afme/
Finance for Europe

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Vice-President Valdis Dombrovskis, European Commission

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Dear Vice-President Dombrovskis

European Securitisation and STS Framework – EMIR Refit and Review of Solvency 2 risk factors

On behalf of AFME, I would like to express our strong support for the formal adoption of the European framework for simple, transparent and standardised ("STS") securitisations (the "STS Framework"), with the European Parliament plenary vote on 26th October and the expected Council adoption of the STS Framework in the coming weeks.

We are confident that the long-term impact of the STS Framework will be positive.

However, for this to be achieved it is equally important that other, related pieces of EU legislation are calibrated to create the right conditions and incentives to support the recovery of safe and well-regulated securitisation in Europe.

Specifically, it is critical that both the EMIR Refit proposals and Solvency II risk factors are calibrated correctly to ensure that securitisation – whether STS or non-STS - remains not only possible but also attractive for both issuers and investors.

The treatment of securitisation swaps under the EMIR Refit proposals risks damaging the success of the STS Framework, and all securitisation in Europe

We are very concerned by the proposal published by the European Commission in May as part of the EMIR Refit dossier (the "EMIR SSPE proposal") to require securitisation special purpose entities ("SSPEs") to be made "financial counterparties" and therefore to clear or post margin.

The EMIR SSPE proposal represents a very significant change to the current framework, where SSPEs are mostly characterised as "non-financial counterparties minus" ("NFC-").

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No consultation or impact assessment has to our knowledge been made regarding the impact of this proposal. We believe that if adopted the proposal would impose a damaging and unnecessary constraint on securitisation activities and run counter to the CMU objective of reviving securitisation in Europe. Lastly, the EMIR SSPE proposal maintains an unjustified lack of consistency with derivatives in covered bond transactions, which currently benefit from a conditional exemption from such margin and clearing requirements[1].

Swaps are critical to securitisations in Europe, both STS and non-STS

Unlike in the United States, where nearly all securitisations are issued in USD and backed by USD assets, and where fixed rate bonds are more prevalent, securitisation in Europe is a multi-currency, floating-rate market. Nearly all term securitisations are based on Euribor or Libor.

The specific characteristics of the European securitisation market need to be recognised. Nearly all European asset classes require interest rate or basis swaps, to hedge the basis risk between the fixed, variable or otherwise diverse cashflows from the assets and the Euribor or Libor based margin on the financing. Auto loans, which are predominantly fixed rate, would be especially badly affected, as would SME securitisations[2] and many residential mortgage transactions.

While Article 42 of the Securitisation Regulation contemplates conditional relief from each of the clearing and margin requirements for swaps in respect of STS securitisations, the rationale for relief applies equally across STS and non-STS transactions. In both cases, swap counterparties will typically have the benefit of the security provided by the SSPE and have a senior ranking entitlement to payment.

SSPEs are limited recourse, bankruptcy-remote vehicles which cannot clear or post margin

SSPEs are unlikely to be subject to any obligation to clear in practice: CCPs do not accept SSPE swaps because of their bespoke features.

SSPEs cannot post margin because they do not have any assets available to do so; a SSPE has access to only the pool of securitised assets, which are already secured in favour of its creditors including (at a senior level) its swap counterparty[3].

1 See Recital 41 of the Securitisation Regulation.
2 SME portfolios often have particularly diverse interest rates and bases on the underlying loans, reflecting the widely differing needs of SMEs.
3 See Recital 40 of the Securitisation Regulation.

The EMIR SSPE Proposal risks serious damage to market stability

It is likely that if the EMIR SSPE Proposal is implemented, a wide range of *existing* securitisations risk being downgraded. This will have highly damaging consequences.

This is because a key provision of securitisation swap contracts throughout the market is the right of the SSPE under *existing*, market-standard documentation to require its swap counterparty to be replaced in the event that it is downgraded[4]. This is done by creating a new swap.

If the EMIR SSPE proposal is pursued, then whether a downgrade of a swap counterparty occurs or not a new swap could not be created - because the SSPE could not post margin[5]. This means the replacement mechanism under the existing swap would no longer function and a downgrade of the securitisation bonds to the rating of the swap counterparty would inevitably follow.

If adopted as drafted, therefore, the effect of the EMIR SSPE Proposal is to make *existing* securitisation swaps no longer fully functional (and to make new swaps no longer viable) - across the entire European securitisation market, both STS and non-STS.

All European securitisations, both STS and non-STS, already contain strong mitigants for derivatives-related risks

SSPEs should not be made FC because across all European securitisations, both STS and non-STS, swaps involving SSPEs will contain built-in features structured to the highest credit quality which already mitigate credit risk for both the SSPE and its counterparty. SSPEs do not use derivatives to gain exposure to or take positions in financial markets for speculative purposes or with a view to generating profits: SSPEs undertake swaps purely to hedge the risks of the cashflows of the assets they hold.[6]

Requiring SSPEs to clear or post margin is therefore unnecessary because of the well-recognised credit mitigants which already exist. This is recognised in Recital 40 to the Securitisation Regulation which says "derivative contracts entered into by SSPEs should not be subject to the clearing obligation … because counterparties are secured creditors under the securitisation arrangements."

4 This has been the market practice for many years and every securitisation which relies on a swap will contain this feature.
5 Even if the SSPE could, existing documentation cannot be amended easily, or at all.
6 Indeed, Article 21 of the Securitisation Regulation requires this to be the case for STS securitisations, and for non-STS securitisations investors and the credit rating agencies make similar requirements. Without such hedging, in most cases it would not be possible to achieve the high credit ratings required or to place the bonds with investors.

We call for the EMIR SSPE proposal not to be pursued

AFME strongly recommends a withdrawal of the EMIR SSPE proposal to allow the existing NFC- regime to continue to apply, supplemented by the various provisions and safeguards already contained in the Securitisation Regulation and the CRD/CRR framework. An alternative approach which classifies SSPEs as FCs but creates certain exemptions from the associated obligations (such as posting margin) will be very difficult to implement in practice across the range of derivatives used in the market, and will also create further uncertainty for market participants.

Maintaining the existing NFC- approach, which works well, will avoid disruption to the wider, existing market, preserve financial stability and underpin the future success of the STS Framework.

We enclose further detailed analysis in separate materials.

For CMU to succeed, Solvency 2 risk factors must help restore securitisation as a risk transfer tool, for both STS and non-STS

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. This is the case for both STS and non-STS securitisations.

It is 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 stopped investing when the current – heavily prohibitive – Solvency 2 calibrations came into effect.

A recent survey of 33 investor firms conducted by AFME resulted in the following key findings:

- 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.

We very much welcome that the Commission is revisiting the risk factors for securitisation under the Solvency 2 regime. AFME urges the Commission to pursue a reform that adjusts the prudential framework for securitisation to levels comparable to the treatment of other fixed income instruments that have displayed similar levels of performance during the financial crisis, such as covered or corporate bonds, or (where relevant, for example for residential mortgages) investment in "whole loan pools".

The revised Solvency 2 framework should make it attractive for insurers to invest in mezzanine and subordinated tranches to help distribute risk from bank balance sheets to the capital markets. It should not just copy the regime for banks.

For example, 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. Any such premium should be reasonable, and set at a level which is lower than for banks: otherwise insurance companies simply will not be encouraged to return to the market.

A revived securitisation market that relies only on bank investors, with limited participation by non-banks, will not deliver the full benefits of the Capital Markets Union and will be less financially stable.

Lastly it is critical that the Commission revisits the Solvency 2 risk factors for not just STS but also for non-STS securitisations.

We enclose a separate briefing note with further detail on our survey and proposals in this area.

The importance of the non-STS market

The STS Framework has the full support of AFME and its members. But it is important to note that not all European securitisations will qualify for the STS designation. Securitisations outside the STS Framework will include, for example, those relating to commercial real estate loans[7], high yield loans to businesses[8] and non-performing loans, among other products. These securitisations will remain valuable mechanisms to provide financing to businesses and to facilitate the process of bank deleveraging. The non-STS market will also contribute to the success of the STS Framework by promoting growth and liquidity in the wider securitisation market and the return of the investor base which has declined so greatly in recent years.

7 Commercial Mortgage Backed Securities (CMBS)
8 Collateralised Loan Obligations (CLOs)

It is therefore crucial that non-STS securitisations are not unduly penalised or subjected to unjustified regulatory requirements.

Conclusion

The adoption of the new Securitisation Regulation and corresponding capital requirements for banks represents a crucial milestone in the development of the CMU.

We urge policymakers to build on this momentum and to ensure that other, related legislation supports the objective to develop successful securitisation markets in Europe. The revision of Solvency 2 and the treatment of securitisation swaps in EMIR are crucial to this process. We call on EU legislators to bear in mind the themes and arguments set out above as these debates progress.

Yours sincerely

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