

The importance of securitisation for jobs and growth in Europe

Perspectives on the post-crisis stigma and considerations in the STS debate

Investors, originators issuers and other market participants represented by the above signatories are committed to supporting a safe and sustainable securitisation market that serves the real economy in Europe.

Despite the strong performance of European securitisation through and since the financial crisis, the market has suffered in recent years. The association of the securitisation technique with the excesses and bad behaviour seen in the US sub-prime mortgage market has led to high capital charges and harsh treatment under liquidity rules – with regulatory costs for holding securitisation paper several times higher than other similarly-rated products. As a result, new issuance levels continue to be low and participants are leaving the market.

We believe the current European debate represents a unique opportunity for the rehabilitation of securitisation on the basis of an optimal framework that benefits the economy and incorporates lessons from the financial crisis.

Policymakers and the general public are justified to raise questions about the risks and benefits of seeking a revival of securitisation in Europe. In this paper we address topics that have been raised since the publication of the European Commission's proposals on securitisation as part of the Capital Markets Union. We hope that this contribution can help to make a positive case for the rehabilitation of securitisation to the benefit of Europe's businesses, borrowers and consumers.

The signatories below – representing a range of participants in European securitisation markets – are convinced that:

- Securitisation can support SMEs and households in many different ways;
- A revival of sound securitisation can help diversify risks, thereby making the financial system more stable;
- A well-designed STS framework will deliver “simple”, “transparent” and “standardised” securitisations;
- Transparency and disclosure standards are already robust in the European market – further requirements should build on existing infrastructure and be carefully calibrated;
- The lessons of the crisis have been learned and reflected in EU regulations;
- Investor due diligence is important, but unnecessary duplication should be avoided as it disincentivises investment;
- Risk retention is important: the existing rules ensure alignment of interests and sufficient “skin in the game” for those who securitise;
- Tranching is common across all debt markets and an essential feature of the securitisation technique to meet investors' needs.

1. Securitisation can support SMEs and households in many different ways

While no silver bullet exists for the challenges facing European SMEs, securitisation can undoubtedly provide a strong contribution to Europe's economic recovery by helping provide finance to SMEs at all stages of the supply chain.

Securitisation finance can support SME economic activity not just directly but also indirectly, supporting demand for SMEs' goods and services across the whole economy.

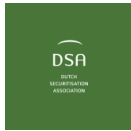
For example, *direct* benefits can be seen in the securitisation of bank loans to SMEs. These securitisations are then sold to investors. This helps banks free up balance sheet capacity that can then be used to grant new credit. The outstanding amount of securitisations of SME loans in Europe is currently €84.1bn, with annual issuance during 2015 amounting to €27bn. However, of 2015 issuance, €25bn was retained but only €2bn placed with investors. This shows that while securitisation meets an important need for SMEs, there is too much reliance on central bank funding because investors are discouraged by factors including regulation as noted under point 5 below. To reduce such reliance, the proposed STS framework must be successful.

In addition, *indirect* benefits to SMEs can come from the development of other securitisation segments that free up space on bank balance sheets to enable them to lend further to SMEs. Securitisation should be considered on a holistic basis, across all asset classes and across the whole economy.

For example:

- Securitisation can finance not just direct loans to SMEs, but also SMEs' working capital (in the form of trade receivables) and leases of crucial assets such as vehicles and manufacturing equipment. Leasing and hire purchase is the most often used source of finance by SMEs after credit lines and overdrafts.
- Tranching Covers – a specific category of synthetic securitizations of SME loans assisted by public authorities or public guarantee schemes – also help enhance access to finance for SMEs. The public guarantee for such instruments is generally provided by public entities to banks with the condition that the latter commit to use the capital relief obtained by the use of securitisation in favour of new SME lending¹.
- Securitisation can also finance the cash flows of SMEs at many different stages in their business: for example through receivables owed by one SME to another or by helping the SME's customer to buy the ultimate product.
- The asset-backed commercial paper (ABCP) market is a major source of credit for European SMEs. An annual average of €288bn of ABCP has been issued in the last five years, with 63% of these funding trade receivables, floorplan loans (stock finance for auto dealers) and equipment leases, which are primarily granted to SMEs.

¹ http://www.eif.org/what_we_do/guarantees/sme_initiative/index.htm?lang=-en



- Even securitisation of residential mortgages can have a positive impact on SMEs and households alike, as the act of house purchase makes a strong contribution to wider economic activity by stimulating demand for the purchase of associated goods and services such as furniture, carpets, interior redecoration, washing machines and other white goods. These are all economic sectors where SMEs play a key role.

The signatories do not claim that securitisation is a panacea. Nor do we argue it should supplant other financing options for SMEs such as equity, venture capital and crowdfunding – securitisation is complementary to these other channels, which we also need to bolster as part of the CMU Action Plan. While Europe continues to develop a stronger equity culture, securitisation can act as a bridge from bank balance sheets – where most SMEs currently obtain their funding – to the capital markets. In the present stage of the economic cycle, securitisation can provide much-needed incremental funding to the real economy and contribute to developing wider and deeper capital markets and high quality investment opportunities. We concur with the European Commission’s estimation that if EU securitisation issuance was restored to its pre-crisis average, it would generate between €100-150bn in additional funding for the economy².

2. A revival of sound securitisation can help diversify risks, thereby making the financial system more stable³

As well as raising cash to lend to the real economy, securitisation can also be used to manage risk. It is a technique that converts a pool of illiquid loans into more liquid and transferable securities that can be sold to investors. As a result securitisation helps to partially remove credit risk from bank balance sheets, enabling banks to recycle and reallocate capital and strengthen their capital ratios.

One of the key drivers of the Capital Markets Union project is the need to reduce Europe’s over-reliance on banks. Securitisation allows banks to share some of the risks from the loans they originate with informed institutional investors who are well-placed to assess and manage such risks.

² European Commission Fact Sheet: http://europa.eu/rapid/press-release_MEMO-15-5733_en.htm?locale=en

³ The signatories fully support the following analysis by the ECB and BoE in their joint paper “The case for a better functioning securitisation market in the European Union” (2014): *Subject to meeting retention requirements, credit risk transfer away from the banking sector can be beneficial to the real economy, the banking sector and both monetary and financial stability. First, where risk is genuinely transferred to non-bank investors, it can free up bank capital, allowing banks to extend new credit to the real economy. This may support the transmission of accommodative monetary policy, where the bank lending channel may otherwise be impaired. It may also reduce the dependency of banks’ lending decisions on business cycle conditions and lower the exposure of real economy borrowers to re-financing or liquidity risk, thereby increasing banks’ resilience and helping to contain systemic risk. Second, if properly structured, securitisations may reduce the potential for concerns to arise around banks’ balance sheets, thus limiting the degree to which banks’ funding sources are withdrawn during times of stress.* Available at: <http://www.bankofengland.co.uk/publications/Documents/news/2014/paper300514.pdf>



In the case of “true sale” securitisations, assets are transferred to a ring-fenced vehicle which issues securities to investors backed by the transferred assets. Similarly, risk sharing transactions (synthetic securitisations) result in sharing credit risk of a designated pool of assets via guarantees or derivative products from non-bank investors.

Securitisation whether undertaken by banks, finance companies or corporates meets the needs of important investors outside the banking system, such as insurance companies and asset managers investing on behalf of pension funds, by enabling them to gain exposure to real economy consumer and corporate assets in an efficient manner. Investors seek diversification of investments as part of their risk management duties towards their clients. With an appropriate calibration of the respective prudential regimes, securitisation can offer high quality diversified investments with attractive risk-return profiles when compared to other asset classes.

It is important to note that securitisation does not seek to eliminate risk in the financial system. It is impractical to seek to regulate away *all* risks involved in securitisation or any other financial product. It makes no more sense to seek to remove all risk from securitisation than to remove it from government bonds, covered bonds, corporate bonds or equities. Sensible risk-taking is what creates rewards for investors (returns) and issuers (risk-reduction) alike. Thus we believe that the new framework's criteria should seek to validate existing best practice in terms of transparency and simplicity for securitisations that have performed very well in Europe. Capital requirements for transactions meeting the STS criteria should therefore be more in line with those for other high quality investments such as covered bonds.

3. A well-designed STS framework will deliver “simple”, “transparent” and “standardised” securitisations

Like most other fixed income securities, securitisation involves a certain degree of complexity and sophistication. For this reason, the investor base for securitisation includes specialised entities including banks, insurers, asset managers, hedge funds, pension funds, public sector entities and large corporates, amongst others. The STS proposals should be beneficial in leading to an expansion of the investor base while retaining the specialised nature of the market. However, to be clear, we do not believe that securitisation (whether STS or not) is suitable for direct sale to retail investors.

Part of the current regulatory complexity is derived from the range of separate European pieces of legislation regulating securitisation (see point five below). The Commission's STS proposals have the advantage of harmonising and consolidating existing sectoral regimes in areas such as risk retention, due diligence and transparency, thus bringing greater clarity for market participants.

While the STS criteria proposed by the Commission are indeed numerous and very stringent, they provide the necessary safeguards against the bad behavior seen in the US sub-prime mortgage market. We stress the following (non-exhaustive) components of the proposed STS framework which promote simplicity, consistency, transparency and standardisation:

- STS Regulation introduces a single uniform regulatory framework for securitisation;
- EU originators, sponsors and original lenders would have a *direct* obligation to retain 5% net economic interest, in addition to the current indirect approach where the risk retention requirement is included in investor sectoral legislation (meaning the requirement is formally placed on investors to check that transactions comply);
- Assets packaged in a securitisation must meet stringent lending, homogeneity and underwriting standards;
- Complex structures are excluded: no “re-securitisations”, NPL transactions or “CDO squared” will qualify;
- Sufficient credit history must be provided for exposures similar to those securitised so that their default risk can be reliably estimated;
- The contractual obligations, duties and responsibilities of all key parties to the securitisation must be clearly specified.

Compliance with the new framework must be practical, quick and certain for issuers and investors. As the EU co-legislators debate the Commission’s proposals, we believe there is scope to further improve certain provisions to maximise clarity, consistency, and speed of obtaining the STS designation along with stability of the STS designation once obtained⁴. It will be important to appoint and regulate one or more independent, credible bodies to issue certification of STS compliance under appropriate supervision. Also a consistent interpretation of the STS designation amongst competent authorities is vital for the success of the new framework.

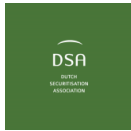
4. Transparency and disclosure standards are already robust in the European market – further requirements should build on existing infrastructure and be carefully calibrated

Securitisation as whole has been tarnished by stigma resulting from shortcomings in disclosure prevalent in the run-up to the financial crisis in certain overly complex structures (such as some CDOs and CDO squared) which used securitisation techniques to create instruments that were opaque. It is important to distinguish these products, which (rightly) fall outside the STS framework, from the STS securitisation market where, being an asset-based form of borrowing, disclosure is extensive. Disclosure in mainstream securitisation is already substantially greater than in many other forms of capital raising as timely, granular information on the precise assets – in most cases, every single underlying loan – is made available to investors supporting throughout the life of the securitisation their investment decisions.

The signatories support further improvements in the scope and accessibility of disclosure. However, care should be taken to ensure that a sensible balance is struck, both with proper

⁴ Further feedback is provided in the following representations:

Investors and issuers unite to support Simple, Transparent and Standardised securitisation (March 2016); and *Joint Note on the EU Commission’s Proposals on Simple, Transparent and Standardised securitisation* (March 2016) Both available at: Available at <http://afme.eu/WorkArea/DownloadAsset.aspx?id=13915>



recognition of the legitimate and reasonable commercial and confidentiality concerns of originators and ensuring that high quality data that is practically useful is delivered to investors. The need for adjusted, principles-based transparency requirements for private transactions (including ABCP) is particularly important.

Building on existing work in this field and existing infrastructure such as the European DataWarehouse⁵ - rather than taking time, effort and expense creating and complying with overlapping portals and diverse regimes - is more likely to deliver accessible, high quality, useful data for investors, in the shortest timescale, lowest cost to the taxpayer and importantly - without further disincentivising issuers. Information on investors, whether disclosed by the issuer or competent authorities/ESMA, and on the transactions they engage in, needs to be protected. Disclosures should only be required when *actually* serving a purpose and then be explicitly subject to confidentiality and data protection regulation.

While some further development may be needed, the objectives behind the proposal for a European Securitisation Data Repository could be best, most practically and most quickly achieved by building on the existing infrastructure, for example the European DataWarehouse.

5. The lessons of the crisis have been learned and reflected in EU regulations

A broad range of regulations and industry initiatives have been put in place in response to the misuse of securitisation in the US sub-prime mortgage market in the run-up to the financial crisis.

As a result securitisation is already one of the most – if not the most – heavily regulated of fixed income products/financial tools, with the most conservative calibrations.

Regulated areas	Framework References
Risk retention: ensured better alignment of risk between issuers and investors	CRR, AIFMD, UCITS, Solvency II
Credit risk: strengthened already robust lending and underwriting practices in Europe	CRD IV/CRR/Mortgage Credit Directive/Consumer Credit Directive
Investor due diligence	CRR, AIFMD, Solvency II

⁵ European DataWarehouse (ED) is an initiative created in 2012 as part of the implementation of the European Central Bank ABS Loan Level Initiative. ED is funded and owned by a mix of market participants. In addition, the European Central Bank (ECB) and National Central Banks (NCB) participate as observers to the Board of ED. ED operates as a utility to respond to the need for improved transparency to investors and other market participants in ABS. ED is the first central data warehouse in Europe for collecting, validating and making available for download detailed, standardised and asset class specific loan level data (LLD) for Asset-Backed Securities (ABS) transactions. Developed, owned and operated by the market, ED helps to facilitate risk assessment and to improve transparency standards for European ABS deals. More information: <https://eurodw.eu/>

Regulated originators	Mortgage Credit Directive/Consumer Credit Directive/CRR/CRD IV
Transparency & disclosure: Increased transparency requirements enabling investors better to assess risks	CRR, CRA3, European Data Warehouse, ECB data templates, BoE data templates
Reduced reliance on credit ratings	CRA3, CRR
Basis risk: stronger derivatives counterparties, margin requirements and clearing obligations for non-CCP OTC-directives	EMIR
Liquidity risk: Liquidity Coverage Ratio	CRD IV/ CRR
Insurance investor capital	Solvency II
Bank investor capital	CRR
Money Market Fund investor requirements	MMFs Regulation (under negotiation)
Significant Risk Transfer and Implicit Support	CRR

The signatories are of the view that excessive capital and liquidity requirements on banks and insurers, together with other factors, are discouraging the recovery of securitisation markets in Europe. Some of the harsh calibrations have been calculated based on the very poor performance of the US sub-prime mortgage market and do not reflect the strong historic credit and price performance of European securitisations⁶.

6. Investor due diligence is important, but unnecessary duplication should be avoided as it disincentivises investment

Double due diligence efforts in case of hiring of an external manager, need to be avoided. When institutional investors outsource purchasing decisions to professional investment funds the due diligence should be only conducted once. A publication of investor’s due diligence is an unnecessary and costly process. Regulated asset-managers should be entitled to perform the due diligence on the assets they are delegated to select and purchase on behalf of end investors.

Prospective investors need to have access to all information. Both elements are extremely important to investors in order to be able to actually be able to enter into a transaction.

⁶ Default rates of European ABS (3-Year default rates) within the ‘AAA’ segment have been almost zero, even during the crisis. For further data and information see: EBA Report on Qualifying Securitisation available at: <https://www.eba.europa.eu/documents/10180/950548/EBA+report+on+qualifying+securitisation.pdf>

7. Risk retention is important: the existing rules ensure alignment of interests and sufficient “skin in the game” for those who securitise

The signatories strongly support risk retention (“skin-in-the-game”) requirements as a core component of the regulatory framework for securitisation. Risk retention practices have been well established in Europe since before the financial crisis and have been enshrined in regulation in the post-crisis regulatory response.

The existing 5% risk retention level was well considered and agreed by the EU co-legislators in 2009. There are specific reasons why the 5% value was selected, including technical considerations related to the interaction with accounting standards.

The effectiveness of the risk retention regime, which has been formally in place since 1 January 2011, has been reviewed and corroborated by CEBS in 2009, the European Commission in 2010 and EBA in December 2014. The 5% level has become a *de facto* global standard in the IOSCO/FSB/BCBS global framework, as well as in the US which has followed Europe’s lead in introducing a requirement at the same level.

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. In fact, we believe it could harm the financial system as higher retention requirements restrict banks’ ability to pledge assets in times of market stress, as well as reducing the potential for capital relief, thereby reducing lending to the real economy.

Proposals to increase the risk retention level – or introduce a differentiated approach to the amount of risk retention – 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. Smaller lenders and new entrants to the consumer lending, specialist finance and SME markets will find it difficult to fund higher levels of retention as they lack balance sheet capacity. A differentiated approach will create confusion for both issuers and investors.

8. Tranching is common across all debt markets and an essential feature of the securitisation technique to meet investors’ needs

Tranching is a simple mechanism to create bonds for the same issuer with different credit, maturity features and risk profiles. Tranching, or other similar techniques, is common across debt markets – it is for instance used in infrastructure finance as well as in structuring corporate balance sheets. Tranching is, for example, central to the Investment Plan for Europe as it is used in structuring EFSI investments.



Tranching is essential in securitisation because it allows the cash flow from the underlying assets to be allocated to different investor groups according to their investment preferences. Far from hindering the quality of securitised products, the technique of tranching cashflows facilitates the creation of higher or lower quality investments to meet different investors' appetites for risk and return, or particular maturities or currencies.

Investors buying the senior tranche receive in priority the cash-flows from 100% of the portfolio, while those buying the non-senior tranches only get paid after all payments owed to the senior tranche are made. In many cases the junior tranche is retained by the originator of the portfolio.

Tranching does not increase or decrease the risk in the pool of assets, nor does it add undue complexity. It simply facilitates the distribution of risk and provides investors with diversification in terms of risk-return in accordance with their investment mandates. Some appear to suggest that a prescribed number of tranches within a securitisation structure is automatically linked to a higher degree of risk, or greater leverage. This is not correct, not least because it ignores the importance of the underlying assets, underwriting criteria, the broader structure of the securitised product, originator incentives and the transparency/disclosure regime.

Conclusion

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 standardised 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 wholeheartedly concur with this important policy objective and urge EU legislators in particular to bear the themes and arguments set out above in mind as the debate progresses.