoring the level of disclosure and reporting for third country securitisations, greater clarity would be provided to European investors seeking to comply with their regulatory obligations in this context. This will also encourage greater consistency in the approaches adopted in practice when complying with the EU investor due diligence requirements.

very challenging in practice for a third country originator or sponsor to meet such requirements, in particular asset-level disclosure standards and reporting designed for EU assets		
Article 9(3) credit-granting standards for acquired portfolios, including non-performing exposures (NPEs)	We note the EBA Q&A response; however this is only partially helpful; a fuller Level 1 solution will provide greater clarity; in this regard AFME supports the initial recommendations made in the EBA Opinion to the European Commission of 23 October 2019 (EBA-Op-2019-13) on the regulatory treatment of non-performing exposure securitisations.	An approach better attuned to the context of acquired portfolios, including NPEs, will encourage the greater use of securitisation as a funding tool for their resolution.

Future development of the Securitisation Regulation

Issue	Remedy	Benefit
Establishment of an STS framework for synthetic securitisations.	This will require primary legislation; we ask that this be considered within CRD 6/ CRR 3.	Synthetic STS: a new framework will provide greater opportunities for banks to transfer risk to non-bank investors which, if recognition of capital relief for the originator is permitted, will enable them to lend more to the real economy. Synthetic securitisation will be especially helpful to securitisation of SME and corporate loans, which are both capital-intensive when held on balance sheet and difficult to securitise in the cash markets given the revolving nature of the credit facilities, thus enabling banks to lend more to this key sector of the real economy.
Establishment of a framework for ESG securitisation.	This will require primary legislation.	This will provide a new funding source to support finance for the new ESG-compliant economy and help achieve the ambitious goals for addressing, among other things, climate change. A simple and clear definition of ESG securitisation (with a particular focus for the time being on "E"/green aspects), together with appropriate incentives, will help to encourage the market to develop more quickly. More work is also needed on more systematic reporting and the tracking of underlying data to make ESG securitisation more tangible for investors[1].
Establishing a third country equivalence regime for non-EU STS/STC securitisations,	This will require primary legislation.	This will mitigate fragmentation of the European securitisation market, both between the EU and third countries that have implemented the Basel framework for simple, transparent and comparable (STC) securitisations (for example Canada) and also

[1] Please refer inter alia to the AFME paper "Principles for developing a green securitisation market in Europe", available here.

particularly the UK where the regime is expected to be broadly parallel.		between the EU and the UK. The EU (plus the UK) has already fallen to third by market size globally, after the US and China.
Calibration of the risk weight formulae for securitisation of non-performing exposures ("NPEs").	Re-calibration of the relevant risk parameters within the SEC-IRBA and SEC-SA which recognise the securitised pool is non-performing at the point of securitisation. CRR 3 would provide an appropriate vehicle for such changes.	Bank-provided leverage to bidders of NPE portfolios will continue to facilitate the reduction of the NPE stock held by European banks as such leverage provides bidders with the ability to provide more competitive pricing / bids.
As internal models are going through TRIM reviews and are harmonized by EBA guidelines, there is no need for floors.	Non-floored LGD should be used for the supervisory formula (SEC-IRBA).	Securitization requires very sensitive models to estimate ratings and LGDs in order to size adequately first loss tranches.
In the context of the forthcoming Basel rules, it is necessary to clarify the possibility to utilize trade and/or credit insurance as eligible credit risk mitigation instruments.	The securitisation SPV, rather than the lender, should be a permitted beneficiary under the CRR, with appropriate capital relief for the assets and liabilities.	This will create a much more stable application of the resulting securitised RWA and also promote a more standardised trade and credit insurance products.

Market is adjusting to over 100 new STS criteria. A review of the application of the STS regime at the ABCP programme-level is required; the lack of notified STS-ABCP programmes is evidence that the criteria for STS ABCP programmes are so strict as to prevent the regime working at all in practice.	EBA feedback has been helpful; there is a need to build more practical experience with support of clear guidance from clearly designated authorities. Further engagement with national regulators and the industry is required in order to identify required adjustments to the applicable STS requirements in the ABCP context. For example, consider whether the STS framework could be broadened to allow ABCP programmes to benefit from STS treatment without all the underlying transactions having to be STS.	Continuing reinforcement of the high quality of the STS standard will underpin investor confidence, as will greater transparency on the views that the EBA and/or national regulators may take when interpreting in practice the application of the STS requirements. ABCP is an important source of funding for corporates (for example, trade receivables). A STS regime for ABCP that is easier and sufficiently attractive for both sponsor banks and corporate borrowers to use will deliver more funding to the real economy.
It is not clear whether the definition of "sponsor" includes non-EU investment firms.	Clarification that a "sponsor" can be a third country investment firm.	Increased flexibility for market participants.