The following article, written by AFME’s head of capital markets, Rick Watson, appeared in Börsen-Zeitung on 26 July 2012:

*Europe’s securitisation industry has just launched a new label – PCS – for high quality asset-backed securities, but its effectiveness in helping to solve Europe’s funding gap is likely to depend on more positive signals from policymakers.*

Europe’s future economic prospects lie delicately balanced in the face of a long-running eurozone crisis, yet there is another growing area of concern in need of urgent action - Europe’s funding gap.

Recent estimates\(^1\) show that some €650 billion of senior unsecured and covered bond funding will mature in 2012 for European banks; for sovereigns, funding of over €900 billion will be needed, comprising debt roll-over and the next year’s deficit. As the sharp fall in bond issuance seen throughout last year further deepens this funding hole for European banks, it becomes increasingly clear that a healthy European securitisation market is critical to plug this funding gap.

However, despite the numerous advantages of securitisation, the European market remains depressed, with issuance placed with third party investors (rather than the ECB or Bank of England) at approximately €90 billion each year for 2010 and 2011, as compared to €450 billion prior to the crisis\(^2\).

**Breaking the myths**

There are two main reasons for Europe’s stagnant securitisation market. Firstly, since the financial crisis, many investors as well as policymakers perceive all securitisation products to be ‘toxic’, even though European asset-backed securities (ABS) have performed very well from a credit standpoint.

For issuances outstanding in mid-2007, the credit performance of securitised European residential mortgages, auto loans, credit cards, consumer loans and SME loans asset classes was excellent with a 0.09% cumulative default rate. Moreover, last year, European RMBS also performed very well from a price standpoint – outperforming all EU sovereign debt, senior bank debt and most covered bonds (see Figure 1 below).

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\(^1\) Source: Bloomberg and BofA Merrill Lynch Global Research, “European Structured Finance Annual Review” published 2\(^{nd}\) December 2011.

\(^2\) Source: AFME.
Secondly, investors have seen a continual stream of new European regulations in recent years and the cumulative effect, could easily give the impression that policymakers are discouraging investment in all securitisations, of any type. These include Basel III, CRA 3, CRD 2, CRD 3, CRD 4, Solvency 2 and new reporting obligations and national implementing regulations. Securitisations have been noticeably absent from European Central Bank purchase programmes, and based on current proposals will not be eligible in the Basel III nor CRD 4 liquidity buffers. Unless the European Commission changes its views soon, Solvency II is looking to propose capital charges for European insurers that will make securitisations prohibitively expensive for them to invest in.

Disincentive to invest

Another example of regulatory bias against the securitisation market can be seen with the European Commission’s Solvency II Directive which imposes severe capital charges on insurance companies to hold asset-backed securities on their balance sheet. The proposed charges will mean that insurers will be charged approximately 10 times more to hold ABS than to hold covered bonds or corporate bonds. Yet the rationale used by the Commission to reach these figures is seriously flawed - the methodology focuses mainly on US subprime mortgages, is not consistently applied across all asset classes and, furthermore, does not differentiate between different types and levels of risk. If the securitisation market continues to be penalised, it is the real economy that will feel the negative effects.

Launch of the PCS label

In June 2012, the industry launched the Prime Collateralised Securities (PCS) initiative, focusing on developing a label for qualifying securitisations, to be granted and maintained by an independent third party.

Developed by AFME and the European Financial Services Round Table, the label aims to revitalize the market by meeting industry best practices in terms of quality, transparency, simplicity, and standardisation, all of which are preconditions to restore secondary market liquidity.
The independent, not-for-profit PCS label is not intended to replace investor due diligence, nor is it a credit rating. It will only be awarded to securitised products that are backed by asset classes which performed well through the financial crisis and which are also of direct relevance to the real economy.

Investors and regulators need clear reference points, setting out best practices around which to build investment guidelines and regulations, which in turn, will encourage issuance and investment and ultimately support Europe’s economic recovery.

**The right regulatory signals**

It is essential for the industry to have the support of Europe’s policymakers as capital markets undergo regulatory reform at unprecedented levels. It is time that the highest quality forms of securitisation be considered to also receive the same benefits as other types of capital market investments.

This means a more accurate calibration is needed for Solvency II – one which reflects price volatility for high quality securitisation, not US subprime and CDO squared, and takes account of reform of EU and US regulation as well as new and better market practices.

The actual experience of European securitisation demonstrates that a properly regulated and transparent securitisation market is a critical component in a stable, competitive and responsive banking system, which in turn, fuels the real economy. Europe needs this market to get back on its feet, now more than ever.