The Economic Benefits of High Quality Securitisation to the EU Economy

November 2013

Association for Financial Markets in Europe

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1. Executive Summary – The Specific Rationale for Change

Given the current state of the European economy, the impact of the Euro zone crisis, pro-cyclical changes to banking regulation, the inability of many European banks to directly access the capital markets, collateral encumbrance constraints, and investor capacity constraints on bank debt, it is important that European policymakers recognise and take proactive steps, together with the industry, to help encourage investment in high quality securitisations. According to recent estimates, Eurozone banks have shrunk by € 3.3 trillion since May 2012 and it is estimated that they will cut around € 2.8 trillion more assets over the next 3-5 years.[1] Corporate loans and are not expected to surpass their pre-crisis peak of € 4.8 trillion until 2015.[2]

The purpose of this report is to: a) summarise as well as provide details on the specific economic benefits of high quality securitisation to the overall European economy, b) provide information which is beneficial to investors, c) provide relevant highlights on changes to banks and regulations, d) provide data on the state of the European securitisation market, including its strong credit and secondary price performance, and e) provide highlights of recent industry initiatives to identify industry best practices in securitisation, such as the Prime Collateralised Securities ("PCS") initiative.

The specific rationale for increased investment in high quality European securitisations is highlighted below. Points 1-8 focus on funding issues, while the remainder focus on investor issues, financial stability, regulatory measures to date and industry initiatives. Supporting data is provided in the text which follows this Executive Summary.

1. Europe's economy is highly dependent on banks for funding, much more so than other major economies such as the US. In the EU, the size of the banking sector relative to GDP is large; bank assets total approximately 300% of GDP. The US bank sector is substantially smaller as a proportion of GDP than in Europe, with total bank assets just under 100% of GDP. This enables proportionately more borrowers more direct access to the capital markets than in Europe. Further, there is a funding gap estimated to be $ 43-46 trillion globally between 2012 and 2016, of which Europe accounts for at least one quarter.[3] Securitisation is a direct means to the capital markets and is an important means for closing the funding gap.

2. Current regulations have a pro-cyclical impact on banks, which forces them to adjust their balance sheets drastically at a time where the economy is faltering. Securitisations provide a means for banks to raise cash directly from capital markets investors, which enables the banks to continue lending directly to companies and consumers. Many of the regulatory changes create permanent, rather than temporary, changes to lending incentives. EU GDP shrank by -0.2% in 2012, while growth in the US was +2.2%.[4]

[1] RBS Macro Credit Research, *The Revolver,* October 2013.
[2] Ernst & Young, *Outlook for financial services*, Summer Edition 2013.
[3] Standard & Poors
[4] International Monetary Fund (IMF), *Data and Statistics*, 2013; IMF, *World Economic Outlook (WEO)*, April 2013.

3. The specific impact of renewed securitisation on growth has not been quantified, but could be significant in terms of GDP. If securitisations provide funding which is incremental to banks' ability to place bank debt (in other words, is not a substitute for bank debt), and if the cash is used to support new lending (rather than refinancing), even a small net incremental increase in lending meeting these criteria would have positive impact on European GDP. Further research is required on this specific relationship, but in any event, if increased securitisation can lead to increased volume of lending and/or lower prices to borrowers, increased securitisation will be a success.
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4. Covered bonds and high quality securitisations are both means of tapping the capital markets for funding for pools backed by good quality assets. There is clearly a further need of more combined issuance of these two instruments. At the end of 2012, the amount of placed securitisations outstanding in Europe was € 812 billion (€ 1.7 trillion including retained tranches), while the balance of mortgage-backed covered bonds outstanding was € 1.8 trillion (€ 2.5 trillion including public sector covered bonds; the breakout of placed vs. retained for covered bonds requires further research). The combined placed balance of these two instruments is relatively small compared to balances outstanding at December 2012 of Eurozone business loans of € 4.5 trillion, residential mortgages of € 3.8 trillion and consumer credit of € 600 billion.[5] Of course, there are additional "real economy" securitisable assets owned by insurers and other institutions on top of this € 9.1 trillion total for Eurozone banks.

5. Funding provided by new placed issuance activity in both of these sectors is declining. In H1 2013 placed securitisation issuance is down approximately 7%, with issuance at € 35.3 billion, down from € 42.6 billion in H1 2012. Placed covered bond issuance is down 43%, year-on-year through the end of August 2013, with YTD issuance volume of € 93 billion, down from € 164 billion recorded at the same point in 2012.[6] For the full year 2012, there were € 84.8 billion of European securitisations placed with investors, with issuance of placed covered bonds at € 108 billion. This compares to pre-crisis placed securitisation issuance levels of € 450 billion per year in 2006 and 2007.[7] Central bank liquidity initiatives may be one factor in this decline, but there are also other longer-term structural factors impacting investment, such as proposed capital charges and liquidity buffer eligibility.

6. The amount of funding that can be provided through securities/securitisation cannot simply be replaced by loans, although growth in the trading of secondary loans should be encouraged. Tradable "whole loan" pools are significantly less liquid than high quality, large size securitisations. Many institutional investors have the ability to purchase both bonds and loans, so an absence of securitisations can be viewed as wasting potential investment capacity.

7. Securitisation increases banks' flexibility to tap additional sources of cash and liquidity, since securitisation investors look to the performance of asset pools, rather than credit of the bank, for repayment. This significantly broadens the pool of cash to be tapped to support economic growth. Also, unlike other products, given a fixed allocation of capital, securitisations enable originators to increase the amount of cash available to the economy, for those securitisations which transfer sufficient amounts of risk to third parties.

[5] Ernst & Young, cited.
[6] JP Morgan
[7] AFME, *Securitisation Data Report Q2 2013*

8. SMEs are a sector which is particularly sensitive to changes in bank lending, since they cannot access the capital markets directly. In addition, SME lending can be impacted by a multiplier effect since SMEs are often customers of large corporates, and any impact of bank regulations on corporate lending impacts both sectors. Although almost € 160 billion of SME securitisations have been issued since 2010, not enough have been placed with third party investors.

9. From an investor standpoint, high quality securitisations can provide a very good performing asset class for European insurers, and in potentially large size. In 2012 European insurers held € 8.4 trillion of assets and had new cash inflows from new premium of € 1.1 trillion for investment in all types of instruments.[8] Securitisations backed by European receivables have performed well during the crisis, from both a credit and price perspective. The potential for additional funding provided by securitisation is significant; AFME estimates that if sufficient changes were made to the regulatory environment, combined with private sector initiatives such as the PCS initiative, that approximately € 200-300 billion or more of funding could be provided through securitisations sold to third party investors, including insurance companies, pension funds, banks and others.

10. Given policymakers' growing concerns about asset encumbrance, securitisations provide a collateral-efficient means of raising cash as compared to other long-term secured funding techniques. Asset encumbrance reduces the ability of the financial system to absorb shocks; there is currently a shortage of good quality collateral in Europe and globally.[9]

11. Significant regulatory changes in Europe have already addressed pre-crisis concerns of policymakers and investors. Specifically, CRD 2, which has already been implemented, requires issuers to retain at least 5% economic risk in order to better align interests. In addition, investors are also required undertake significant due diligence prior to investment. Similar regulations will take effect for EU insurers under Solvency II. A summary of regulatory measures impacting securitisation is included in the text of this document.

12. To codify best practices in European securitisation, the industry has launched PCS. PCS is a label which identifies best practices in securitisation quality, simplicity/standardisation, and transparency, which are attributes which lead to improved secondary market liquidity. In short, PCS helps define "high quality," although it is recognised there are additional securitisations which are high quality which might are not included in the PCS label for a variety of reasons.

In summary, there are a wide variety of very sound economic reasons why high quality securitisation can provide significant benefits to European growth.

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[8] Insurance Europe, *European Insurance Key Facts*, August 2013

[9] Llewellyn & Dharmasena Independent Consulting, *Financing European Growth; The Challenge for Markets, Policymakers and Investors*, August 2012, available on AFME website www.afme.eu.

What people say:

"Europe needs a healthy securitisation market and we are confident that this initiative, alongside regulatory changes, will revitalise the market as a source of funding for the real economy."
Francesco Papadia, newly appointed Chairman of the Prime Collateralised Securities initiative, November 2012

"IOSCO believes that securitisation markets can play a role in supporting economic growth … Securitisation markets potentially [make] bank lending less sensitive to abrupt changes to the cost of funds, ultimately affecting the availability of finance to economic growth. For that reason, access to these funding sources may be important to those economies experiencing slow growth."
IOSCO, Final Report on "Global Developments in Securitisation Regulation", November 2012

"The ECB welcomes the [PCS] initiative, which aims at increasing the attractiveness of assetbacked securities among investors and originating banks. A well functioning ABS market in the EU would allow investors to diversify their investments and … thereby contribute to a smooth financing of the real economy."
Mario Draghi, President of the European Central Bank in a letter to the European Financial Services Round Table supporting the PCS Initative, June 2012

"EBA believes that the European securitisation market can play an important role in meeting the funding needs of the originators and the asset diversification needs in Europe in the future. The PCS label could be an important component to re-establish a sound and well controlled market for securitisation in Europe."
Andrea Enria, Chairman of the European Banking Authority, June 2012

"From a European perspective, there is a view that securitization is a viable alternative source of funding for the banking sector at a time when it needs funding diversification. Good functioning of, and access to, securitization as a funding alternative would, in turn, support recovery in the real economy."
"There is concern among issuers, in particular, that securitization continues to be stigmatised by subprime crisis events."
IOSCO, Global Developments in Securitization Regulation Consultation Report, p. 4, June 2012

"For investors, RMBS offers the ability to tailor risk/return tradeoffs and their desired degree of liquidity — diversification of credit, interest rate, currency, and maturity exposures — allowing them to match their preferences in these areas more precisely than if they were confined to conventional investment opportunities. For the economy more widely, well operated RMBS make intermediation of financial flows between savers and investors more efficient (including on a crossborder basis). Assets that otherwise be quite illiquid can be mobilized, and financing can be made available to home buyers at lower cost than otherwise."
IIF Global Developments in Securitization Regulation Consultation Report, p. 37, June 2012

"[The securitisation market is] … a very important market that deserves to repair its damaged reputation and restore investor confidence."
Steven Maijoor, Chairman of ESMA, speaking at AFME's European Market Liquidity, Conference, February 2012

"I would like to reaffirm that for the Commission securitisation is considered as an efficient mechanism to increase the credit availability and lower the cost of credit in line with the G20's November 2010 report that noted that "re-establishing securitisation on a sound basis remains a priority in order to support provision of credit to the real economy and improve banks' access to funding in many jurisdictions." Furthermore, there is no question that it is in the private and public sector interest to reactivate securitisation markets.
Emil Paulis, European Commission, speaking at AFME's Funding Conference in Madrid, November 2011

"Securitisation is a useful funding technique for financial institutions, and an efficient means to diversify risk."
FSB, Shadow Banking: Strengthening Oversight and Regulation, p. 21, 27 October 2011

afme/ Finance for Europe

Discussion

2. State of the EU Economy

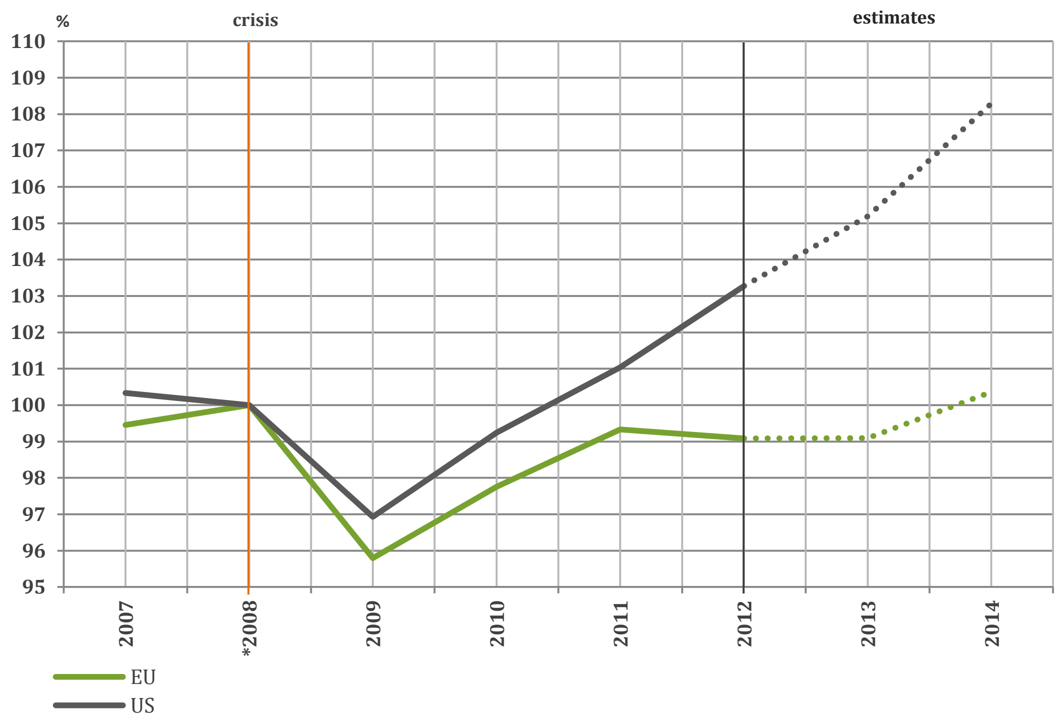
2.1. European vs. US Economic Growth

Europe is facing negative growth and weak investment. According to statistics released by IMF in April 2013, the European Union GDP shrank by 0.2% in 2012 compared with the previous year. A resilient economic performance from the Europe's biggest economy, Germany (+0.8%), was offset by sharp contractions in the economies of Portugal (-3.1%), Italy (-2.3%) and Spain (-1.4%). The Greek economy shrank at an annualised pace of -6.3%.[10]

Other leading countries are showing signs of progress: as a comparison at the end of 2012, GDP in the United States increased by 2.2% compared with the previous year.

Chart 1 below shows the trend in GDP level of the European Union and United States from the onset of the financial crises in 2007. Over this period, the European GDP has risen from its low in 2009, but this increase has gradually subdued and growth flatlined from 2011.

Chart 1 - GDP Levels 2007 - 2014



Source: IMF, AFME

***Note:** 2008 = 100%

[10] International Monetary Fund (IMF), *Data and Statistics*, 2013; IMF, *World Economic Outlook (WEO)*, April 2013

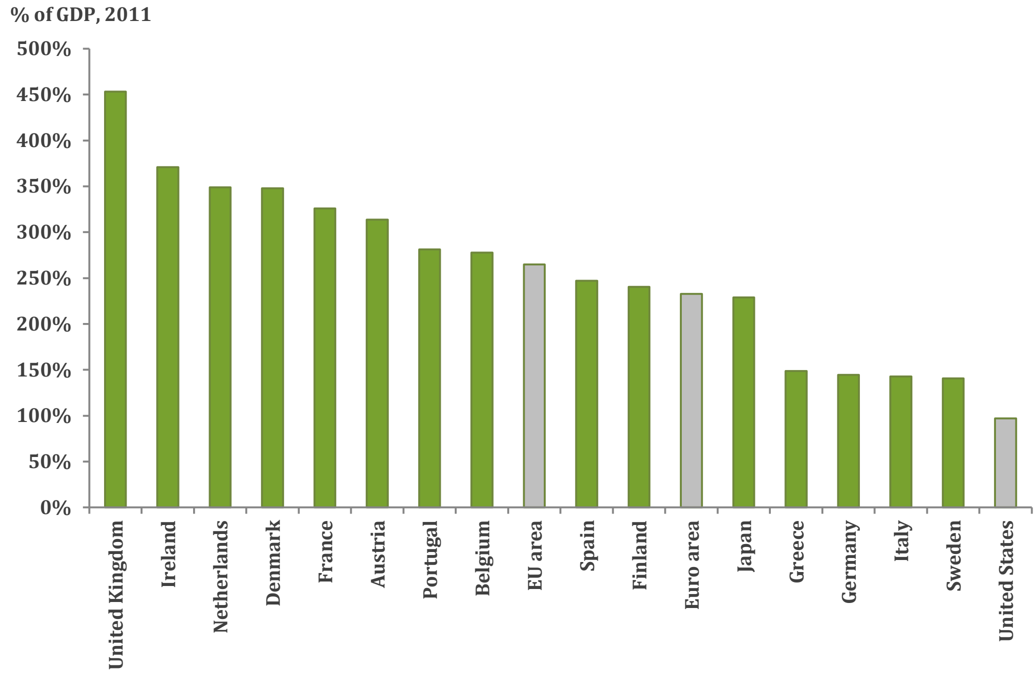
2.2 Unemployment

The EU area's seasonally-adjusted unemployment rate was 11.0% in July 2013, a clear indicator that the European real economy remains depressed. The estimates are that 26.654 million men and women in the EU were unemployed in July 2013. Compared with June 2012, unemployment rose by almost 1 million (995,000).[11]

3. Changes in European Banking Sector

Historically, European banks have provided a significant proportion of funding to the European economy. As Chart 2 shows, for the Eurozone area as a whole, bank assets total around 250% of GDP; for the EU the number is even higher (265%). In the US, capital markets are more developed and larger than in Europe, enabling borrowers more easily to bypass banks. As a result, the US bank sector is substantially smaller than in Europe, with total bank assets just under 100% of GDP. In 2012, stock market capitalisation was $ 18.7 trillion in the US, significantly higher compared to $ 10.4 trillion in the EU.

Chart 2 - Banks' Activities as a Percentage of GDP



Source: IMF GFSR April 2013

[11] Eurostat, *Statistics*, July 2013.

The banking sector has been severely affected by the financial crises. According to the ECB, by the end of 2012, the number of credit institutions, of which almost 80% are banks, in the EU had fallen by 3.1% to 6,019, from 6,334 in 2010.[12] However, it is when looking at banks' balance sheets and funding activities that the negative impact becomes visible. Table 1 provides an overview of the Eurozone's banking sector, highlighting the recent trend in the banks' main asset classes and the prospects for this year.

Table 1 - Overview of Bank Asset Composition in the Eurozone

Values in € billions	**2011**	**2012**	**2013**
Total assets	33,543	32,698	31,842
Total loans	12,322	12,197	11,897
Business/corporate loans	4,720	4,543	4,500
Consumer credit	628	604	595
Residential mortgage loans	3,784	3,831	3,785
Loan/deposit %	113	110	104

Source: Ernst & Young

In the course of last two years, pressures on European banks to deleverage have increased, as funding strains intensified and regulators imposed new capitalisation targets. Eurozone banks have shrunk by € 3.3 trillion since May 2012 and it is estimated that they will cut around € 2.8 trillion more assets over the next 3-5 years, to comply with upcoming European regulatory requirements. Large banks will have to reduce assets by around € 661 billion and raise € 47 billion in additional capital; whereas small and mid-sized banks, vital for lending to SMEs, will reduce assets by around € 2.2 trillion.[13]

Consequently, the amount of credit available to households and companies is also expected to shrink, curtailing consumer spending and business investment and, hence, overall economic growth. As the funding gap widens, an open question is whether other financial institutions will be able to substitute for European banks as the latter continue to deleverage.

Corporate borrowers, especially SMEs, which rely on debt finance for 80% of their funding needs, are continuing to face difficulties in accessing funding. According to a recent ECB survey, between October 2012 and March 2013, Euro Area SMEs reported an increase in external financing needs for bank loans (5%). They also reported a deterioration in the availability of bank loans, although the situation has improved compared with the previous survey (-10% of respondents, in net terms, up from -22%).[14]

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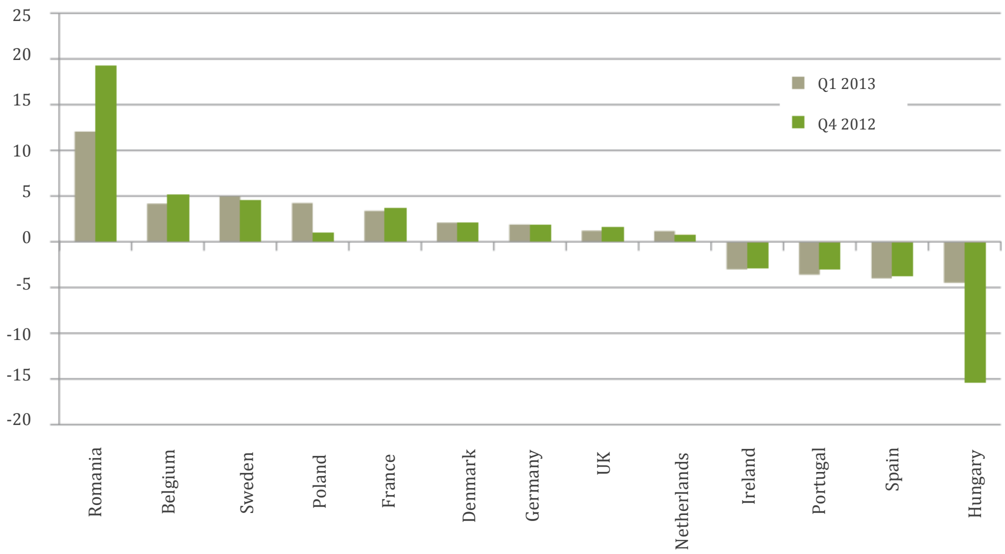
12 ECB, *Financial intermediaries*, http://www.ecb.europa.eu/mopo/eaec/intermediaries/html/index.en.html.

13 RBS Macro Credit Research, *The Revolver,* October 2013. Note: Eurozone bank assets peaked in May 2012

14 ECB, *Survey on the access to finance of Small and Medium-sized Enterprises in the Euro Area: October 2012 to March 2013,* p. 5 and 8.

With regards to the specific asset class of residential mortgage loans, Chart 3 shows, for each country listed, for Q1 2013 and Q4 2012, the growth in this asset class compared with the same quarter in previous year.

Chart 3 - Total Outstanding Residential Lending, Year-on-Year Growth Rates (%)



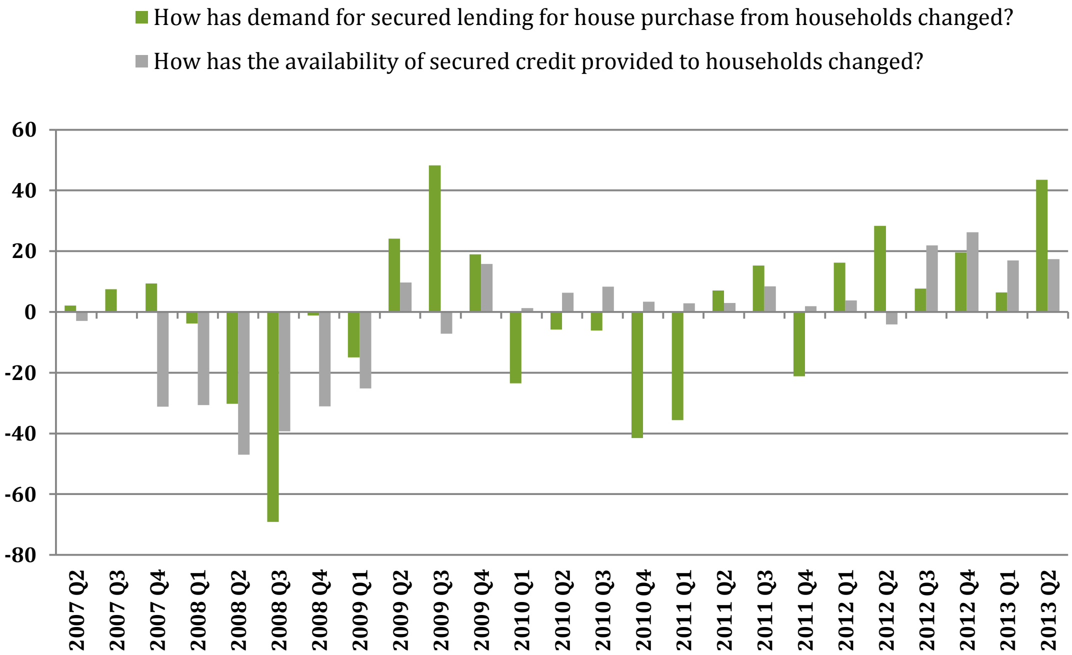
Source: European Mortgage Federation (EMF)

Q1 2013 figures reveal that new mortgage lending continued to be affected by low demand, a result of ongoing macroeconomic tensions (poor GDP growth, high unemployment rates, continued sovereign debt crisis and subsequent high yields). Outstanding values show significant differences across national markets. In Q1 2013, outstanding residential lending contracted quarter-over-quarter for the second consecutive quarter in the European Union and registered its lowest year-over-year increase since Q2 2011.[15]

15 European Mortgage Federation (EMF), *Quarterly Statistics Q1 2013*.

The supply and demand of credit to households has also been impacted during the crisis, as indicated in Chart 4 below.

Chart 4 - Demand and Supply of Credit to Households

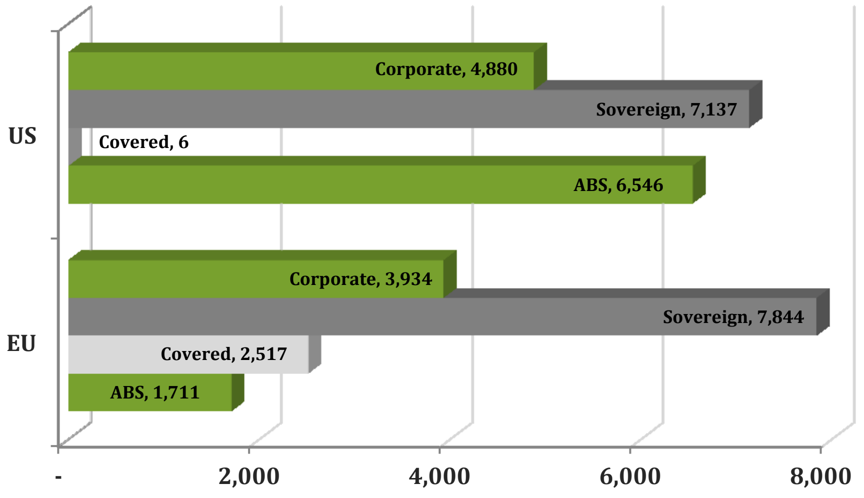


Source: Bank of England Survey Q2 2013

4. State of European Securitisation Market

The major global securitisation markets are in the US and Europe. Chart 5 shows the substantial size of the securitisation market relative to other markets in these regions, reflecting the major role it plays in financing real assets in the European and US economies.

Chart 5 - Bond Market Relative Sizes in US and Europe (end of 2012), €Billions



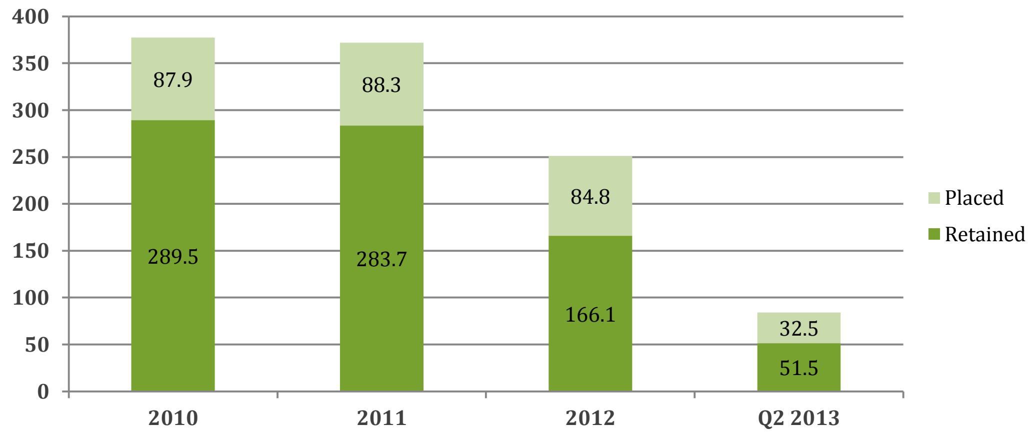
Sources: **ABS:** AFME Securitisation Report Q2 2013 Report. **Corporate:** Bloomberg, AFME, SIFMA. **Covered Bonds:** ECBC European Covered Bond Fact Book 2013. **Sovereign:** ECB (Europe Sovereign: EU27 Central Governments including long-term securities other than shares), SIFMA (US Central Government: bonds, notes and TIPS).

Securitisation grew significantly in Europe and in the euro zone before the crisis.[16] In 2006 and 2007, pre-crisis issuance of European securitisation placed with third party investors reached € 450 billion per year. With the outbreak of the financial crisis, issuance dropped to almost zero in 2008.

[16] European Central Bank, *Shadow Banking in the Euro Area*, 2012.

As Chart 6 below illustrates, during the period 2010-2012, placement with third party investors was still only € 80-90 billion per year, due in large part to macro volatility, regulatory uncertainty and government/central bank liquidity programmes.

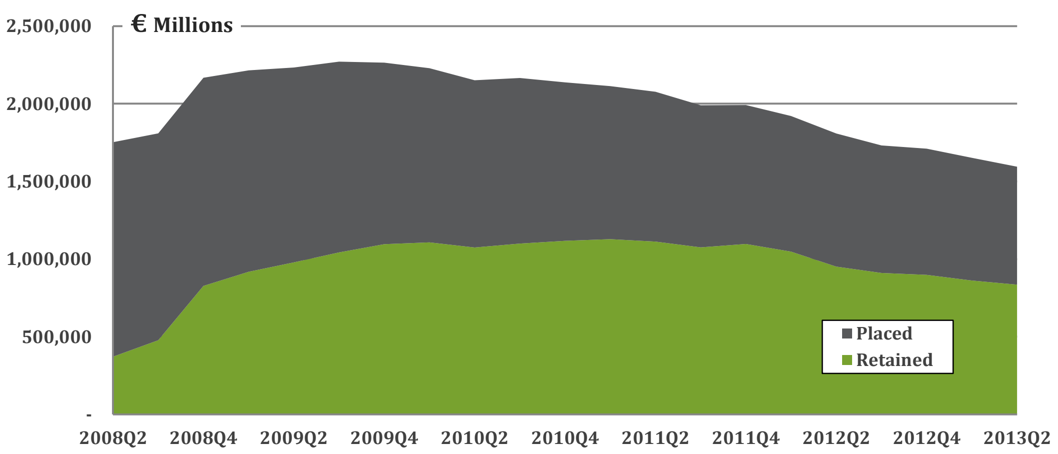
Chart 6 - European Securitisation Issuance 2010–Q2 2013, € Billion



Source: AFME Securitisation Data Report Q2 2013

With regard to outstanding levels of securitised products, Chart 7 below illustrates the trend of placed vs. retained levels from Q2 2007 to the end of Q2 2013. As highlighted, retention activity initiated around Q2 2007, as a result of the financial crisis. As of Q2 2013, approximately 48% of total outstanding was placed with third party investors, while approximately 52% was retained on bank balance sheets, to be used for repo, or used for other secured funding. As a result, approximately € 850 billion of currently outstanding securitisations has been placed with investors, down by one-third from approximately € 1.4 trillion before the crisis.[17]

Chart 7 - European Securitisation Outstanding Q2 2008 - Q2 2013



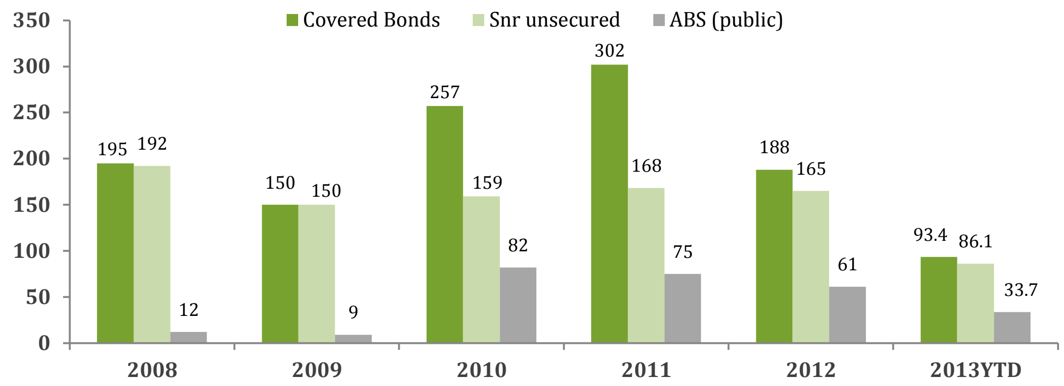
Sources: AFME/SIFMA Members, AFME, Bloomberg, Dealogic, Thomson Reuters, SIFMA
Note: Retained outstandings do not contain retained, then subsequently placed, issues.

17 AFME, *Securitisation Data Report Q2 2013*

4.1 Covered Bond Market

In the covered bond market in 2013 there has been a drop in new issuance levels; at the end of August, distributed covered bond issuance was € 93 billion, a sharp decline of 43% from the € 164 billion recorded at the same point last year.

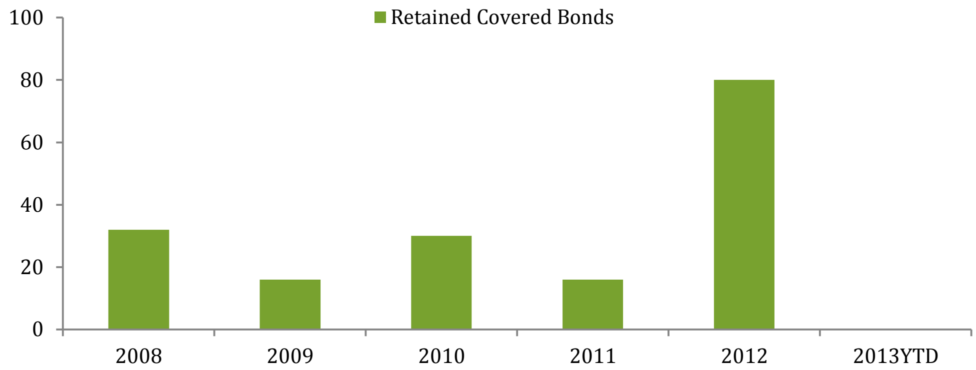
Chart 8 - Covered Bond, ABS and Senior Unsecured Issuance, € Billions



Source: JP Morgan

As highlighted in Chart 9, the decline issuance placed has not coincided with higher retention levels, as no covered bonds were placed at the end of August 2013.

Chart 9 - Retained Covered Bond Issuance, € Billions



Source: JP Morgan

4.2 Securitisation Market

4.2.1 Size of issuance

As indicated in Table 2, at the end of Q2 2013, € 83.5 billion of securitised products were issued in Europe. RMBS issuance was the highest at € 27.9 billion, followed by SME loans (€ 13.6 billion) and Auto securitisations (€ 12 billion). Table 3 offers a breakdown of total issuance levels, highlighting placed vs. retained issuance by asset class; approximately € 18.9 billion of securitised products were placed with third party investors, representing 32% of issuance. In 2011 and 2010, placement of securitised products was respectively, 24% and 23% of total issuance. Despite an increase in placed levels over the last two years, the share of retained issuance is still significant. This is a stark reminder of both the funding difficulties faced by European banks and the important role the ECB is playing as liquidity provider to the European Banking system.[18]

Table 2 - European Issuance by Country and Collateral at Q2 2013, € Billions

	Auto	Consumer	Credit Card	Leases	Other ABS	CDO	CMBS	RMBS	SME	WBS	Total
Belgium											
Denmark	0.8										**0.8**
France	2.1	0.9			0.3						**3.2**
Germany	7.3	1.9					3.9				**13.0**
Greece											
Ireland											
Italy		7.2		1.8				0.1	6.3		**15.5**
Netherlands	0.1							22.0			**22.1**
Portugal					0.5				1.1		**1.5**
Spain				1.2	1.6			0.8	6.0		**9.5**
United Kingdom	1.3		2.1				2.4	5.0		3.5	**14.2**
PanEurope						2.4					**2.4**
Other Europe	0.5		0.2		0.3				0.3		**1.2**
Multinational											
Total	**12.0**	**10.0**	**2.2**	**3.0**	**2.6**	**2.4**	**6.3**	**27.9**	**13.6**	**3.5**	**83.5**

Source: AFME Securitisation Data Reports

18 OECD, *Outlook for the Securitisation Market*, 2011

Table 3 - European Issuance by Collateral Retained vs. Placed Q2 2013, € Billions

Retained	2010	2011	2012	Q2 2013
ABS	17.2	44.0	23.3	19.7
CDO	26.2	8.6	0.7	0.4
CMBS	1.7	0.2	0.9	0.5
RMBS	205.1	171.6	97.2	14.6
SME	38.2	59.3	44.2	12.9
WBS	-	-	-	-
Total	**288.3**	**283.7**	**166.2**	**48.2**

Placed	2010	2011	2012	Q2 2013
ABS	14.2	29.5	29.2	10.1
CDO	3.5	1.0	12.8	2.0
CMBS	4.4	1.9	4.2	5.7
RMBS	61.0	52.4	35.6	13.3
SME	1.5	1.3	1.0	0.7
WBS	4.5	2.2	2.1	3.5
Total	**89.0**	**88.3**	**84.8**	**35.3**

Source: AFME Securitisation Data Reports

4.2.2 Balances outstanding

As indicated in Table 4, at the end of Q2 2013 European securitised debt outstanding was approximately € 1.6 trillion. Securitisations backed by real economy assets such as RMBS were the largest asset class, with € 920 billion outstanding. Consumer ABS outstanding was € 211 billion, and securitisations backed by SMEs were € 136 billion.

Table 4 - Summary of Outstanding by Collateral Q2 2011, 2012, 2013, € Billions

	Q2 2011	Q2 2012	Q2 2013
ABS	207.9	208.3	211.5
CDO	226.2	177.7	152.6
CMBS	149.0	127.9	113.0
RMBS	1,263.5	1,069.1	920.1
SME	173.0	166.4	136.6
WBS	58.2	59.2	61.0
Total	**2,077.8**	**1,808.6**	**1,594.7**

Source: AFME Securitisation Data Reports

Table 5 below offers a breakdown of total securitisation outstanding in Europe by asset class and country. The largest outstanding levels are in the UK market (€ 459 billion), the Netherlands (€ 278 billion) and Italy (€ 189 billion).

Table 5 - European Outstanding by Country and Collateral 2013 Q2, € Billions

	ABS	CDO	CMBS	RMBS	SME
Austria			0.2	1.9	
Belgium	0.1		0.2	68.3	18.1
Finland	0.2				
France	20.6		2.0	16.6	3.0
Germany	35.6	2.2	16.3	16.2	5.4
Greece	15.5	1.8		5.8	7.3
Ireland	0.3	0.2	0.4	45.5	
Italy	56.6	3.6	9.8	88.3	30.3
Netherlands	5.2	1.1	2.8	260.8	8.8
Portugal	5.2			27.0	6.0
Russia	0.0			1.5	
Spain	20.7	0.5	0.4	118.5	44.2
Turkey	1.8				
UK	42.6	16.4	63.5	269.5	8.1
Other	3.7	0.8		0.1	0.1
PanEurope	1.7	31.7	15.2	0.2	4.7
Multinational	1.8	94.2	2.1		0.5
Total	**211.5**	**152.6**	**113.0**	**920.1**	**136.6**

Source: AFME Securitisation Data Report Q2 2013

4.2.3 Asset Credit Quality Performance

Despite the fact that the performance of European securitisation has been very good, it still has a bad reputation which is undeserved. Unlike certain products such as US subprime and CDOs squared, the vast majority of European securitisations have performed well through the crisis from three perspectives.

a. Credit Performance

Credit performance has been excellent, for almost all product sectors. As Table 6 below shows, only 0.08% of European RMBS outstanding before the crisis started in 2007 have defaulted (all tranches, including those below AAA).

Table 6 - European Securitisation Default Performance, by Asset Class Q2 2007 – Q1 2013

	Original Issuance (€ billion)	Default Rate (%)
Europe		
Total PCS eligible asset classes	**959.9**	**0.10**
Credit Cards	33.2	0.00
RMBS	755.7	0.08
Other Consumer ABS	68.0	0.13
SMEs	103.0	0.29
Only senior tranches to be PCS labelled, the default rate for which is zero, like Covered Bonds		
Total Non-PCS eligible asset classes	**732.6**	**5.30**
Leveraged Loan CLOs	71.3	0.1
Other ABS	71.3	0.16
Corporate Securitisations	65.8	0.34
Synthetic Corporate CDOs	254.3	2.76
CMBS	163.2	9.08
Other CDOs	77.8	6.37
CDOs of ABS	28.9	40.21
Total European securitisation issuances	**1,692.5**	**2.35**
Covered Bonds	**1,085.0**	**0.00**
Total European issuances	**2,777.5**	**1.43**
Select US asset classes		
Credit Cards	295.4	0.04
Autos	198.2	0.04
Student Loans	266.8	0.29
RMBS	3,254.9	19.80

Source: Standard & Poor's

A study further attests the resilience of EMEA ABS and RMBS in crisis years. Between 2007 and 2011 the migration of investment-grade securities to impairment/default was minimal:

- 1.0% of total investment-grade ABS tranches became impaired and 2.0% of total transactions issued;
- 1.47% of total investment–grade RMBS tranches became impaired and 3.8% of transactions outstanding during the period.[19]

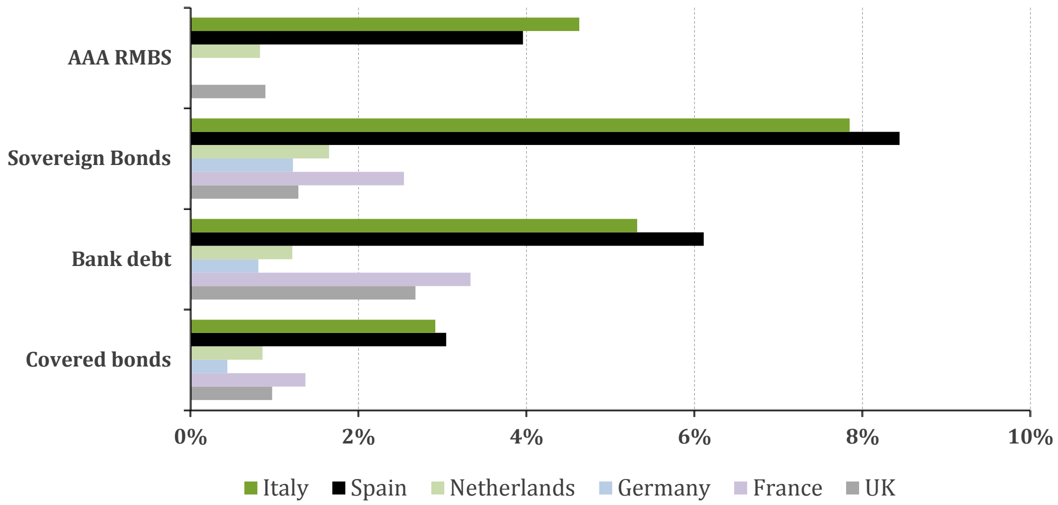
[19] Standard & Poors, *EMEA Structured Finance Report*, June 2012

b. Secondary Market Price Performance

As Chart 11 and Table 7 below show, during the period from January 2011 to July 2013, the market price performance of European RMBS has been superior to most EU sovereign debt, senior bank debt and many covered bonds.

Chart 11 - Market Price Performance Jan 2011 – Jul 2013

European RMBS vs. Sovereign Debt, Bank Debt and Covered Bonds



Source: BofA Merrill Lynch Global Research

Table 7 - European RMBS Price Performance vs. Other Instruments

Spread volatility by sector

	2011				2012				2013 to end July			
	CB	Bank	Sovs	RMBS	CB	Bank	Sovs	RMBS	CB	Bank	Sovs	RMBS
UK	0.9%	3.3%	1.1%	0.8%	1.0%	2.2%	1.6%	1.0%	0.4%	1.4%	0.7%	0.6%
France	1.5%	4.3%	3.1%	-	1.2%	2.7%	2.5%	-	0.5%	1.6%	0.8%	-
Germany	0.4%	0.8%	1.3%	-	0.5%	0.8%	1.2%	-	0.2%	0.6%	1.0%	-
Netherlands	0.7%	1.1%	1.9%	0.9%	1.0%	1.0%	1.8%	0.8%	0.8%	1.6%	0.8%	0.7%
Spain	2.3%	6.1%	8.8%	3.6%	3.3%	7.0%	9.5%	4.6%	3.4%	3.9%	5.2%	3.1%
Sweden	0.4%	2.6%	1.0%	-	0.5%	1.6%	1.4%	-	0.3%	1.0%	1.2%	-
Italy	3.0%	6.2%	9.1%	4.3%	2.7%	4.9%	7.5%	5.2%	2.0%	3.6%	5.1%	3.0%

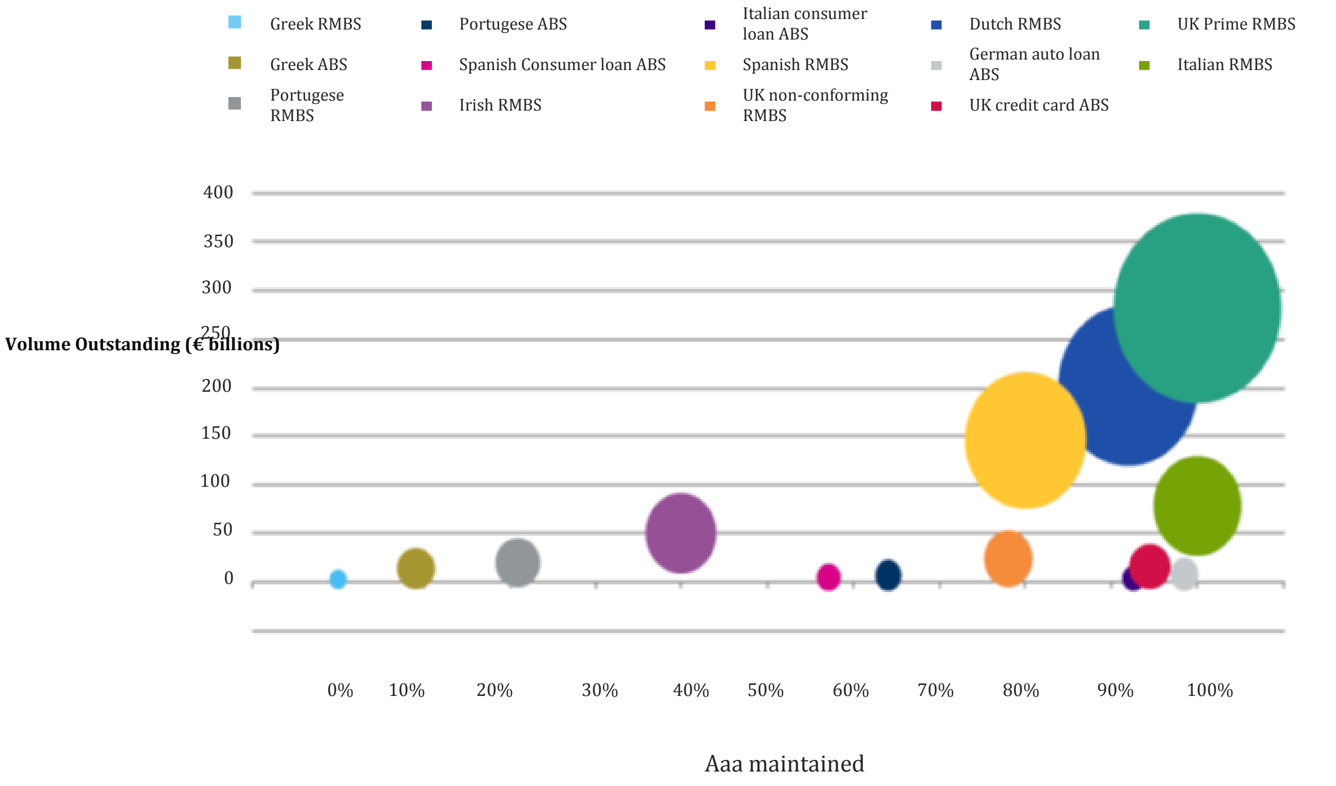
Source: BofA Merrill Lynch Global Research

c. Ratings Performance

As Chart 12 shows, the credit ratings performance of most AAA tranches has been very good, with downgrades mostly in countries experiencing sovereign downgrades.

Chart 12 - European Securitisation AAA Tranche Ratings Performance

Portion of ABS and RMBS Aaa maintained, May 2007 to May 2011 (by market size)



Source: Moody's Investor Service

5. Assisting the funding of SMEs and the Real Economy

SMEs are the backbone of the EU economy, accounting for 99% by number of enterprises in the EU and for 85% of new job creation between 2002 and 2010. A mix of bank regulatory reforms and the current economic downturn has hindered bank lending significantly, consequently affecting SMEs, whom rely on debt finance as their prime funding source.

A recent ECB survey, has confirmed the gap between SMEs' demand for funds and their supply. Between October 2012 and March 2013, Euro Area SMEs reported an increase in external financing needs for bank loans (5%). They also reported a deterioration in the availability of bank loans, although the situation has improved compared with the previous survey (-10% of respondents, up from -22%).[20]

In 2012 the Breedon report estimated a finance gap for UK SMEs between £ 84 billion and £ 191 billion over the following five years.[21]

A possible source of liquidity for banks providing finance for smaller companies is the loan securitisation market. Publicly-available statistics from Standard & Poor's show that in the period from 2007 to 2013, the amount of funding provided through SME loan securitisation has been significant and performed very well: € 103 billion of SME loan securitisation was issued and rated by S&P, with a very small cumulative default rate across all tranches of 0.29% of total issuance.

Therefore, securitised products could play an important role in reducing the funding gap by helping to free up banks to clear their balance sheets for further SME lending.

[20] ECB, *Survey on the access to finance of Small and Medium-sized Enterprises in the Euro Area,* cited.

[21] *Boosting Finance Options For Business ("Breedon Report")*, March 2012, http://www.bis.gov.uk/assets/biscore/enterprise/docs/b/12-668-boosting-finance-options-for-business.pdf.
See also the feasibility study, prepared by a Taskforce led by AFME, to explore the creation of an aggregation agency to lend directly to SMEs and/or to pool SME loans to facilitate SME access to the public corporate bond markets, available at the following link http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=7139

6. Implications of Certain Regulatory Measures

As Table 8 below indicates, the financial industry and investors in the securitisation market are being targeting with a significant amount of regulatory reforms, both at European and international level, the full cumulative impact of which could be excessive and damaging. The table below highlights the advantages and disadvantages of each regulatory measure. One of the most pressing issues is the negative effects Basel III, CRD4 and Solvency II will have on corporate lending. The combined impact for businesses across Europe could be higher funding costs, lower availability of longer term credit and a lower equity investor base.[22] The effects will particularly harsh on SMEs, the smaller and less creditworthy companies, at a time when they are already facing significant difficulties in their access to finance.

Table 8 - Increased Global Regulatory Burden on ABS Issuers and Investors

Regulation	Date	Advantages	Disadvantages
Capital and non-risk-based prudential measures			
Basel proposals for revised RWA	Proposed December 2012; discussions continuing. Re-proposal expected late 2013, AFME is cautiously optimistic that a more balanced calibration will be proposed.	Intend to address perceived misalignment of bank capital with risk during the financial crisis. Aim to increase risk sensitivity, remove cliff effects, reduce reliance on ratings.	Objectives not achieved and will severely discourage investment in SME securitisation. Not risk sensitive - capital requirements vary only within a narrow band between caps and floors. Cliff effects remain. Reliance on ratings not eliminated. Complex, difficult to implement, and inconsistent.
EU Solvency II proposals	Detailed discussions underway between AFME and EIOPA with a view to achieving a more balanced calibration.	Modernises risk management for insurance company investors.	Extremely harsh capital charges (ten times that for identically rated covered bonds) will and have driven insurance company investors away from SME securitisation .
BCBS proposals for recognising the cost of credit protection purchased	Proposed March 2013; discussions continuing.	Intend to prevent banks from reducing capital requirements while deferring recognition of expected losses and without transferring credit risk to third parties.	While capturing a small number of transactions deemed abusive, the rule will have a disproportionate effect and make it more difficult for banks to manage SME risk on their balance sheets in the context of securitisation and generally. This should be addressed by regulatory supervision and changes to accounting standards, without amendments to Pillar 1 rules.
Basel proposals for measuring and controlling large exposures	Consultation paper issued March 2013 for response June 2013.	Non-risk based measure intended to complement regulatory capital rules.	Proposes a look-through approach requiring information which often cannot be disclosed within the law, and imposes substantial compliance burdens not balanced by prudential benefits.
EU proposals for measuring and controlling large exposures (draft RTS under CRR)	Consultation paper issued Mary 2013 for comment August 2013.	Non-risk based measure intended to complement regulatory capital rules.	As above. Exceedingly conservative approach which ignores credit enhancement. Reduces existing "granularity exemption" to 0% bringing small companies and natural persons within scope.
Basel proposals for leverage ratio	Proposed July 2013; work in progress	Intention is to create a non-risk based measure for prudential framework.	Including securitisations which achieve significant risk transfer is overly conservative and will make it harder for banks to deleverage.

[22] *Why Basel III and Solvency II Will Hurt Corporate Borrowing In Europe More Than In the US*, Standard & Poor's, September 2011

Regulation	Date	Advantages	Disadvantages
Liquidity			
Basel Liquidity Coverage Ratio	In force as of January 2013. Consultation on disclosure standards announced July 2013.	Only some limited types of RMBS included.	SME loans remain excluded, along with many other types of "real economy" assets. Will reduce investor appetite for SME securitisation.
EU Liquidity Coverage Ratio (CRR)	Work in progress: expected to be in force in 2015	Primary text of CRR allows for inclusion of certain securitisations.	Calibration delegated to EBA. Discussions continue, but progress is slow and methodology opaque.
EU outflow calibrations for liquidity lines to ABCP conduits	Work in progress: expected to be in force in 2015	Intend to reduce risk of liquidity runs on banks.	As above. Proposals equated multi-seller ABCP conduits funding real economy assets with "arbitrage" SIVs. Calibration harsh and not evidence-based. Will discourage funding of SME securitisations through ABCP conduits.
Securitisation-specific			
EU bank investor due diligence requirements (Regulation 575/2013 – "CRR")	Introduced January 2011 but under review as of May 2013	Forces less investor reliance on CRAs.	Increases investor compliance process.
EU risk retention requirements for banks (CRR)	Introduced January 2011 but under review as of May 2013	Mandates alignment of incentives, although most originators already held "skin in the game".	Places burden of compliance on investors and discourages new investors from entering the market. Uncertainty created by May 2013 proposed RTS which will not be finalised until well into 2014.
EU equivalent due diligence and risk retention requirements for insurance company investors and AIFMs	July 2013 and ongoing	As above, provisions are designed to be equivalent to bank rules.	Rules are not consistent and (for AIFMs) require a higher due diligence burden than for banks. Will drive AIFM investors away.
ECB and Bank of England increased investor reporting, standardised definitions and prospectuses, cash flow models	Throughout 2011 - 2014	Improves investor confidence through better data granularity and transparency.	Industry has adjusted, although issuers incur increased IT and compliance costs. Need consistency. Overlapping between different sets of disclosure requirements duplicates the compliance burden.
EU increased disclosure requirements (Article 8b Regulation 1060/2009)	Mid-2014	Stated objective is to increase transparency.	High standards of transparency already exist and are separately already mandated by law (CRR - see above). Parallel regime unnecessary and creates compliance uncertainty.
Derivatives			
IOSCO and Basel proposals for initial and variation margin on non-centrally-cleared derivatives (also EMIR in Europe)	Final Policy Framework published September 2013	Increases collateral available to conterparties; reduces systemic risk.	Securitisation structures require swaps to manage interest currency and basis risk for end-investors. However, the structures do not have collateral available to provide margin. All collateral is pledged to investors. Published requirements seem to create some flexibility in this regard, but issue remains under review by industry.

7. Conclusion

Securitisation is a key funding tool in Europe and a channel for borrowers to access capital markets. Traditionally, it has contributed to funding real economy assets such as residential mortgages, auto loans and SME lending and other assets. At a time when businesses and households across the EU are experiencing difficulties in accessing finance, securitisation can improve the availability of credit, by allowing banks to free up their balance sheets for further lending.

The European securitisation market has been significantly affected by the financial crisis and current macroeconomic volatility. Placed issuance levels have dropped to € 80-90 billion from € 450 billion of pre-crisis years (2006-2007). Moreover, investment in the market has stalled due to uncertainty and negative signaling surrounding the new set of regulatory measures.

While a regulatory framework which creates a well–functioning, transparent securitization market is necessary, its unintended consequences need to be considered. Under Basel III/CRD IV, banks, traditionally the key investors in the securitisation sector, will now be forced to increase capital, deleverage and change the mix of assets they have available to meet regulatory standards; as a consequence, a reduction in their exposure to securitized products is likely.

With Solvency 2, very harsh capital requirements are likely to eliminate altogether demand for securitised products from insurance companies.

With key players pulling out of the market, serious doubts are being raised about which part of the investor community will be capable of filling the void. In general, the new regulation regime risks imperiling the region's already struggling securitization market, further constricting credit supply to Europe's economy.

From the industry side, AFME has been active in trying to revive the securitisation market in Europe with important initiatives such as its Prime Collateralised Securities ("PCS") securitisation labelling project. The purpose of PCS is to identify market best practices in terms of securitisation quality, transparency and simplicity/standardisation, leading to improved secondary market liquidity; however, it is necessary that initiatives from the private side be complemented by appropriate policy measures.

A recovery in the securitisation market should play an important role in unlocking credit markets and supporting a wider economic recovery across Europe. In the light of this, it is important for policymakers to support the sector through well calibrated regulatory measures.