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European Commission

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Addressing the imbalances in the European securitisation framework to support the green transition and economic recovery

Dear Executive Vice-President

As part of the Capital Markets Union (CMU) work programme, AFME has been very supportive of the work towards scaling up the EU securitisation market in order to make it more conducive to credit provision, while preserving the EU's financial stability.

We consider this to be among the most pressing aspects of the CMU Action Plan as well-functioning securitisation markets can provide a unique contribution to meeting important challenges currently facing the European financial system.

The economic impacts of **recent geopolitical developments, the Covid-19 pandemic and the prospective end of accommodating monetary policies** further underscore why the EU needs securitisation to function optimally as part of a strong, resilient and diversified financial system. Its considerable potential to be used as a tool to both transfer credit risk away from the banking sector to markets and to recycle capital into new lending to support SMEs and corporates is increasingly evident in these testing times.

Current economic challenges will be made even greater through the introduction of the Basel 3 framework in Europe. Basel 3 will likely increase capital needs in the coming years and push banks to either retain earnings for building up additional capital buffers or deleverage balance sheets by shrinking credit portfolios. In this context, as **European Stability Mechanism** analysts have acknowledged¹, a well-functioning securitisation market can help banks comply with new rules, whilst making an important contribution to meeting the challenges faced by the European economy.

With its potential unlocked, securitisation can also be a powerful tool to allocate capital in supporting the **green transition**, noting that 44% of the funding required to meet the Paris 2C requirements will be required in the form of loans to businesses and households². Europe's nascent ESG securitisation market has the potential to be an important enabler in this journey given the EU's global leadership in the issuance of sustainable bonds, reliance on bank financing and the strong track record of European securitisations. Today, however, the contribution that green securitisation makes in relation to the total financing of the EU green transition is dwarfed by its contribution in both the US and China (1% vs. 50% and 11% respectively)³.

¹ As noted in this blog by the [European Stability Mechanism](#).

² GFMA-BCG Report "Climate Finance Markets and the Real Economy" (December 2020) – available [here](#).

³ EBA Report "Developing a Framework for Sustainable Securitisation" (March 2022).

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Despite its importance for the CMU, the **European securitisation market remains subdued**. In 2008, the size of the European market, including the United Kingdom, was 75% that of the US. In 2020, it was just 6%⁴. While multiple factors have contributed to this decline, there is a broad consensus within AFME's membership, including banks and specialised investors, that the lack of proportionality in aspects of the framework has been a significant factor in securitisation becoming unviable for many market participants despite the benefits that it can offer.

As we approach the advanced stages of the current legislative cycle, we very much hope that that the review of the securitisation framework as part of the CMU work programme remains a priority. We believe the Commission and the co-legislators should consider whether the ongoing legislative discussions on CRR3/CRD6 and Solvency 2 provide opportunities to implement adjustments to securitisation-related calibrations in these legislations, or to include mandates for the Commission and the European Supervisory Authorities (ESAs) to develop concrete proposals for consideration and adoption.

We believe that Europe needs an open debate about the importance of securitisation and how it can function properly to meet our economic needs. This debate should consider the many fundamentally sound elements of the regulatory framework, but also aspects which require fine-tuning to better reflect the risk profile of all securitisations issued under the new framework (both under the simple, transparent and standardised (STS) securitisation label, as well as non-STS transactions).

I wish to stress that the robust regulatory standards of European securitisation should be preserved and any recalibration should be driven by evidence and a rigorous analysis of risks. We do not suggest in any way that standards should be adjusted merely to support this or another market product. AFME members are engaged across the broad range of asset classes and we do not favour securitisation over other instruments. If we make a strong case for the recovery of Europe's securitisation market, it is because we see the economic value of this mechanism and its unfulfilled potential in Europe.

I would like to take the opportunity to offer AFME's perspectives in the annex below on three important areas of focus, namely:

- The current **review of the prudential framework for securitisation** – where we see a strong case for the EU to consider adjustments to the treatment of securitisation in the banking capital and liquidity frameworks (**CRD/CRR**) and the insurance investor prudential framework (**Solvency 2**) to introduce more proportionality and risk sensitivity taking into account Europe's unique risk-mitigating safeguards;
- The **transparency and disclosures framework** – where there is a need to review the template-based reporting framework to enhance proportionality, practicality and usefulness for all parties;
- The **integration of sustainability considerations into the securitisation framework** – where it is vital that the EU Green Bond Standard framework being

⁴ As noted in this blog by the [European Stability Mechanism](#).

finalised accommodates the characteristics of securitisation transactions, reflecting European market practice; we also call on policymakers to initiate work on a framework for green synthetic securitisation in the near future.

We will continue to provide detailed analysis to the Commission, the co-legislators, the ESAs and other institutions involved in the policymaking process.

Thank you for your consideration and we look forward to engaging with authorities on the steps ahead.

Yours sincerely



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CEO, AFME

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Reviewing the prudential frameworks: CRD/CRR and Solvency 2 recalibrations are vital

We welcome the Commission's Call for Advice to the ESAs to review the prudential framework for securitisation in the CRR and Solvency 2, requested by 1 September 2022. We believe that this review is urgently needed to establish a comprehensive understanding of how the prudential frameworks for banks and insurance company investors have performed, as noted by the European Commission, "relative to the framework's original objective of contributing to the sound revival of the EU securitisation market on a prudent basis."

While the analyses of the EBA and EIOPA remain under development, we would like to offer the following observations in relation to this exercise.

Understanding how regulation affects market participant incentives and behaviours

It is very important that the ESAs conduct a thorough analysis of how regulatory requirements have shaped market participant behaviours in recent years. AFME very much agrees that regulation is not the sole factor at play in the evolution of the European securitisation market in the past decade; however, we believe a comprehensive evaluation of the market dynamics through interviews with participants in the markets will evidence that the impact of regulation on the stagnation of the product is an important factor.

In particular, we caution against drawing conclusions about market participants' appetite for and perception of securitisation products on the basis of the current (low) levels of investment activity in most market segments without considering how regulatory requirements have fundamentally shaped their investment incentives and risk-return analysis in the first instance. To understand this fully, direct engagement is needed with bank treasury departments, asset managers and insurance investors to truly understand asset allocation drivers in the context of securitisation.

We believe the ESAs should also take into consideration the prudential treatment of securitisation relative to other comparable fixed income asset classes. This is fundamental as securitisation is only one of the options in the financing toolkit for originators and investors, which has proven itself as a viable option with its own characteristics and benefits.

In this context, AFME has provided data analysis to the EBA and EIOPA on whether the wide disparities in the treatment of securitisation compared to covered bonds and other products in the Liquidity Coverage Ratio (LCR)⁵ and Solvency 2⁶ are justified on the basis of actual credit and liquidity performance, as well as the risk profile of European securitisations⁷.

⁵ See analysis by Risk Control Limited, commissioned by AFME, "A comparison of ABS and Covered Bond Liquidity" (February 2022) – available on [AFME's website](#).

⁶ See analysis by Risk Control Limited, commissioned by AFME, "An analysis of ABS and Covered Bond Risk and Solvency II Capital Charges" (February 2022) – available on [AFME's website](#).

⁷ In assessing credit performance, we observe that over the last 20 years annualised credit deterioration, as measured by ratings transition, between 1995 and 2021 has in several cases been higher in covered bonds than in EU ABS, according to Fitch Ratings: 2021 Transition and Default Studies, published in March 2022. In the period 1995 – 2021, only 1.7% of EU ABS downgraded from AAA to AA, which is a much lower percentage than 5.87% of covered bonds which suffered the same downgrade over the same time period. Similarly, EU Structured Finance

Evaluating the prudential framework in the context of Europe's unique risk-mitigating reforms

The European securitisation product that exists today, when measured against any credit metric over the past 20 years has demonstrated strong stability in terms of ratings and losses and compares favourably to other fixed income asset classes. Notwithstanding, the product has become the most highly regulated and transparent fixed income asset class in existence. The European regulatory framework – both for STS and non- STS securitisations – represents an international “gold standard”, with a set of far-reaching safeguards not seen in other jurisdictions.

AFME members remain convinced that certain prudential calibrations developed in the aftermath of the global financial crisis, and which remain the basis of today's CRD/CRR and Solvency 2 frameworks, are heavily coloured by experiences in the US sub-prime mortgage and products which no longer exist in the marketplace or have been prohibited by the European regulatory framework (eg, re-securitisations).

It is therefore critical for the ESAs to take into consideration the robustness of Europe's securitisation framework today in assessing whether the prudential treatment remains fit for purpose and proportionate to the underlying risks.

In the context of banking regulation, it is particularly important for the EBA to assess the prudential framework taking into account the extensive reforms and market context specific to Europe⁸. Calibrations initially developed at the global level are not always appropriately set, as demonstrated in the EBA's own work in 2019 on the regulatory treatment of securitisations of non-performing exposures (NPEs) where the EBA identified disproportionately high capital charges on NPE securitisation positions⁹. The EBA should continue to evaluate other aspects of the framework with the same critical perspective and on the basis of an assessment of the track record of European securitisations.

Understanding the role of banks and the incentives for insurance company investors

In order for Europe to harness the potential of the technique, banks must have proportionate capital treatment to be able to use securitisation both as a risk transfer tool as well as a tool to directly finance the real economy.

When we refer to risk transfer, we refer to the technique deployed by banks in transferring expected and unexpected loss on a portfolio of assets originated by the bank, to a non-bank, leaving residual risk with the originating bank. The capital calibrations are critical in determining the economic viability of these significant risk transfer (SRT) transactions, as

(SF) has performed better than North America Structured Finance (NA SF). 4.25% of EU SF downgraded from AAA to AA, percentage which is again lower than 5.97% of NA SF which also downgraded from AAA to AA. The strong performance of EU ABS is mirrored down the ratings categories.

⁸ Other major jurisdictions have taken into account local specificities in the implementation of the Basel 3 framework – for example the United States has recalibrated the alpha factor in SA-CCR as it applies to commercial end users.

⁹ EBA [Opinion](#) on the regulatory treatment of non-performing exposure securitisations.

banks have to hold capital against the aforementioned residual risk they retain. A review of these calibrations is urgent as the current capital requirements, which we believe are already disproportionate compared to the risk profile of securitisations issued under the existing regulatory framework, are set to materially increase with the implementation of the Basel 3 output floor.

Meanwhile, improved treatment of STS securitisations in the LCR, which is supported by evidence, would enable bank treasuries to better access diversified liquidity through more equitable regulatory treatment of the asset class. Both bank prudential capital treatment and LCR treatment have wholly disincentivised bank treasuries from considering the most senior and well rated tranches within their Liquid Asset Buffer.

A revision of the Solvency 2 capital charges is equally important. The participation of European insurance companies in the securitisation market remains well below potential. While the capital calibrations for senior STS tranches have been set to levels which are appropriate, the calibrations of non-senior investment grade STS tranches, which naturally fit European insurer investment mandates, remain disproportionately high. The same is equally true of non-STS securitisations, where we believe the magnitude of the capital requirements, in comparison to those for STS, does not reflect the reality of the risk within these transactions.

Meeting investor needs in transparency requirements and other areas

AFME members agree that a high level of transparency and effective diligence are very important. However, certain aspects of the current framework remain impractical and extremely challenging for market participants three years following its implementation.

In particular, the application of template-based reporting continues to create compliance challenges and uncertainties for originators and high hurdles for issuers and investors – this is particularly the case for new issuers. A significant number of AFME members – including investor members – report that investors, particularly on private securitisations, often still require additional (more tailored) reports in the forms they received prior to the Securitisation Regulation reporting framework being in place and that the current template-based reporting is costly for both sell-side and buy-side and not entirely fit for purpose.

Furthermore, the recent introduction by the European Central Bank (ECB) of yet another reporting template required by the ECB for the purposes of supervision of compliance by the significant institutions (when acting as originators or sponsor) with risk retention, transparency and ban on re-securitisation requirements further illustrates the point that the prescribed reporting templates are also not fit for purposes from the perspective of regulatory supervision.

AFME stands ready to engage constructively with ESMA and other authorities in undertaking an assessment of current disclosure requirements with a view to enhancing proportionality, practicality and usefulness for all parties, especially investors and supervisors.

Enabling securitisation to support the green transition: the importance of the EU Green Bond Standard

As noted above, the EU green securitisation market is significantly less developed than that of the United States and China. There is no doubt in AFME's membership that the challenges referred to above have contributed to the EU lagging behind in this area of sustainable finance. Fragmentation and a lack of standardisation have also made it more challenging for Europe to build sufficiently deep pools of green collateral on a single market scale.

The EU Green Bond Standard (GBS) has the potential to be an important enabler to close this gap and support the development of a sound European green securitisation market.

It is vital to ensure that the GBS framework accommodates the characteristics of securitisation transactions, reflecting European market practice. Importantly, this means a framework that acknowledges the important role of the commercial parties to the securitisation, and – at least as a transitional matter – providing optionality between "green assets securitisation" and "green use of proceeds"¹⁰ securitisations. AFME supports the recommendations put forward by the EBA in this regard, which we hope will be considered by the legislators as the GBS framework is finalised.

AFME would also strongly support a green framework for synthetic securitisation considering it is the most cost effective way of securitising project finance and other green assets which cannot be easily securitised via true-sale securitisations. Whilst acknowledging the complexities of including synthetic securitisations within the scope of the GBS, we urge policymakers to start work on a parallel framework for synthetics in the very near future. AFME members remain ready to help with such a process in any way we can.

Conclusion

Three years following the implementation of the new framework, the objective to scale up the European securitisation market on a prudent basis remains an unfinished aspect of the CMU agenda.

A well-designed regulatory environment, with a greater emphasis on proportionality and relevance, will have a very positive effect on market development, at a time when securitisation will be increasingly needed with the end of accommodating monetary policies. The current review presents a crucial and timely opportunity to comprehensively evaluate aspects of the framework against the risk profile of European securitisation today and scrutinise the real disincentives for potential issuers and investors.

We are convinced that targeted improvements to the framework will make a significant difference to market participants willing to issue and invest in securitisations without compromising on financial stability and investor protection standards. AFME will continue to provide constructive feedback and evidence based analysis in line with this objective.

¹⁰ "Green use of proceeds" securitisations are an important component of the market, particularly in the current state of the transition as there is limited Taxonomy-aligned green collateral to securitise (this is expected to increase over time).