afme/
Finance for Europe

High-quality securitisation for Europe

The market at a crossroads

June 2014

Association for Financial Markets in Europe
www.afme.eu

Contents

Preface

The legislative cycle after the 2014 European elections should be focused on long-term growth. As the new European Commissioners and MEPs look forward to the next five years, they have a key task – to introduce legislation that promotes sustainable economic growth in Europe, so reducing unemployment and debt through improving the structure of the pan-European economy.

Substantial progress has been made in establishing a framework of financial regulation that reduces the risk of the banking system endangering the economy again. As that framework moves from legislation to implementation, it is time to focus on addressing the growth agenda.

The European Commission acknowledges in its 'roadmap to meet the long-term financing needs of the European economy',[1] that the funding model needs to be improved. Europe is too reliant on its banks for funding and needs to develop its capital markets in order to improve the availability and cost of finance. As the Commission says, if long-term growth is to be improved, then companies need better access to large and liquid capital markets.

This paper highlights the potential for high-quality securitisation in Europe to play a part in unlocking jobs and growth. Yet for it to do so, the proposed regulatory framework needs to be sensibly calibrated – recognising risk, but also taking into account the strong performance of high-quality securitisation in Europe over the past few years.

We welcome the support of central banks and policymakers in calling for a revival of high-quality securitisation, and stating that a revived and sustainable securitisation market would contribute to lower cost of capital, higher economic growth and a broader distribution of risk.

In our view, there is an urgent need for coordinated action to revive securitisation. It would be a first step in helping Europe's banks fund their customers more efficiently. It would broaden the range of tools available to help them manage and transfer risk. And it would also help rebalance Europe's financial system by widening and deepening its capital markets.

Simon Lewis
Chief Executive, Association for Financial Markets in Europe

1 Commission roadmap to meet the long-term financing needs of the European Economy, 27 March 2014

Introduction

I would like to thank all our members, fellow trade associations and especially the real economy issuers and investors who have taken the time to contribute to this report. AFME's work to revive high-quality securitisation in Europe would not be possible without your support.

Europe is indeed at a crossroads in its treatment of securitisation. One road is paved with balanced, evidence-based regulation that protects against risk, but also recognises the strong credit and price performance of European high-quality securitisation through and since the financial crisis.

If we take that road, we will swiftly arrive at a new, rebuilt and sustainable high-quality securitisation market, serving the needs of real consumers, real businesses and the real economy.

The other path takes us to a place where all securitisation is treated as "sub-prime". Our destination will be a Europe where securitisation volumes continue to stagnate or decline, investors exit the market, capital markets lose diversity and skills, and consumers, businesses and the economy are constrained.

Yves Mersch, Member of the Executive Board of the ECB and a keynote speaker at Global ABS 2014, a major annual gathering of the European asset-backed securities (ABS) community, recognised the stark nature of this regulatory choice when he warned in November 2013 of "calibrating the price of flood insurance on the experience of New Orleans for a city like Madrid".

Three key regulations currently being finalised will determine the future size and shape of the European market for the coming years. The Basel re-proposal of new rules for risk-weighted assets will determine the appetite of bank investors. Solvency II will set capital weightings for insurance company investors and the asset managers who manage funds on their behalf. And the Liquidity Coverage Ratio under the Capital Requirements Regulation will establish whether or not banks have an incentive to hold a wide range of high-quality securitisations in their portfolios.

AFME very much appreciates the constructive engagement we have had with the regulators leading these important work streams. In many cases, our concerns have been noted and reflected in changed proposals. However, much work remains to be done before the strong performance of high-quality securitisation is fully recognised – treated on a level playing field with other fixed-income instruments, and properly calibrated to the risk of the underlying assets.

Let us hope 2014 is the year when that recognition is achieved.

Richard Hopkin
Managing Director, Securitisation, Association for Financial Markets in Europe

1. Executive summary

- Central banks and policy makers are calling for a revival of Europe's securitisation market. The European Commission's March 2014 Communication on Long-Term Financing of the European Economy explicitly noted the ability of securitisation to "unlock capital resources, increasing the ability of banks to expand their lending and finance economic growth." Predicting future volumes is difficult, but, by way of example, if securitisation regained even the issuance volumes of a decade ago, this could release up to €150bn a year of funding for Europe, benefiting vital economic sectors and southern Europe's 'crisis' economies.[2] With the right regulatory framework, significantly greater amounts are achievable.

- The regulatory treatment of securitisation in Europe is complex and under review. While there have been significant positive changes, there is a risk that the final rules do not allow the market to flourish. Fundamentally, the current regulatory treatment was calibrated to reflect the weak performance of some US securitised assets – notably, US sub-prime mortgages – during the financial crisis, rather than the strong performance of European securitisation.

- For all the market's attractions in terms of providing finance for industry and a rewarding investment for institutional investors such as pension funds, banks and insurance companies, it is shrinking in Europe. Although total issuance in Europe for 2013 was €181bn – a fall of 28% from 2012 – only €76.4bn of this, or less than half, was placed with investors. The rest was retained by issuers and used for repo purposes with the European Central Bank (ECB) or national central banks. AFME's latest statistics show this trend continuing. For the first quarter of this year (2014), the volume of placed issuance fell to only €13.6bn.

- Representatives of key sectors of the economy – including the car industry, small- and medium-sized enterprises (SMEs) and mortgage lenders – fear that new regulation will reduce their access to capital and raise the cost of financing. They foresee that new regulations, if introduced in their current form, would increase the funding gap for SMEs that already exists in some European countries, while harming the growth prospects of important industries such as Germany's car manufacturers.

- Against this background, AFME is calling for an urgent, coordinated international solution to the discriminatory treatment of securitised assets — in particular, the Basel proposals for risk-weighted assets, the Basel rules and European proposals for the Liquidity Coverage Ratio (LCR) and Europe's Solvency II capital requirements. The right regulatory choices will enable securitisation to play its rightful role in funding Europe's real economy, strengthen capital markets and create the right incentives for broader participation by non-bank investors to support the banking system; 2014 will be a pivotal year for securitisation.

- Securitisation market participants have already taken steps to learn the lessons of the past and embrace sensible new regulations, frameworks and practices, and will continue to do so.

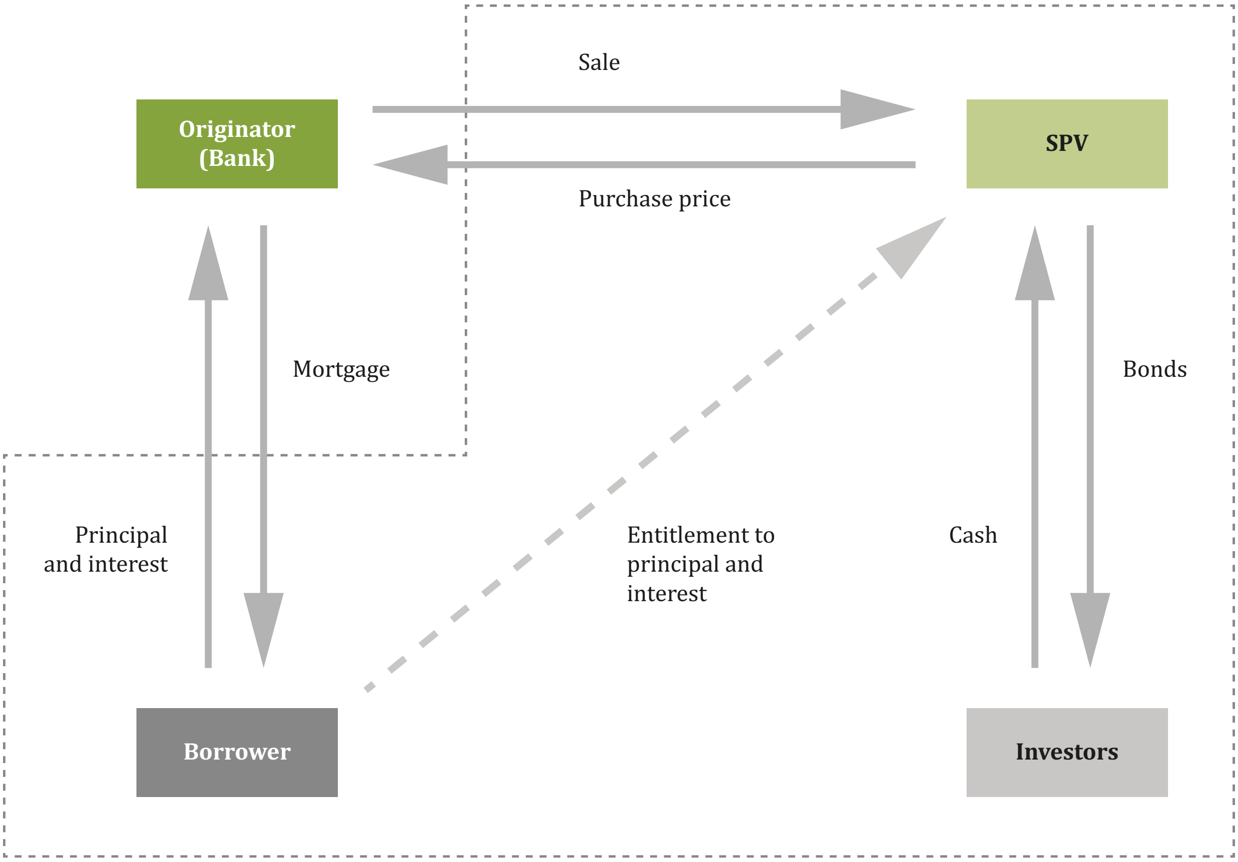
2 In 2001 to 2004, before the pre-crisis boom, placement of securitisation with investors was €75bn-€150bn higher than in 2013 (approximately €150bn-€240bn, versus €76.4bn in 2013), according to AFME data. AFME and Oliver Wyman's joint report "Unlocking finding for European investment and growth" (June 2013) also addressed securitisation and other issues in the context of the growth debate.

What is securitisation?

Securitisation is the pooling together of cash-generating assets, such as mortgages, auto loans or SME loans, created by banks and initially funded on their balance sheets, and funding these assets instead by issuing bonds in the capital markets.

These bonds are bought by a range of investors – typically banks' treasury departments, insurance companies and a range of investment funds. The investors receive regular payments reflecting the interest and principal payments made by the underlying borrowers. Often, the bonds are divided into different tranches with different characteristics and varying levels of risk. The higher-risk tranches yield a higher return for investors.

Figure 1: **A basic securitisation structure**



The **Bank** (the **Originator**) grants a mortgage to the **Borrower**, who in exchange pays principal and interest.

The **Bank**, the owner of the assets, sells a pool of mortgages that are to be securitised to an **SPV** (Special Purpose Vehicle). An SPV is a stand-alone entity, created exclusively for the purpose of the securitisation.

The SPV pays the purchase price to the bank by issuing debt securities (bonds) to investors, typically on a floating-rate basis. The interest payments to investors are funded by cash flows generated by the underlying assets.

Although the Borrower still makes payments to the originator – usually also the servicer of the mortgages – the entitlement to the principal and interest is transferred to the SPV via a ring-fenced (dotted line) financial structure protecting the bonds from a default of the Originator.

2. What policymakers say

Momentum for a recalibration of regulations governing securitisation is growing – as shown by the increasing number of statements from central bankers and policymakers, in both the EU and US.

European Central Bank and Bank of England joint paper, April 2014

“A market for prudently designed ABS has the potential to improve the efficiency of resource allocation in the economy and to allow for better risk sharing. It does so by transforming relatively illiquid assets into more liquid securities. These can then be sold to investors, thereby allowing originators to obtain funding and, potentially, transfer part of the underlying risk, while investors in such securities can diversify their portfolios in terms of risk and return. This can lead to lower costs of capital, higher economic growth and a broader distribution of risk.”

Jose Vinals, International Monetary Fund (IMF) Financial Counsellor and Director of the Monetary and Capital Markets, *Boersen Zeitung*, April 2014

“It could be very helpful to adjust the regulatory treatment so that for safe asset-backed securities, such as those in Europe, risk weights apply that better reflect the low risk compared to the complex structures in the United States.”

Yves Mersch, Member of the Executive Board of the European Central Bank, speech at Deutsche Boerse – Clearstream *‘Exchange of Ideas’* event, London, April 2014

“There is a need to restore coherence across financial sectors in particular amid the unfavourable regulatory treatment of (high-quality) securitisation instruments without violating prudential principles. By doing so, we must act fast and in a manner that is sensitive to our own European reality. If the Bank of England and the ECB were to put forward a joint statement on this issue at the forthcoming IMF Spring Meetings, it would underline the European determination to decisively move forward.”

Mario Draghi, President of the European Central Bank, press conference following ECB Governing Council meeting, March 2014

“If we consider just the revitalisation of the ABS market, there are many things that need to change in regulation and in legislation. Today, the capital charges for ABS discriminate ABS unfavourably with respect to other instruments with similar degrees of riskiness. The current capital regulation of ABS was calibrated on a reality which is not the European one. To give you an idea, I can’t remember exactly the period of reference, but let’s say over five or ten years, the default rate of ABS in the United States was 17.4%; in Europe, it was 1.4%. So you see that the capital charges are certainly not being calibrated on European ABS, which are traditionally of a much simpler, transparent and unstructured form. These things have to be changed, and it will be up to the Basel Committee and the European Commission, as far as legislation within the EU is concerned, to change some of these regulations. Also there are issues like the sovereign cap: ABS are rated according to their sovereign – perhaps with a few points difference, but this often does not make much sense. So there are several issues and, in the end, it may well be the case that, to launch this market, one may need third-party guarantees. So, it is a complex thing on which the ECB’s staff is working.”

Mario Draghi, President of the European Central Bank, *Financial Times*, March 2014

“We think that a revitalisation of a certain type of [asset-backed security], a so-called plain vanilla [asset-backed security], capable of packaging together loans, bank loans, capable of being rated, priced and traded, would be a very important instrument for revitalising credit flows and for our own monetary policy.

Yves Mersch, Member of the Executive Board of the European Central Bank, speech to the *Institute of International European Affairs*, Dublin, February 2014

“This is why I have been vocal in supporting the revitalisation of the securitisation market in Europe, which has virtually dried up in recent years. I see this as an important tool to help banks manage the credit risk associated with lending to SMEs. However, for it to recover it is critical that the regulatory treatment of asset-backed securities (ABS) is based on real data and not the legacy of the US sub-prime disaster. We have a very different experience with ABS here in Europe: between mid-2007 and the first quarter of 2013 the default rate on ABS in the EU was only around 1.4%, whereas it was 17.4% in the United States.”

Andrew Haldane, Director of Financial Stability at the Bank of England, December 2013

“… securitisation could be the “financing vehicle for all seasons” if proper standards are maintained […]. In a world where we are squeezing risk out of the banking system we would want a simple, safe, vibrant set of channels for non-bank financing to emerge and securitisation is one of those.”

Yves Mersch, Member of the Executive Board of the European Central Bank, November 2013

“… we should promote other forms of financing to complement the banking channel […] through strengthening capital markets and in particular securitisation […] We need to revive this market. This implies removing some key impediments to its functioning.”

Mark Carney, Governor of the Bank of England, discussion about restoring SME lending, August 2013

…”a well-functioning securitisation market does mean more efficient balance sheets for the financial sector as a whole that frees up capacity, which then can have a knock on effect.”

Governor Daniel K. Tarullo, Federal Reserve, March 2013

“The growth and deepening of capital markets lowered financing costs for many companies and, through innovations such as securitisation, helped expand the availability of capital for mortgage lending.”

Thomas J. Curry, Comptroller of the Currency, January 2013

“The credit-availability pendulum has swung, as it was bound to do, in reaction to poor performance of the underlying assets, home price instability, and a lack of investor demand for anything other than a government-guaranteed product. As these factors abate, underwriting standards will need to find a new equilibrium of risk and reward for a sustainable mortgage market. Getting the securitisation pipeline flowing again is a critical component in turning this picture around.”

What is 'high-quality securitisation'?

High-quality securitisation is a concept that differentiates securitised assets that have performed well, with low underlying loan default rates, from those that performed poorly in the crisis. The concept has received increased attention from regulators in recent months as calls to revive the securitisation market have increased in frequency and volume.

As yet, there is no single universal definition of 'high-quality' – although there is a range of methods for differentiating premium-standard securitised assets. The European Central Bank (ECB) and the European Insurance and Occupational Pensions Authority (EIOPA) have different definitions of what constitutes premium quality, designed to serve their slightly different needs.

The European Banking Authority (EBA) has been asked by the European Commission to research and advise on this concept further. In 2012, AFME, together with the European Financial Services Round Table, established the Prime Collateralised Securities (PCS) initiative. PCS is now an independent entity established to help rehabilitate the European securitisation market by assigning labels denoting adherence to certain standards for quality, transparency, simplicity and standardisation throughout the asset-backed market.

While these different approaches share a common principle, much work remains to be done to agree a single universal definition that can be recognised in regulation.

Case study: Implications for Germany's car industry

If the proposed regulatory changes affecting securitisation are not amended, they will have "serious negative repercussions for the refinancing and therefore the sales, of the German automotive industry," according to a paper published by the Verband der Automobilindustrie (VDA) in May 2013.[3]

Highlighting the damage that the Basel proposals for risk-weighted assets, Liquidity Coverage Ratio (LCR) and Solvency II capital requirements in their current form would do, the German car industry's trade association called for a revision to the proposed regulatory framework for securitisations.

In the eyes of the VDA, the new regulations do not take into account the strong credit performance and liquidity of auto asset-backed securities (auto ABS). Failure to amend the regulatory framework to reflect this historical evidence would, according to the paper, drive banks and insurance companies away from the auto ABS market, "with serious negative repercussions for the real economy."

Illustrating the importance of auto ABS to car sales, in 2012 some 9% of the 3.4 million cars sold in Germany were refinanced through securitising sales receivables. Additionally, SMEs used ABS-backed leases to finance their car pools. Further demonstrating the importance of securitisation, Stefan Rolf, Head of Asset Backed Securitisation, Volkswagen Financial Services AG, estimates that around 14% of Volkswagen's worldwide car sales are refinanced through ABS.

In the same year, German car manufacturers employed 420,000 staff, while their vehicles were sold through a network of approximately 18,000 independent dealers.

To avoid damage to the sector, the VDA paper concludes that refinancing through auto ABS should not be restricted by "inappropriate increases in equity capital for bank investors and insurance companies and by exclusion in the LCR calculation."

3 Position on the proposed changes in the regulatory framework for credit securitisations, May 2013. VDA, BDI, AKA.

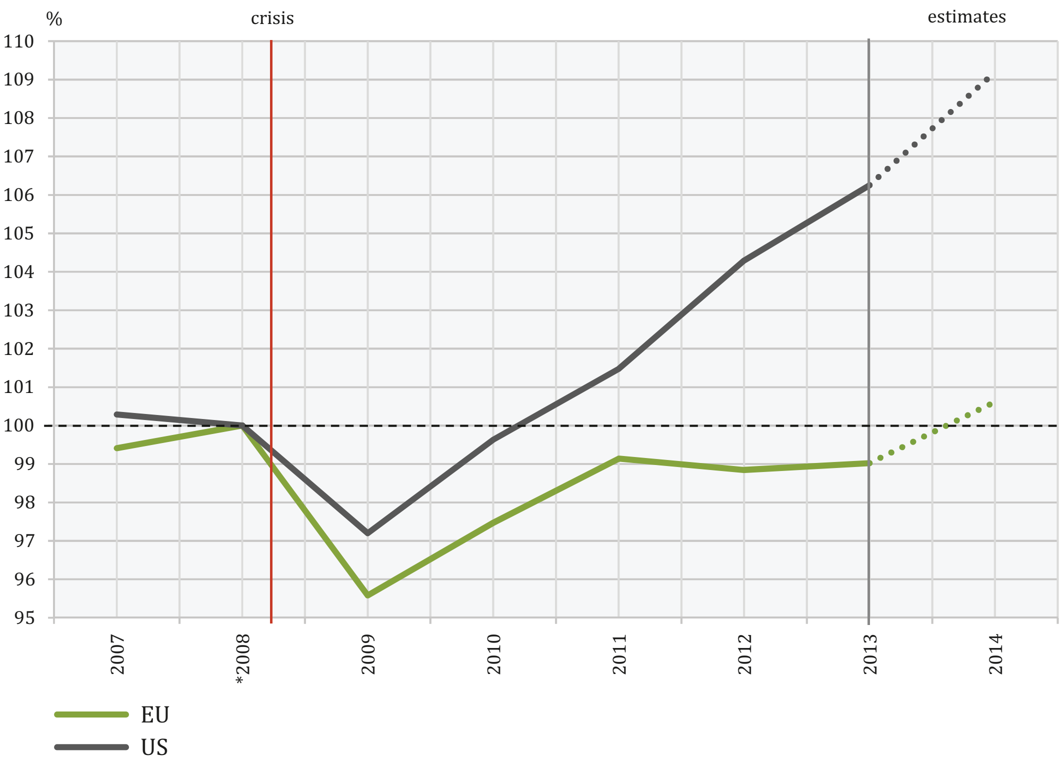
3. The EU's structural need for stronger capital markets

Europe faces an enormous challenge in the years ahead to stimulate growth, increase employment and dispel the threat of deflation. To achieve this, it needs a financial system that can deliver enough capital at the right price. Yet Europe is highly reliant on bank funding at a time when banks are deleveraging, and there is a funding gap for SMEs in some countries.

The economic and financial crisis has reduced the ability of banks to provide funding; increasing the structural need to develop capital markets financing, at least at the level of medium-sized and larger companies. The European Commission recognises this in its "roadmap to meet the long-term financing needs of the European economy",[4] which, among other things, prioritises developing liquid and transparent capital markets, including revived securitisation markets.

As the EU economies return to growth in 2014, remaining weaknesses emphasise the need for structural improvement. The Euro area shrank by -0.5% in 2013, according to the IMF, but is expected to expand by 1.2% in 2014 (Chart 1). Yet the pace of growth remains uneven, with Germany forecast to grow at 1.7%, while Italy, Spain and Greece are expected to grow at only 0.6%, 0.9% and 0.6% respectively.[5] High unemployment and debt, low inflation, contracting private sector credit in the crisis countries, low investment and persistent output gaps are weighing on the recovery.

Chart 1: **GDP Levels 2007 - 2014**



Source: IMF, AFME

*Note: 2008 = 100%

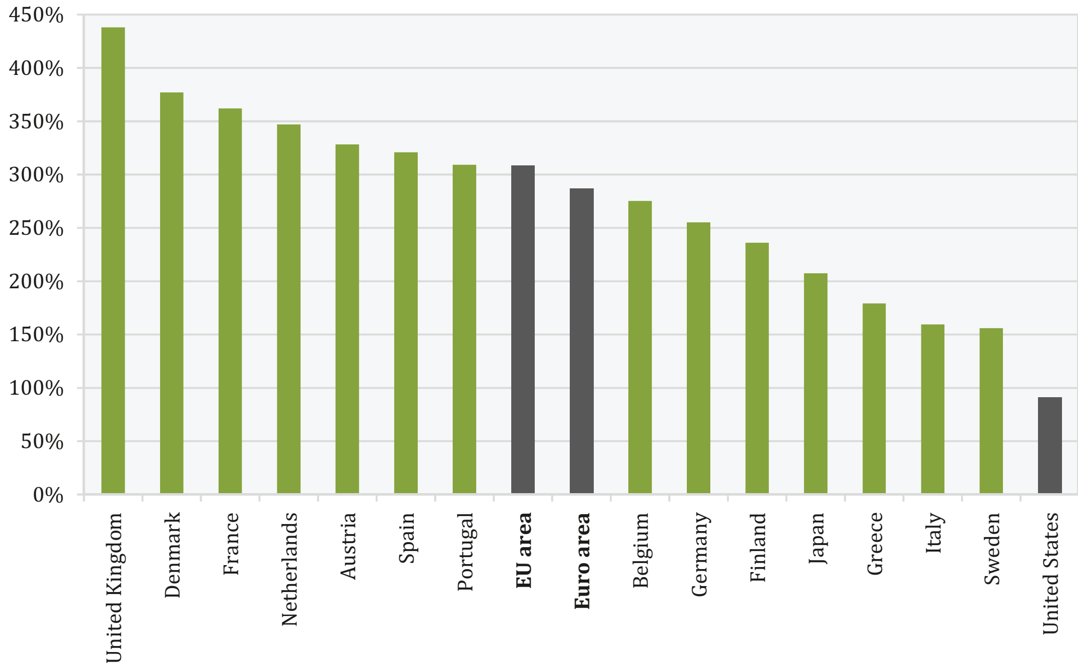
4 Commission roadmap to meet the long-term financing needs of the European Economy, 27 March, 2014.

5 IMF World Economic Outlook: Recovery Strengthens, Remains Uneven, April 2014.

Shrinking bank credit

At a time of shrinking bank credit in Europe, the disadvantage of being highly dependent on banks for funding is particularly apparent. In the Euro area, bank assets total around 290% of GDP (Chart 2), and for the EU as a whole the number is even higher (310%). The US banking sector is far smaller, with total bank assets just under 100% of GDP. Capital markets are more developed and larger than in Europe, giving easier access to a range of funding sources.

Chart 2: **Banks' activities as a percentage of GDP**



Source: IMF GFSR April 2014

In their response to the crisis, regulators have tried to follow two competing goals – to make banks less risky and to keep credit flowing to companies and consumers. Getting the balance right is exceedingly difficult. In the course of the past few years, the availability of credit in Europe has shrunk significantly. Pressures on European banks to de-lever have increased, as funding strains intensified and regulators imposed new capitalisation targets. Eurozone bank assets shrank by €3.3tn between May 2012 and October 2013, according to a study by RBS.[6]

The same study estimated that Europe's banks would cut around €2.8tn more assets over the next three to five years, to comply with upcoming European regulatory requirements. SMEs are likely to suffer most, as small and mid-sized banks, vital for lending to SMEs, will have to reduce assets by around €2.2tn; large banks will have to reduce assets by around €661bn and raise €47bn in additional capital.

As the funding gap widens, the amount of credit available to businesses and households is likely to fall, reducing business investment and consumer spending. Whether other financial institutions or sources of finance will be able to make up for the gap left by Europe's shrinking banks is an open question.

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

SME funding gap

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 recent ECB survey confirms the gap between SMEs' demand for funds and its supply – SMEs rely on debt finance for 80% of their funding needs. Across the Euro area as a whole, SMEs reported a marginal deterioration in the availability of bank loans over the six months to March 2014. SMEs in countries such as Italy, Spain and Greece reported the greatest problems, while large corporates did not experience so much difficulty accessing funds.[7]

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 performed very well: €103bn of SME loan securitisation was issued and rated by S&P, with a very small cumulative default rate across all rated tranches of 0.41% of total issuance.

While the diversity and, at times in the economic cycle, risk of SME lending means SME loans are not the easiest assets to securitise, for a bank originator these assets are highly suitable for securitisation. They carry risk, and are therefore capital intensive – so the ability of securitisation to achieve risk transfer from the bank's balance sheet to capital markets investors (including – most importantly – non-bank investors) is very attractive. The capital so released can then be recycled and reallocated into further lending by the bank originator, delivering more funding for this important engine of the real economy.

In this way, securitised products could play an important role in reducing the funding gap by helping banks to clear their balance sheets for further SME lending. Indeed, before the financial crisis, some European countries had very active and significant SME securitisation sectors. This significant market share has sadly shrunk today to insignificant levels – partly due to the factors set out in this paper, and partly because of broader macro-economic issues.

//
Securitisation is an important instrument for a healthy funding mix of the real economy. Unfortunately, the financial crisis of 2007 has damaged the image of securitisation a lot, which is understandable from a global perspective, but seems unjustified with respect to the European securitisation market. We consider the current discussion on high-quality ABS, based on past experience and best practice, as an excellent opportunity to regain public confidence and lay a solid cornerstone for a future, well-balanced regulation.
//

Dr Christian Peter, Vice President, KfW Bankengruppe

7 ECB, Survey on the access to finance of Small and Medium-sized Enterprises in the Euro Area: October 2013 to March 2014

//
The access to sources of liquidity that are sustainably available is an important factor in enabling financing to be offered. It is clear that the existence of fewer refinancing alternatives may result in fewer financing options for the customers. Moreover, it is possible that these offers will become more expensive. Since the terms and conditions of vehicle financing are a decisive criterion when buying a car, any increase in such costs for the customer would, in the worst case, bring about a decline in sales figures.
//
Stefan Rolf, Head of Asset Backed Securitisation, Volkswagen Financial Services AG

Effect on mortgage lending

The new regulatory framework has the potential to damage recovery in Europe's mortgage market. Illustrating the extent of deleveraging in the residential mortgage markets, gross residential mortgage lending in the EU during the third quarter of 2013 was just 49.2% of its 2007 average, according to the European Mortgage Federation. Furthermore, in the same period, the total amount of outstanding mortgage lending decreased year-on-year for the second consecutive quarter (-0.5% in Q3 2013 vs -0.7% in Q2 2013).[8]

While the average continued to fall, the pattern varied from country to country, as Table 1 shows. Some countries are beginning to return to growth, yet others are still seeing falls.

Table 1: **Total outstanding residential mortgage lending (€m)**[8]

	IV 2011	I 2012	II 2012	III 2012	IV 2012	I 2013	II 2013	III 2013	Latest y-o-y change (%) (Q3 13). EUR values	Previous y-o-y change (%) (Q2 13). EUR values	Latest y-o-y change (%) (Q3 13). local currency	Previous y-o-y change (%) (Q2 13). local currency
BE	164,548	166,870	169,657	171,322	173,401	174,193	176,152	177,823	3.8	3.8	3.8	3.8
CZ	19,761	20,961	20,575	21,290	21,750	21,495	21,737	n/a	n/a	5.6	n/a	6.9
DK	238,829	239,556	241,373	241,761	242,856	244,066	244,561	245,078	1.4	1.3	1.4	1.7
FR	847,000	852,000	857,600	863,900	874,200	880,800	888,500	897,500	3.9	3.6	3.9	3.6
GE	1,163,783	1,164,627	1,167,711	1,176,349	1,184,853	1,186,614	1,193,162	1,202,466	2.2	2.2	2.2	2.2
HU	21,950	20,906	20,890	20,509	19,985	19,346	19,142	18,856	-8.1	-8.4	-3.8	-6.1
IE	130,568	129,593	128,696	127,538	126,744	125,688	124,553	123,708	-3	-3.2	-3	-3.2
IT	367,645	366,801	367,089	366,235	365,588	364,624	363,908	362,363	-1.1	-0.9	-1.1	-0.9
NL	645,291	642,946	648,994	651,283	650,747	649,347	646,084	644,498	-1	-0.4	-1	-0.4
PL	71,883	75,663	76,334	78,277	79,434	78,339	75,500	n/a	n/a	-1.1	n/a	1
PT	113,916	113,703	112,655	111,606	110,520	109,615	108,573	107,544	-3.6	-3.6	-3.6	-3.6
RO	7,561	8,066	8,248	8,510	8,766	8,962	9,187	9,057	6.4	11.4	4.6	11.6
SE	308,498	313,848	320,461	336,142	334,922	348,732	336,349	344,782	2.6	5	5.1	5
SP	666,946	659,940	654,417	647,992	641,510	633,572	627,797	619,168	-4.4	-4.1	-4.4	-4.1
UK	1,491,971	1,499,259	1,565,940	1,587,307	1,553,837	1,498,424	1,480,111	1,521,524	-4.1	-5.5	0.4	0.4

Source: European Mortgage Federation

Note: Non seasonally-adjusted data.
Please note that the conversion to euros is based on the bilateral exchange rate at the end of the period (provided by the ECB).
Please note that the positive Hungarian y-o-y change in Q4 2011 is explained by the devaluation of the forint versus the Swiss franc and the euro.
The series has been revised for at least two figures in:
- The Netherlands
- Spain
- The UK

8 European Mortgage Federation (EMF), Quarterly Statistics Q3 2013

Case study: Virtuous circle promotes SME growth

Securitisation plays a part in the prosperity of SMEs, which are at the core of Europe's economic ecosystem. Securitisation allows banks to recycle and reallocate capital, creating a virtuous circle that ultimately increases the health of the banking sector and releases funds for further SME lending.

There are fears that the incoming banking and insurance regulations might inflict considerable damage in this important sector.

"Securitisation is an important form of funding for the real economy in Germany – for SMEs, autos and sales and leasing receivables," says Dr Reinhard Kudiss, Senior Economist at BDI, the German industry federation. "Around 150 German companies use sales and leasing receivables securitisation for finance, while auto financing affects not just the car manufacturers but the whole supply chain. We are very concerned that this area could suffer under present and upcoming regulations."

Just as a healthy securitisation market has a direct benefit for some types of SMEs, its indirect benefits through helping banks to fund themselves more efficiently and to reallocate capital may be far greater. "Can securitisation help? If the bank securitises assets such as residential mortgages it becomes a healthier institution, becomes a better bank and gets charged less to borrow. It passes on that margin improvement to SMEs, which ultimately helps them," explains Gareth Davies, Executive Director in ABS and Covered Bond Research at JP Morgan.

In 2012, AFME studied the feasibility of a state-guaranteed aggregation agency to lend directly to SMEs in the UK, inspired in part by the model adopted by Germany's KfW government-owned development bank. AFME proposed pooling SME loans and financing them in the public bond markets, through securitisation and other forms of capital markets and other borrowing and risk transfer techniques. It concluded that an 'Agency for Business Lending', or ABLe, could raise tens of billions of pounds a year from the capital markets.

Unless positive steps are taken further to develop ideas like this, securitisation's greatest benefits for SMEs are best delivered for now through the banking and auto sectors.

4. The state of securitisation markets today

As Europe seeks to build a financial system that delivers enough capital at the right price, securitisation has an important part to play in the effective operation of deep and liquid capital markets. Securitisation's benefits for Europe's economy go beyond its direct effect on funding specific sectors such as SMEs and residential mortgages. By helping banks to recycle and reallocate capital, it helps them to become healthier institutions and frees up capital for further lending to the real economy.

Yet issuance is falling, due to regulatory uncertainty, weak economic growth and today's highly unusual monetary conditions, which make securitisation look expensive and difficult compared with direct borrowing from central banks. Total issuance in 2013 was €181bn, a fall of 28% from 2012. Of this, only €76.4bn – less than half – was placed with investors. AFME's latest statistics show the declining trend continuing: for the first quarter of this year, the volume of placed issuance fell to only €13.6bn.

In the years leading up to the financial crisis, securitisation grew significantly in Europe and the Eurozone. Issuance to third-party investors peaked at €477.6bn in 2006, before dropping to almost nothing in 2009. Current issuance is far below the level reached even in the pre-boom years of 2001-2004, when issuance ranged from €152.6bn in 2001 to €243.5bn in 2004, according to AFME data – all of it placed with third-party investors.

It is difficult to estimate the effect of falling securitisation on economic growth, but issuance is far below previous levels as a proportion of GDP. In Spain, for example, it stood at 3.34% of GDP in 2003, peaked at 8.94% in 2007, and fell to 1.21% in 2012.

In the UK, it was 5.22% in 2003, peaked at 13.89% in 2008, then subsided to 3.26% in 2012.[9] Clearly, falling securitisation has contributed to the shortage of credit in some European countries. (See Table 2 below.)

The size of the US securitisation market shows the potential for European asset-backed securities to grow as a source of funding for the real economy. Chart 3 shows the importance of asset-backed securities in the US compared to Europe.

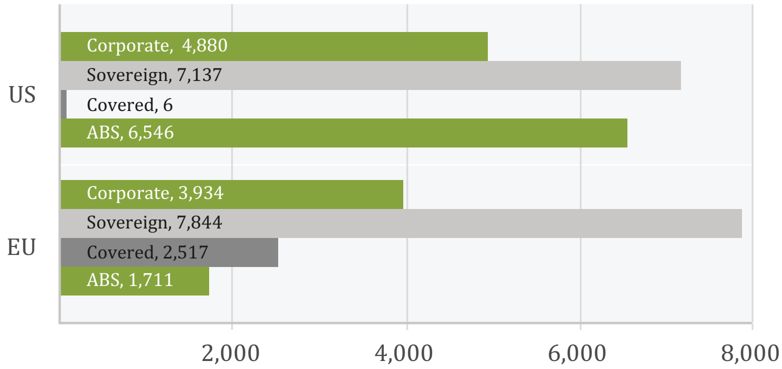
Table 2: **GDP, bank assets and securitisation in select European countries (€bn)**

		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Germany	GDP	1,924.43	2011.47	2,336.36	2,199.55	2,278.30	2,593.72	2,303.06	2,452.85	2,796.74	2,598.45
	Total SF % of GDP	0.32%	0.33%	0.96%	1.83%	1.05%	2.88%	0.91%	0.42%	0.41%	0.30%
	Bank assets	6,432.05	6,617.36	6,859.40	7,154.39	7,592.39	7,892.67	7,436.09	8,304.80	8,393.48	8,226.62
	% of GDP	334%	329%	294%	325%	333%	304%	323%	339%	300%	317%
Spain	GDP	701.74	770.7	955.07	936.84	988.02	1,140.52	1,015.53	1,027.96	1,121.23	1,002.78
	Total SF % of GDP	3.34%	3.65%	4.55%	7.28%	8.94%	7.79%	5.70%	4.86%	4.01%	1.21%
	Bank assets	1,560.97	1,775.42	2,207.73	2,526.87	3,005.27	3,409.44	3,446.81	3,471.03	3,643.07	3,581.07
	% of GDP	222%	230%	231%	270%	304%	299%	339%	338%	325%	357%
France	GDP	1,422.96	1,516.66	1,804.52	1,709.26	1,770.09	2,026.91	1,829.26	1,904.00	2,144.68	1,980.50
	Total SF % of GDP	0.52%	0.39%	0.43%	0.51%	0.45%	0.70%	1.31%	0.05%	0.26%	0.58%
	Bank assets	4,351.47	4,783.76	5,471.90	6,172.27	7,120.41	7,710.57	7,656.74	7,830.08	8,391.53	8,075.88
	% of GDP	306%	315%	303%	361%	402%	380%	419%	411%	391%	408%
UK	GDP	1,488.80	1,638.50	1,960.61	1,881.50	1,958.38	1,923.84	1,541.79	1,707.68	1,912.61	1,873.56
	Total SF % of GDP	5.22%	6.09%	6.98%	9.93%	8.94%	13.89%	5.36%	4.47%	3.23%	3.26%
	Bank assets	6,210.64	7,026.82	8,454.30	9,781.26	9,969.91	8,727.50	8,958.86	9,175.03	9,708.31	9,559.30
	% of GDP	417%	429%	431%	520%	509%	454%	581%	537%	508%	510%
Italy	GDP	1,202.46	1,280.45	1,508.68	1,419.25	1,458.07	1,651.50	1,474.16	1,525.67	1,693.55	1,527.07
	Total SF % of GDP	2.23%	2.65%	2.35%	2.15%	2.21%	4.84%	4.34%	1.18%	1.83%	2.43%
	Bank assets	2,246.10	2,379.07	2,599.14	2,870.51	3,407.40	3,693.94	3,746.46	3,789.22	4,065.04	4,219.49
	% of GDP	187%	186%	172%	202%	234%	224%	254%	248%	240%	276%
Holland	GDP	427.4	449.97	539.25	513.52	536.41	623.3	556.06	576.88	641.93	584.06
	Total SF % of GDP	6.03%	4.07%	6.96%	9.00%	16.15%	10.68%	7.68%	22.23%	9.67%	7.47%
	Bank assets	1,476.14	1,677.58	1,697.78	1,843.18	2,168.28	2,231.51	2,217.01	2,259.58	2,428.74	2,492.76
	% of GDP	345%	373%	315%	359%	404%	358%	399%	392%	378%	427%

Sources: BofA Merrill Lynch Global Research, World Bank, Bloomberg, European Banking Federation, ECBC

9 ECB bats for SME ABS, Bank of America Merrill Lynch, 11 April 2014.

Chart 3: **Bond market relative sizes in US and Europe, end of 2012 (€bn)**

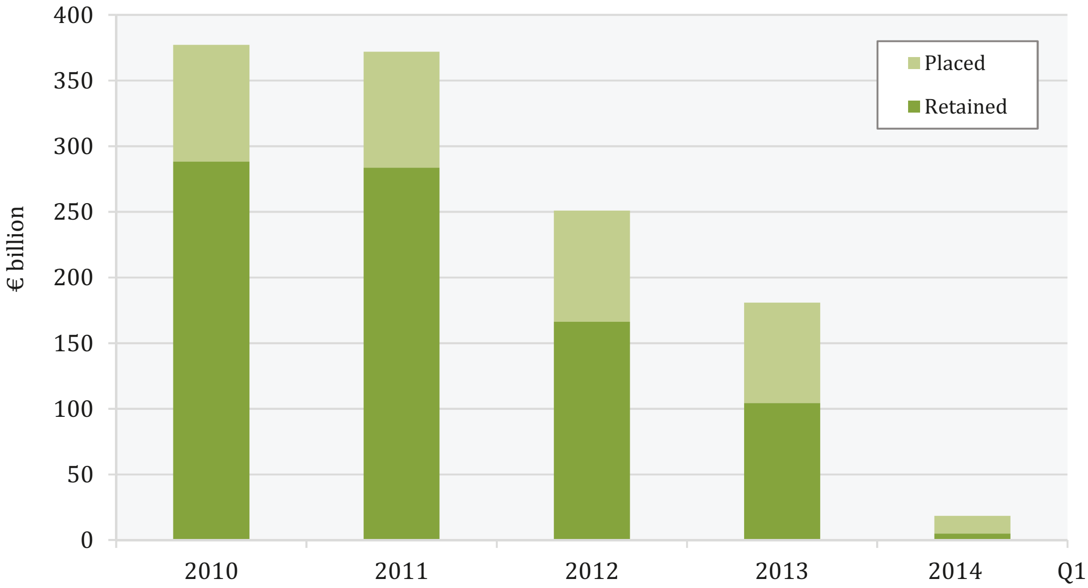


Sources:
ABS: AFME Securitisation Report.
Corporate: Bloomberg, AFME, SIFMA.
Covered Bonds: ECBC European Covered Bond Fact Book 2013. **Sovereign:** ECB (Europe Sovereign: EU27 Central Governments including long-term securities other than shares), SIFMA (US Central Government: bonds, notes and TIPS).

Retained versus placed issuance

The health of Europe's securitisation market has declined significantly in the past five years, and its function as a provider of investor capital to the real economy has diminished more than the headline market volumes suggest. In early 2008, at the height of the financial crisis, central banks started accepting securitisation as collateral for commercial bank funding, as normal sources of interbank credit stopped flowing. As a result, banks started to retain securitisations on their balance sheets, using it as collateral for repo or other forms of secured funding (Chart 4 and Table 3).

Chart 4: **European securitisation issuance 2010 to Q1 2014 (€bn)**



Source: AFME Securitisation Data Reports

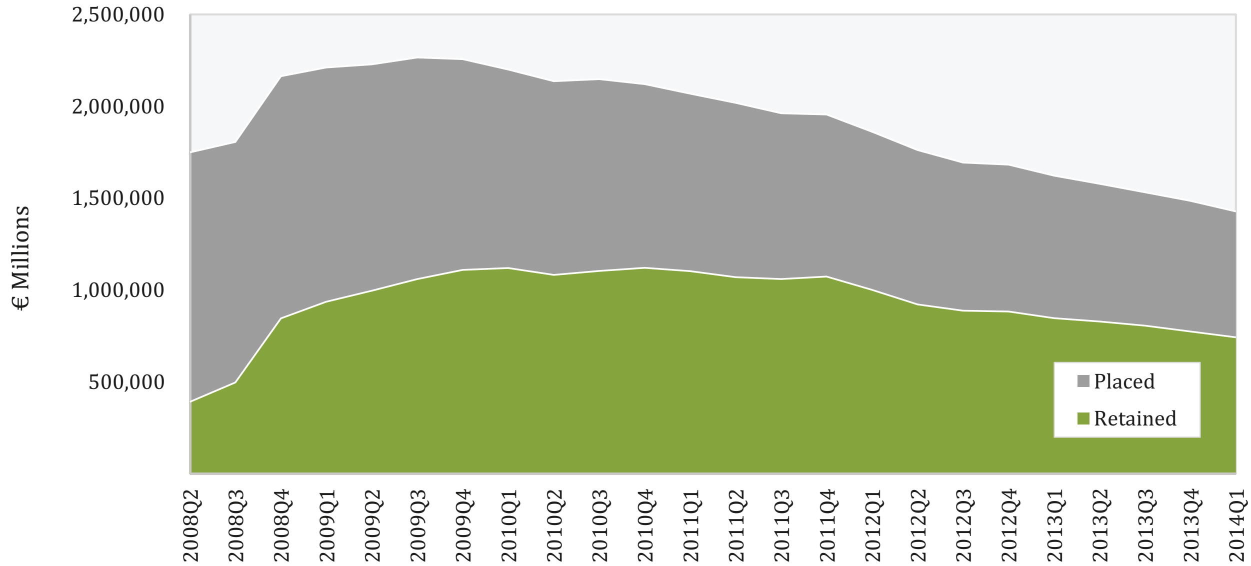
'Retained' securitisation quickly climbed to represent a large part of outstanding issuance (as Chart 5 below shows). By the first quarter of 2014, just 48% of all outstanding securitisation was placed with third party investors, with 52% retained on banks' balance sheets. As a result, investors held approximately €680bn of outstanding securitisation bonds – down by a third from approximately €1.4tn before the crisis.[10]

Comparing issuance placed with investors against issuance retained by banks for funding purposes serves as a stark reminder that Europe's banks still receive considerable funding support from the ECB. Clearly, the ECB remains a vital liquidity provider to Europe's banking system.[11]

10 AFME, Securitisation Data Reports

11 OECD, Outlook for the Securitisation Market, 2011

Chart 5: **European securitisation outstanding Q2 2008 to Q1 2014**



Sources: AFME/SIFMA Members, AFME, Bloomberg, Dealogic, Thomson Reuters, SIFMA
Note: Retained outstandings do not contain retained, then subsequently placed, issues when data are available. Placed deals include bank tenders.

Table 3: **European Issuance by Collateral, Retained vs Placed, 2011-2013 and Q1 2014 (€bn)**

	2011		2012		2013		Q1 2014	
	Retained	Placed	Retained	Placed	Retained	Placed	Retained	Placed
Auto	9.6	13.6	10.3	16.6	12.0	16.7	0.1	2.6
Consumer	14.0	1.0	8.3	4.4	17.5	2.1	1.5	0.5
Credit Card	1.3	6.6	1.6	6.8	9.7	0.8	-	-
Leases	15.3	0.7	1.8	0.1	3.0	0.3	-	-
Other ABS	2.1	6.7	1.3	1.3	0.5	9.1	-	-
CLOs	8.6	1.0	0.7	12.8	0.8	8.4	-	2.5
CMBS	1.6	2.2	0.9	4.2	0.6	8.9	0.1	1.4
RMBS	170.1	52.1	97.2	35.6	43.1	21.8	2.5	3.9
SME	61.1	1.3	44.2	1.0	17.4	2.8	0.7	0.8
WBS/PFI	-	3.2	-	2.1	-	5.4	-	1.8
Total	283.7	88.3	166.2	84.8	104.5	76.4	4.9	13.6

Source: AFME Securitisation Data Reports

Issuance by sector and country

Data shows clearly the importance of securitisation in different countries and economic sectors. In the first quarter of 2014, RMBS (residential mortgage-backed securities) accounted for the highest volume of issuance, at €6.5bn (Table 4). The automotive sector received the second highest level of funding, at €2.7bn. SMEs received €1.6bn. On a national basis, most securitisation funding originated in The Netherlands (€6.0bn), followed by the UK (€4.8bn) and then Germany (€3.5bn).

Indeed, the role of the Netherlands as the country with the biggest securitisation market in Europe was an interesting development in 2013. UK RMBS issuance, a major sector of the market in the UK and historically also Europe's biggest sector, was artificially depressed as a result of the Bank of England's Funding for Lending scheme.

Table 4: **European issuance by collateral and country at Q1 2014 (€bn)**

	Auto	Consumer	Credit Card	Leases	CLO	CMBS	RMBS	SME	WBS/PFI	Total
Germany	2.1	1.4	0	0	0	0	0	0	0	3.5
Italy	0	0	0	0	0	0.1	0	0.7	0	0.9
Netherlands	0	0.7	0	0	0	0	5.3	0	0	6.0
Portugal	0	0	0	0	0	0	0	0.8	0	0.8
United Kingdom	0.6	0	0	0	0	1.3	1.1	0	1.8	4.8
PanEurope	0	0	0	0	2.5	0	0	0	0	2.5
Total	2.7	2.0	0	0	2.5	1.4	6.5	1.6	1.8	18.5

Source: AFME Securitisation Data Reports

Outstandings: the historic picture

The full picture of the role of securitisation in financing Europe's economy can be seen by analysing the figures for outstandings – these show the historic "stock" of securitisation in Europe (Table 5).

At the end of the first quarter of 2014, there was approximately €1.4tn outstanding. RMBS (residential mortgages) accounted for the largest proportion, with €834.5bn outstanding, followed by asset-backed securities of €190.4bn. Outstanding SME collateral stood at €108.2bn. However, note that total outstandings fell by 23% from 2012 to date, reflecting the continuing dearth of new issuance.

Table 5: **Summary of outstanding by collateral Q1 2012, 2013, 2014 (€bn)**

	Q1 2012	Q1 2013	Q1 2014
ABS	190.3	195.6	190.4
CDO	167	150.9	126.4
CMBS	131.9	115.3	95.9
RMBS	1,130.2	941.6	834.5
SME	172.9	148.4	108.2
WBS/PFI	70.1	71.1	73.4
Total	1,862.4	1,622.9	1,428.9

Source: AFME Securitisation Data Reports

When viewed on a national basis (see Table 6), the UK has the largest outstanding amount (€412.8bn), followed by The Netherlands (€261.7bn). Spain and Italy also have high levels of outstanding collateral (€169.2bn each). This reflects historical issuance. However, recent issuance in both countries has been dominated by retained rather than placed transactions.

In the case of Spain, issuance has been hindered by not just the issues set out in this paper, but also wider macro-economic concerns about the Spanish economy, asset quality and the sovereign rating. It is no longer possible to achieve the highest AAA credit rating from every major credit rating agency for a securitisation using Spanish assets, as Spain's sovereign rating is currently too low.

In Italy, pricing has been the constraining factor, along with similar challenges regarding the sovereign rating. However, Italy did see one large and successful SME transaction in 2013, where the most senior tranche was AA-rated. It may be that AA-rather than AAA-rated senior tranches will be the way forward in countries constrained by sovereign ratings.

Table 6: **European outstanding by country and collateral 2014 Q1 (€bn)**

	ABS	CDO	CMBS	RMBS	SME	WBS/PFI	TOTAL
Austria	0.3	-	0.2	1.8	-	-	2.3
Belgium	-	-	0.2	62.4	17.7	-	80.3
Finland	0.5	-	-	-	-	0.5	1.0
France	19.5	-	2.0	9.7	1.7	0.5	33.5
Germany	36.3	1.8	9.5	14.8	3.0	0.1	65.4
Greece	13.4	1.8	-	4.4	6.7	-	26.3
Ireland	0.3	0.1	-	36.9	-	-	37.3
Italy	47.7	1.7	10.1	81.5	27.7	0.5	169.2
Netherlands	2.6	0.7	2.5	248.4	7.6	-	261.7
Portugal	3.3	-	-	25.8	7.6	-	36.7
Russia	-	-	-	1.2	-	-	1.3
Spain	24.1	0.5	0.3	115.3	29.0	-	169.2
Turkey	2.0	-	-	-	-	-	2.0
UK	34.1	12.5	57.6	231.9	5.9	70.7	412.8
Other	3.7	0.8	-	0.4	0.1	-	4.9
PanEurope	1.8	33.4	11.7	0.2	1.0	0.2	48.3
Multinational	0.5	73.1	1.8		0.4	0.9	76.6
European Total	190.4	126.4	95.9	834.5	108.2	73.4	1428.9

Source: AFME Securitisation Data Reports

Case study: Asset managers anticipate loss of insurance investors

As insurers prepare for Solvency II's new capital charges, asset managers report they are already cutting back their investments in securitised loans, preparing for the heavy capital charges the directive currently proposes for securitisation. AFME welcomes the considerable progress that has been made in reducing the European Commission's original proposals, and the December 2013 report of EIOPA (right), which broke new ground in recognising for the first time the concept of "high-quality securitisation". However, the absolute levels of the currently proposed capital charges remain too high to encourage greater participation by insurer investors. Also, there remain severe cliff effects between the treatment of AAA-rated and non-AAA-rated senior securitisations, senior and non-senior high-quality securitisation, as well as direct investment in "whole loan" pools.

EIOPA

"Key from our point of view is that the securitised market is at extreme risk of loss of all investment from the insurance universe due to Solvency II," says Chris Greener, Director and Lead Portfolio Manager of the EMEA Securitised Assets Investments Team at BlackRock. "In our view, the capital charges are entirely unwarranted using historical evidence and make no sense in the current environment."

Mark Hutchinson, Head of Alternative Credit at M&G Investments, one of the larger securitisation managers, says: "There are many instances where we have spoken to potential investors on the insurance side and taken them through the stress resilience tests and it has been acknowledged that spreads look favourable compared to corporates, unsecured financial debt and covered bonds. However, in most cases they point to the brutal capital charges under Solvency II versus those of other markets. If the Solvency II capital charges for ABS recognised the strong credit performance of the asset class, I would think you would see much more participation in the markets from insurers."

With insurers moving into competing asset types in order to avoid the capital charges, there is a fear that smaller asset managers might start cutting back their securitisation investment capabilities. Beyond the capital charges, Solvency II and the AIFMD directive impose considerable operational requirements on asset managers in terms of software licenses, technology and expertise. All of these add to the cost of investing in securitised assets, creating high barriers to entry for smaller asset managers without sufficient scale to spread the upfront cost.

Ironically, regulation is forcing investment out of securitised assets at a time when many commentators judge other fixed-income assets fully valued in a rising interest rate environment. In terms of relative value, there is a strong case for securitised assets, showing their value to investors as a form of diversification.

"It is one area of the market where there is still a significant amount of value, both on a real basis and relative to the rest of the market," notes Rob Ford, a founding partner at fixed-income specialist TwentyFour Asset Management. "Also, these investments are appropriate in this type of environment, as they are floating rate."

//

This is really important for us. In view of the deleveraging of banks we need securitisation more than ever, and we can see the potential damage; not just from a Mittelstand point of view but for big companies too. If these instruments diminish or get marginalised, it will be difficult for companies to access proper credit financing.

//

Dr Reinhard Kudiss, Senior Economist at BDI, the German industry federation

5. Credit and price performance of European securitisation

Most European securitisations have performed well, both during the crisis and since, showing the need to differentiate them from US sub-prime mortgage securitisations and the associated, highly-levered artificial exploitations of securitisation techniques such as CDOs and CDOs squared. The evidence clearly shows the strong fundamentals of European high-quality securitisation – in terms of both creditworthiness and secondary market price performance.

Credit performance

Credit performance has been excellent for almost all product sectors. For example, only 0.12% of European RMBS outstanding in mid-2007 have defaulted since then. See Table 7 below, which includes all tranches, not just senior ones. By contrast, the default rate for US RMBS in the same period was 22.05%.

Table 7: **European securitisation default rates: mid-2007 to end 2013**

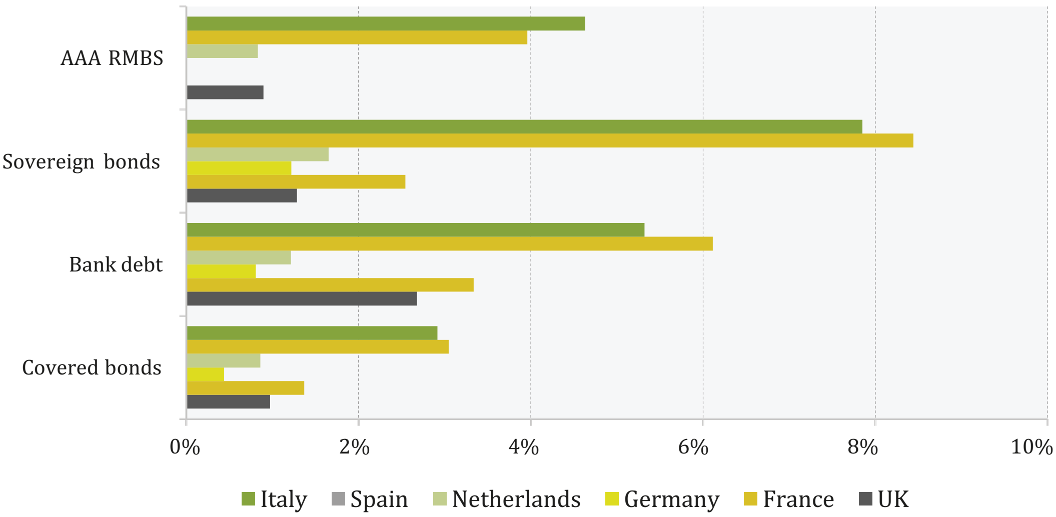
	Original Issuance (€bn)	Default Rate (%)
Europe		
Total PCS eligible asset classes	960.2	0.15
Credit Cards	33.2	0.00
RMBS	756.0	0.12
Other consumer ABS	68.0	0.13
SMEs	103.0	0.41
Only senior tranches to be PCS labelled, the default rate for which is zero, like covered bonds		
Total Non-PCS eligible asset classes	728.9	5.66
Leveraged loan CLOs	70.6	0.10
Other ABS	69.1	0.00
Corporate Securitisations	64.9	0.13
Synthetic Corporate CDOs	254.4	2.87
CMBS	163.3	10.34
Other CDOs	77.8	6.54
CDOs of ABS	28.9	41.04
Total European securitisation issuance	1,689.1	2.53
Covered Bonds	1,085.0	0.00
Total European issuance	2,774.1	1.54
Select US asset classes		
Credit cards	295.4	0.07
Autos	198.2	0.04
Student loans	266.9	0.34
RMBS	3,254.9	22.05

Source: Standard & Poor's

Secondary market performance

In terms of secondary market price performance, during the period of turbulence associated with perceived issues around the stability of the Euro, from January 2011 to July 2013 the market price performance of European RMBS was superior to most EU sovereign debt, senior bank debt and many covered bonds (see Chart 6 and Table 8).

Chart 6: **Market Price Performance Jan 2011 – Jul 2013**



Source: BofA Merrill Lynch Global Research

Table 8: **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

//
We have been issuing the relevant securities for almost 20 years now: up to the present date, no single loss at all has been incurred by the respective investors as a result.
//

Stefan Rolf, Head of Asset Backed Securitisation, Volkswagen Financial Services AG

Case study: Driving up the cost of mortgages

Just as mortgage lending is recovering in some countries, the new regulatory framework threatens to limit mortgage lenders' funding options. This risks driving up the cost of mortgages for homeowners, with negative implications for Europe's housing market.

Rob Collins, Head of Funding in Treasury at the UK's Nationwide Building Society, said: "Securitisation features significantly in our funding plans looking forward. Regulation is at the forefront of our minds and we do retain a degree of nervousness about the possible effects on the cost of funding if potential barriers such as the Basel RWA proposals and Solvency 2 do not land in a sensible place.

"This is echoed in the Society's role as an investor in securitisations for secondary liquidity purposes. My colleagues may struggle to make the case for investment if, for example, AAA investments backed by UK mortgages prove significantly more capital-intensive than originating the same high-quality loans as a lender."

He continued: "Could we survive without securitised funding? The answer is, yes we could, but we would not have the balance and options to diversify that we desire. If the securitisation markets were closed, Nationwide would be reliant on a narrower spectrum of funding sources to complement its retail member savings franchise, and if at any point such sources were not available that could affect our ability to fund growth in our lending activities."

While the recovering UK housing market is driving up demand for mortgage finance, making sources of funding a more pressing issue, in much of the rest of Europe the housing recovery is at an earlier stage. For this reason, a reduction in the availability of securitisation funding might not have an immediate impact. However, once a strong recovery takes hold, the picture might change.

"If Dutch RMBS does not get a fair position in the Basel III Liquidity Capital Ratio and Net Stable Funding Ratio, and if investors get a punitive capital charge for holding RMBS, compared with covered bonds and whole loans, then investor interest in RMBS will fade away and the RMBS product will gradually disappear," asserts Rob Koning, Director of the Dutch Securitisation Association.

"What does that imply for Dutch mortgage finance? Not much with mortgage outstandings falling, but the housing market is turning the corner this year. Holland's savings gap means there's no other way to fund mortgages. The result: more expensive mortgages, putting pressure on the economy in general."

6. Impact of new regulation

The new regulatory framework has made welcome progress in creating a well-functioning, transparent securitisation market. Further refinement, through recalibration of the detail of its treatment of securitised assets, would attract investors back to the market.

Under current proposals, banks, traditionally the key investors in the securitisation sector, will be forced to increase capital, delever and change the mix of assets they have available to meet regulatory standards. Consequently, they are likely to reduce their exposure to securitised products.

Within the insurance industry, the Solvency II Directive's still-heavy capital requirements are likely to eliminate insurers' demand for investment in securitised products altogether.

If these new regulations are not recalibrated, the impact for businesses across Europe could be higher funding costs and lower availability of longer-term credit.[12] The effects will be particularly harsh on SMEs – critical generators of growth and employment – at a time when many are already facing significant difficulties in their access to finance.

Table 9 below summarises the regulations being introduced that will affect securitisation.

Table 9: **Key regulations affecting prospects for the revival of securitisation**

Capital and non-risk-based prudential measures	Securitisation specific
Basel proposals for revised RWA	EU bank investor due diligence requirements
Solvency II	EU risk retention requirements for banks
Basel and EU proposals for measuring and controlling large exposures	EU due diligence and risk retention requirements for insurance company investors and AIFMs
Money Market Funds Regulation	ECB and BoE increased investor reporting, standardised definitions and prospectuses, cash flow models
	EU increased disclosure requirements (Art. 8b Regulation 1060/2009)
Liquidity	**Derivatives**
Basel and EU Liquidity Coverage Ratio	Margin requirements for non-CCP OTC-derivatives

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

Case study: Limiting challenger banks' funding options

Consumer groups and politicians have encouraged challenger financial institutions to take on Europe's large financial institutions, so increasing competition and choice. But unless the securitisation market recovers and volumes improve, and these institutions have access to the retail deposit markets in scale and on a cost-efficient basis, they may face difficulties funding their businesses.

"Where you see the biggest potential problem is the challenger institutions that either don't have access to retail deposits or don't want to rely too much on such deposits as a sole funding source," notes Robert Plehn, Head of Asset Backed Securitisation, Lloyds Banking Group. "Historically, for many of these organisations, securitisation was their main funding tool. Today, even if they have access to retail deposits, securitisation represents one of their few alternative wholesale funding sources – especially if they are unrated or not highly rated."

A treasurer at a European financial institution adds: "It probably has most impact on smaller players. If you look at the Funding for Lending Scheme (FLS) in the UK there are some interesting names in the challenger arena. If a proportion of their funding comes from FLS, and they do not have the large deposit base of some of the banks and building societies, are they going to need securitisation more going forward?"

If securitisation is no longer a viable source of funding for these institutions, what other options will be open to them?

7. An action plan to revive securitisation

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. At a time when businesses and households across the EU are experiencing difficulties in accessing finance, securitisation can improve the availability of credit; both directly by providing new sources of cash to finance growth and investment, and indirectly by allowing banks to recycle and reallocate capital for further lending.

The economics of securitisation need to be restored. For issuers, the yield on highly rated securitised tranches must be economic compared with other sources of both secured and unsecured funding. Key investors are unsure about remaining in the market, raising serious doubts about which part of the investor community will be capable of filling the void.

In general, the new regulatory regime risks imperilling the region's already struggling securitisation market and further constricting credit supply to Europe's economy.

//
I think the big issue for securitisation in terms of making it a real backer of the real economy is how do you grow the market? And I think regulation is really holding it back.
//

Kevin Ingram, Partner and Head of Securitisation, Clifford Chance

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 sensibly calibrated regulatory measures. At the same time, the industry has learned the lessons of the past and will continue – as it has done for several years – to work constructively with regulators in the future.

In order to save Europe's securitisation market, for the benefit of the real economy, AFME proposes an action plan of five practical steps to revive the securitisation market in Europe.

Capital requirements for bank investors While the December 2013 re-proposal by the Basel Committee for Banking Supervision (BCBS) of its new rules for risk-weighted assets for bank investors in securitisation is a significant improvement on the original proposal, the capital requirements set out in the re-proposal remain much higher than justified by either historic losses in most asset classes, or by comparison with other methods of finance or in relation to the capital requirements of the underlying asset pools. This is especially so for higher quality exposures and for medium-term and longer maturity transactions.

Excessive capital requirements will discourage banks from investing in securitisation transactions. Banks are key investors, because without their participation other types of investors, such as asset managers, insurers and pension funds, will not return. AFME therefore urges a recalibration of the proposals better to reflect historic performance, and to bring securitisation into line with the capital requirements for other fixed income securities and underlying asset pools.

Capital requirements for insurers In December 2013, the European Insurance and Occupational Pensions Authority (EIOPA) issued a report outlining capital requirements for insurance companies seeking to invest in ABS. Again, there were positive aspects to the proposals: for example, they recognised – for the first time in European regulation – the concept of "high-quality securitisation".

//
The market is so low that we need to get some really good positive signalling from policymakers and regulators that things will start to get better. According to the timetables governing when a lot of these rules will come into force, the next nine months are crucial.
//

Ian Bell, Head of the Prime Collateralised Securities (PCS) Secretariat

Also, in the report, EIOPA reduced its original calibration for AAA securitisations from 7% per year of duration to 4.3%. Since then, the *Financial Times* has reported a further reduction to 2.1%. These reductions may look dramatic, but insurers themselves report that they are still too high to encourage those who have left to return, or those who remain to stay. Even at 2.1%, a five-year AAA prime European RMBS would still require €10.50 of capital for every €100 invested, compared with €0.12 defaults over the last seven years (across the capital structure, not just at AAA) and (in some cases) zero capital if an insurer invested in the same assets by buying them directly as a whole loan portfolio.

AFME therefore urges still-lower capital charges to create, at the very least, a comparable playing field with other fixed income securities such as corporate and covered bonds, and direct investment in the same assets.

Liquidity coverage ratio The European Banking Authority's (EBA) December 2013 report on the liquidity coverage ratio generally treats ABS poorly: only RMBS, subject to certain conditions, is suggested for inclusion as a high-quality liquid asset (HQLA). Much discussion has taken place since then, to which AFME contributed by commissioning an independent academic study[13] which shows that certain other forms of high-quality securitisation – for example auto loan ABS – can also be very liquid, and in some cases more liquid than many covered bonds. We continue to argue for the inclusion of a wider, rather than a narrower, range of assets as HQLA. Unconfirmed reports exist that greater flexibility on the definition is being considered. If so, we welcome this, but await official confirmation. As with everything in securitisation, much depends on the details.

Transparency and disclosure Standards of transparency have always been good in securitisation for the simple reason that, as an asset-based form of lending, this is what investors have rightly demanded. Since the crisis, further improvements have been implemented, including the loan-level data disclosure requirements of the ECB and the Bank of England, broadly supported by the industry, as well as Article 409 of the Capital Requirements Regulation, which requires by law that investors have "readily available access to all materially relevant data". Yet regulations continue to be proposed, such as Article 8b of the CRA Regulation, which are unnecessary and create duplication, confusion and intrusion into the free choices of issuers and investors in this field, further hindering the revival of the market.

Practical steps The recent announcement by IOSCO and BCBS of a joint working group "to look at how the securitisation markets are working, and to see whether new thinking is needed" is very welcome. But again such encouraging statements from high-level policymakers need to be translated into positive developments on the ground – in all of the fields referred to above. Better co-ordination between regulators within Europe and internationally would help prevent the "layering" effect of overlapping regulations, and bring us a step closer to mutual recognition of equivalent standards where they exist.

2014 is a pivotal year for European securitisation. Sensible outcomes on capital, liquidity and transparency are within reach. The right regulatory choices will enable securitisation to play its full role in funding Europe's real economy, strengthening our capital markets and broadening the investor base to support our banking system.

13 William Perraudin, Risk Control Limited: "Covered Bond versus ABS liquidity: a comment on the EBA's proposed HQLA definition", 24 January 2014, available at **www.riskcontrollimited.com/public/ABS_and_Covered_Bond_Liquidity.pdf**

Contacts

Richard Hopkin
Managing Director, Securitisation
richard.hopkin@afme.eu
+44 (0)20 7743 9375

Anna Bak
Manager, Securitisation
anna.bak@afme.eu
+44 (0)20 7743 9314

Sidika Ulker
Director, Capital Markets
sidika.ulker@afme.eu
+44 (0)20 7743 9305

/ About AFME

The Association for Financial Markets in Europe (AFME) is the voice of Europe's wholesale financial markets.

We represent the leading global and European banks and other significant capital market players.

We believe that liquid capital markets and a well-functioning banking system are central to any successful modern economy.

We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

Focus
on a wide range of market, business and prudential issues

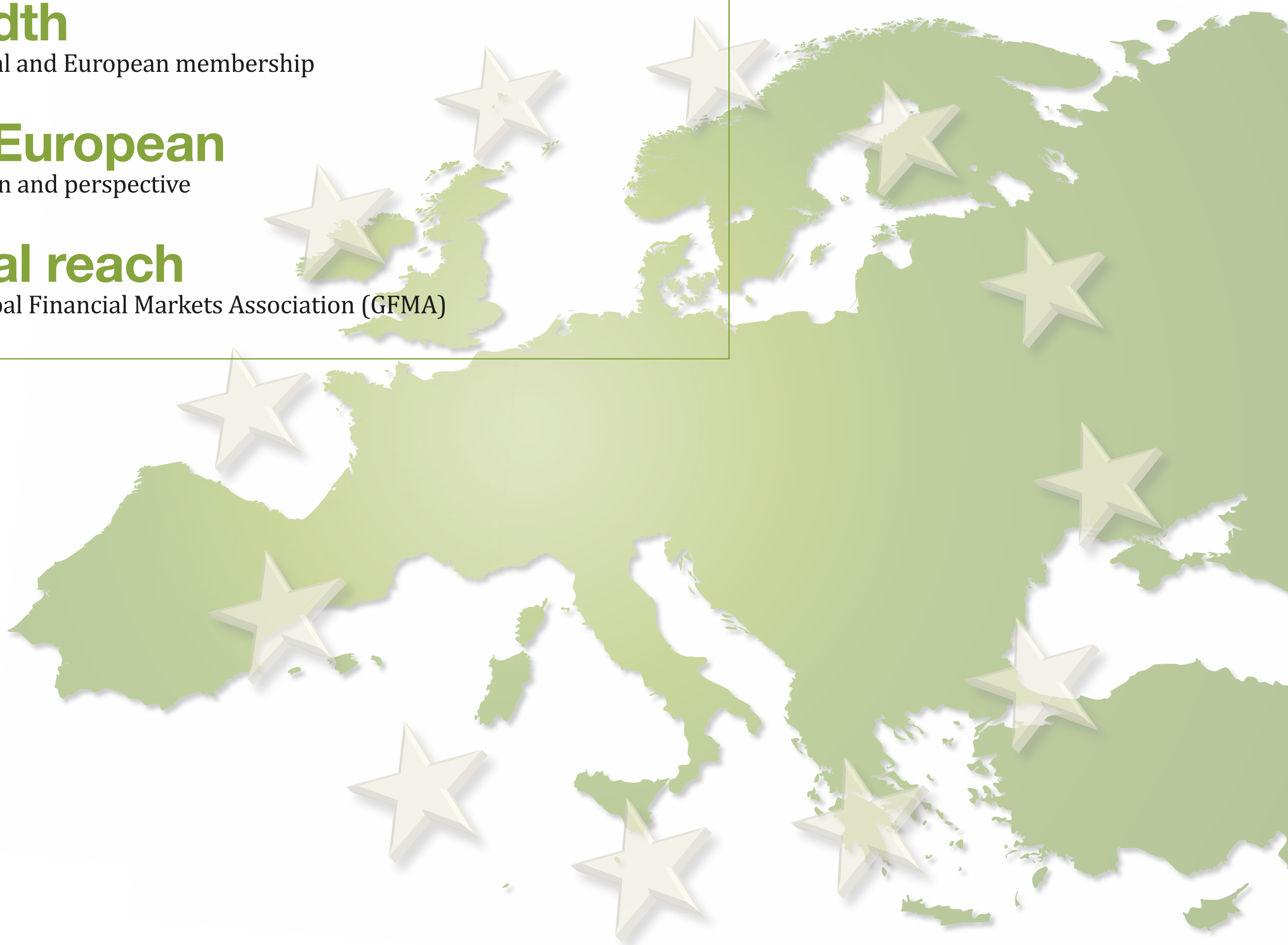
Expertise
deep policy and technical skills

Strong relationships
with European and global policymakers

Breadth
broad global and European membership

Pan-European
organisation and perspective

Global reach
via the Global Financial Markets Association (GFMA)



Finance for Europe

London Office
St Michael's House
1 George Yard
London EC3V 9DH
United Kingdom

Switchboard:
+44 (0)20 7743 9300

Brussels Office
Square de Meeûs 38-40
1000 Brussels
Belgium

Switchboard:
+32 (0)2 401 8724

Press enquiries
David Waller
david.waller@afme.eu
+44 (0)20 7743 9504

Anna Schoeffler
anna.schoeffler@afme.eu
+44 (0)20 7743 9367

Follow AFME on Twitter
@News_from_AFME