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The new framework for on-balance-sheet securitisation

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When the European Commission unveiled its Covid-19 capital markets recovery package in July 2020, a much welcomed measure was the proposal to extend the framework for simple, transparent and standardised (STS) securitisations to cover on-balance-sheet securitisations.

On-balance-sheet securitisation can be a vital tool in the current economic environment. The mechanism is especially helpful in managing credit risk and capital requirements in relation to corporate and SME loans, which are both capital-intensive when held on balance sheet and difficult to securitise in the traditional securitisation markets. A well-designed framework can therefore make it easier to lend to new borrowers, including homeowners, consumers, SMEs and entrepreneurs, and help support Europe's economic recovery.

A new regulatory framework must always be prudentially sound and provide strong levels of investor protection. But it must also be economically viable and attractive for its targeted users; in this case, it must provide the necessary incentives for banks and investors to use this type of securitisation.

Following the political agreement recently announced by EU legislators, has the right balance been achieved between these objectives?

A better capital treatment, improved standards and integration of sustainability considerations

In order to encourage the use of the STS label and increase bank lending, EU legislators have introduced preferential risk weights for the senior tranche of an on-balance-sheet securitisation which is retained by the originator. Subject to supervisory approval of the risk transfer, this frees up capital for the originator bank to continue making new loans to other borrowers.

The new framework will also further increase transparency in relation to on-balance-sheet securitisation and, in time, will lead to greater standardisation in a way which conforms to what are seen as "best practice" standards. Greater standardisation will also make it easier for investors to compare transactions across different originators and jurisdictions.

Another positive element in the legislation is the introduction of provisions to integrate sustainability into the wider securitisation framework. Standards will be developed to report on the sustainability of securitisation products and the European Banking Authority will draft a proposal for a dedicated framework for sustainable securitisation. An appropriate framework can do much to support the market for green securitisation, which is in early stages of development.

Could some new requirements undermine the effectiveness of the framework?

Extensive analysis of EU on-balance-sheet securitisation markets since 2008 shows that, even without the availability of the STS label, this portfolio management tool has been widely used by banks in many jurisdictions across the EU, and that these securitisations have experienced extremely low loss rates. In particular, there have been virtually no losses affecting the senior tranches of on-balance-sheet securitisations which are retained by the originator.

A number of additional safeguards included will preserve and strengthen the prudent use of this mechanism.

However, some provisions introduced by the legislators are likely to increase complexity and make the framework more expensive to use.

One example of this is the requirement for the investor to have recourse to high-quality collateral to secure repayment of their investment. These requirements are more onerous than those generally used in existing on-balance-sheet securitisations, and will add cost and complexity to transactions.

Another concern stems from the newly-introduced requirement to risk weight synthetic excess spread expected to be made available for future periods, particularly as this applies to all on-balance-sheet securitisations, regardless of whether they achieve the STS label. These requirements risk undermining the economic viability of future transactions, including those involving the European Investment Fund when it acts as Protection Seller which have recently provided vital support to thousands of SMEs across the EU. Much will depend on how the EBA approaches the implementation of this requirement through the development of technical standards in this area.

It would indeed be unfortunate if these requirements lead to a more limited use of the new STS label or make many on-balance-sheet securitisations transactions uneconomic at a time when they are most needed.

In conclusion, EU legislators should be commended for fast-tracking this initiative intended to support bank lending to European businesses and households through very difficult times. It is, however, too early to draw conclusions on how effective the framework will be in meeting these objectives. The design of the technical standards will be an important consideration. The success of the framework will ultimately depend on whether a good balance has been achieved between the necessary regulatory safeguards and incentives for market participants to make use of, and invest in on-balance-sheet securitisations.