afme/ Finance for Europe

Association for Financial Markets in Europe

Position Paper

January 2017

Proposed changes to the securitisation risk retention regime

Introduction

The risk retention regime is an important prudential measure and one of the key post-crisis elements of the regulatory framework of securitisation. It has always been intended to align interests between issuers and investors in securitisations and to require originators to retain so called "skin in the game".

From a policy standpoint, it is important to agree on a single retention figure that is simple and transparent. A retention percentage of 5% has been confirmed as being sufficient for all forms of retention by the European Commission, the EBA and the European Central Bank. It is important to note that the Commission did not propose any changes in their original proposals when first published in September 2015; nor did the Council in their review of November 2015.

However, we are deeply concerned that changes recently proposed by the Parliament to increase the retention requirement and further complicate the regime run counter to the objective to revive securitisation markets. Indeed, the proposed changes will create significant additional hurdles to the revival of the *entire* securitisation market in Europe – not just STS – damaging efforts to build Capital Markets Union (CMU).

We set out our reasons below, but first we highlight some important issues of process.

The process leading to the proposals has not been supported by evidence of any shortcomings in the current regime

- Fundamental changes to an important prudential measure have been proposed without any evidence produced or impact assessment carried out, and in the face of opposition from many expert bodies, including the EBA. It would surely be extraordinary for co-legislators to concur with such an approach to changing a major element of prudential regulation in this way, both as a matter of principle and because the full range of consequences of such changes are not known.

- The existing retention requirement of 5% was thoroughly considered and agreed by the EU co-legislators in 2009. There are specific reasons why the 5% amount was selected, including technical considerations related to the interaction with accounting standards[1]. The effectiveness of the risk retention regime, which has been in place since 1 January 2011, has been reviewed and corroborated by CEBS in 2009, the European Commission in 2010 and EBA in December

[1] A recent analysis is available in the following paper *The 5% risk retention threshold – A short technical history* available at: http://www.riskcontrollimited.com/wp-content/uploads/2016/07/5_Percent_Securitisation_Retention.pdf

2014. Following Europe's lead, the 5% retention requirement was then adopted as the global standard in the IOSCO/FSB/BCBS global framework, as well as in the United States.

- European securitisation has performed well in credit and pricing terms. This was not obvious in 2009, when a retention requirement of 5% was concluded to be sufficient. It would be ironic indeed for the retention requirement to be increased today, nearly ten years after the financial crisis, when the evidence of the strong performance of European securitisation over this period is plain for all to see.

- We are not aware of any evidence or analysis by a regulatory authority that a change from a 5% requirement to a different approach would produce a better alignment of interest between issuers and investors or improve financial stability.

- Indeed, quite the contrary: in its December 2014 report, the EBA found that *"the current framework … has a positive impact on EU markets. Therefore, **the EBA recommends that this approach should be kept** … The … five different methods of retention … are well established and … seem to work well. Consequently, the EBA believes that … no other form should be considered at this time … **the EBA does not believe that any alternative mechanisms should be used as a substitute or are equivalent to the current retention rules in place regardless of the asset class or securitisation structure**."*

- Further, a January 2017 Working Paper (no. 601) published by the Bank for International Settlements, which focused on credit register data for loans to Italian firms over a period of several years, found that *"… moral hazard is confined to weak relationships, indicating that a strong relationship is a credible enough commitment to monitor after securitization. Importantly, the selection of which loans to securitize based on observables is such that it largely offsets the (negative) effects of asymmetric information, **rendering the overall unconditional quality of securitized loans significantly better than that of non-securitized ones**. Thus, despite the presence of asymmetric information, our results do not accord with the view that credit-risk transfer leads to lax credit standards."*

- Lastly, the purpose of the risk retention rules was to ensure alignment of interest between originators / issuers and investors, and to avoid the risks of and damage to the financial system caused by the "originate-to-distribute" model prevalent in the United States, especially in the US sub-prime mortgage market. Such a business model has never been present in Europe to any meaningful extent, and remains absent today. The existing regime has therefore done its job well, and continues to do so.

Why will the proposed changes to the risk retention regime create hurdles to the revival of the entire securitisation market in Europe?

Damage to smaller lenders; disincentives to lend and to invest in bank deleveraging

An increase in the retention requirement will be particularly problematic for smaller lenders, non-banks and new entrants to the consumer lending, specialist finance, portfolio purchase and SME markets. Such firms are key to the desired de-leveraging process that is so badly needed in Europe. Smaller lenders will find it extremely difficult and onerous to fund higher amounts of retention because unlike larger banks they lack balance sheet capacity.

For example, for auto manufacturers securitisation is a relatively effective and efficient form of funding: increased retention results in a lowering of financing proceeds received. Non-bank and captive auto ABS issuance in 2016 constitutes 64% of the total issuance, so the impact on this important market sector, which funds the real economy, will be significant.

The provision of new and incremental funding to the real economy - particularly from non-bank investors and funds - is a key objective of CMU. Securitisation is key to the ability of such investors to provide such funding, in several jurisdictions. All investors seek a target internal rate of return (IRR) on their capital. To the extent that changes are made which increase the amount of capital required to support new lending then investors will be forced to maintain the same IRR by adjusting the price charged to the underlying borrower.

Market participants have indicated to us that moving from a vertical retention percentage of 5% to 10% could require increasing interest rates charged to borrowers by 0.2%-0.6% in order to retain the same commercial return. Alternatively, a lower IRR could dissuade investors from participating in the market at all.

Purchases of asset portfolios are a key contributor to the de-leveraging process for Europe's banks. For example, over recent years a variety of legacy mortgage portfolios have been sold by banks and government entities to non-bank investors. Expectations are that banks in Italy will need to undertake considerable securitisation of non-performing loans in 2017 and beyond.

A key factor in the success of portfolio sales has been the utilisation of securitisation to fund their purchase. Securitisation has, without question, widened the base of potential buyers and helped increase the price investors have been willing to pay. This has in turn assisted the sellers to achieve the most efficient and cost-effective result for their shareholders and taxpayers.

A number of portfolios have been purchased using a vertical risk retention structure. While precise figures depend on asset class, jurisdiction and other factors, market participants have indicated to us that the impact of an increase in risk retention on the price an investor can pay can be between 0.15% to 0.50%. Given the amount of de-leveraging required by Europe's banking system this is a meaningful additional cost to impose on the market.

As well as the additional cost in absolute terms it is important to note that in the competitive market for portfolio purchases, investors can win or lose based on price differences of as little as 0.05-0.10%. Knowing that pricing could be off-market by up to 0.50% would potentially dissuade those who require a vertical retention structure from participating in the bidding process, which itself requires an up-front investment of time and structuring costs.

Damage to CLO issuance which funds the real economy

CLOs are a form of corporate loan securitisation. Like other forms of securitisation, they can provide additional funding that would not otherwise be available, and transfer risk. The increase in risk retention requirements will damage the viability of CLO issuance in the EU.

CLOs assist banks' leveraged finance businesses to lend more to large and mid-sized corporate borrowers by providing a method for the syndication of loans and risk. Although CLOs are generally not STS eligible, they provide funding to real economy participants.

CLOs provide a means of bringing non-bank investors into the corporate loan market. These investors include insurance companies, pension funds and private equity funds. The encouragement of greater participation in capital markets by such non-bank investors is a principal objective of Capital Markets Union. The over-reliance of Europe on bank funding is widely acknowledged[2].

Thus, the CLO sector helps real economy companies by enabling banks and other entities to recycle capital, and support further lending through their established networks. Retention via a first loss tranche is not an efficient holding option for all CLOs and there has been significant use of the vertical slice holding option in this market to date.

Increases in the retention requirement above 5% will significantly affect the economic efficiency of transactions which in turn will reduce CLO issuance. For example, broadly speaking an increase to 10% (as proposed for the vertical slice holding option) would reduce the return on equity on the risk investment made by the CLO manager to below 5-7% - a level unlikely to be acceptable for the risk.

Elimination of CLO investors from the corporate loan market will mean that less funding is available at a competitive price.

Increased fragmentation of the global market

As mentioned above, 5% is now a global standard and deviations from it will create rather than lower barriers to the flow of capital between the EU and third countries. This will make it more difficult for issuers and investors in the EU to raise funding and to invest.

EU investors will be less able to invest in third country assets; this will have a negative, if indirect, impact on their ability to invest in the EU because reducing diversification in portfolios increases risk and consequently reduces the total amount available for investment.

Reduced ability for banks to transfer risk, limiting the success of CMU

As stated above, transferring risk outside the banking system is a principal objective of CMU. An increased retention percentage will make it more costly for banks to achieve this through "significant

2 See, for example, Larry Fink Chairman and CEO of Blackrock quoted in the Financial Times, 17th January 2017: "Larry Fink calls for Europe to bolster its capital markets; 'Excessive reliance' on banks and insurers to fund growth hobbling region's economy".

risk transfer" (SRT) under Articles 243 and 244 of the CRR. A bank's capacity to do so is evaluated on a case by case basis by its national competent authority (NCA). Other things being equal, the higher the retention percentage, the less efficient is the transfer of risk – reducing incentives for banks to contribute to the success of CMU.

Negative knock-on impact on the leverage ratio

Proposals under CRD 5 enable securitisations which achieve SRT to fall outside the Leverage Ratio for the originator bank. If implemented, this will be a rare example of an incentive, rather than a disincentive, for an originator bank to securitise. But if it becomes more costly and less efficient to achieve SRT (see above), then there will be a damaging knock-on effect on banks' incentives to manage their Leverage Ratio obligations - particularly for low capital-intensive assets such as residential mortgages, and the more constrained bank lending will be. This will damage the real economy in Europe.

A revival of negative stigma for European securitisation, which has performed well

Ten years after the financial crisis, securitisation has only now begun to dissipate the negative stigma caused by the US sub-prime mortgage crisis. From a policy standpoint, to increase the retention requirement today, several years after the financial crisis, will send a very negative signal. This is all the more inappropriate when the credit and price performance of most securitisations in Europe has been excellent.

Grandfathering: new requirements cannot be "retro-fitted" to existing transactions

If co-legislators decide not to accept the arguments in this paper, and to increase the retention requirement, then such a change can only be applied prospectively. It is not possible to increase the retention requirement for existing transactions.

Grandfathering for existing transactions must apply for the whole life of the transactions affected. Further, any new requirements should not be applied with reference to the *issuance* of new liabilities under existing arrangements, but rather apply only to newly *established* arrangements. This is the approach taken under the current regime.

Without sensible grandfathering, asset managers with existing holdings could become forced sellers, damaging market stability and reducing future investment.

See also Article 16a below.

Article 16a proposals create even more uncertainty and instability

The European Parliament's proposal for ongoing review and possible increase of the retention level under proposed Article 16a introduces a source of ongoing uncertainty and instability in the EU regime. This will create further disincentives to use securitisation.

Further, currently, the European Parliament text proposes to provide protection only for those transactions notified at the time of the increase under Articles 243/244 CRR. This would not apply to non-bank originated transactions and/or transactions not undertaken for SRT purposes. Proper provision for grandfathering must be made and this should refer to the retention level required at the time of *establishment* of the relevant transaction to operate properly, and fully protect transactions.

As a separate but related point, the additional sanction under Article 4(1a) suggested by the European Parliament is unworkable. By definition, securitised pools are selected at a given time and in accordance with eligibility criteria that are specific to individual transactions. To compare the performance of different selections or vintages of assets in this context is simply not feasible.

Conclusion

Consequently, changes to the risk retention regime will damage the efficiency and attractiveness of the STS framework and securitisation in general as they will both reduce the efficiency of funding and the capacity of originating banks to "free up" regulatory capital to manage and transfer risk and support further lending. It may be that some sectors will be more severely affected than others, but for some the effect will be existential. This will drive away funding and investment for Europe, and send a highly negative signal regarding securitisation in Europe.

In its proposal "laying down common rules on securitisation and creating a European framework for STS securitisation" the European Commission states:

The development of a simple, transparent and standardized securitisation market constitutes a building block of the CMU and contributes to the Commission's priority objective to support job creation and a return to sustainable growth. A high quality framework for EU securitisation can promote integration of EU financial markets, help diversify funding sources and unlock capital, making it easier for credit institutions and lenders to lend to households and businesses.

We urge policymakers to consider the proposals to change the already well settled and prudent risk retention regime against these policy objectives. The proposals should be evaluated against their propensity to make a successful STS regime and a revived European securitisation market more, rather than less, likely. For the reasons set out in this paper, they should be rejected.

Association for Financial Markets in Europe
Level 39
25 Canada Square
Canary Wharf
London
E14 5LQ
020 3828 2700

www.afme.eu