

Securitisation as an essential tool for Europe's economy

Policy priorities ahead of
the review of the European
securitisation framework



Europe's economy today faces two main challenges

- The Covid-19 recovery: the damage to the economic fabric and growth prospects caused by the pandemic will take time to repair
- The green transition: achieving targets will require enormous capital mobilisations
- The EU financial system needs to be well-equipped to react to these challenges:
 - Economic growth requires financing and capital, both from banks *and* institutional investors
 - New Basel rules will increase the cost of capital for banks, constraining lending
 - Volumes and ratios of non-performing loans will likely increase in the near future; while the financial system remained resilient during the pandemic it also benefited from significant government and central bank support
 - Continued over-reliance on bank financing makes advancing the CMU an increasingly urgent priority
- **Securitisation is uniquely placed to address these challenges through its ability to transfer risk while still enabling banks to continue to lend.**

- Securitisation is a powerful structuring technique which through risk transfer, credit and maturity tranching can create significant added value when distributed and held by institutions qualified to evaluate the customised cash flows.
- Securitisation can support financial stability as it:
 - facilitates the sharing of risks originated by banks and other originators in their services to the economy with expert institutional investors, thus reducing the risk concentration and promoting diversification
 - rebalances funding of the European economy away from banks to capital markets
 - contributes to capital planning and absorption of upcoming pressure as capital requirements increase
 - helps to resolve NPE portfolios by removing them from banks' balance sheets, sharing risks with highly specialised investors in distressed debt markets
 - As noted in the Final Report of the High-Level Forum on CMU (June 2020): "Importantly, securitisation can play a key role in addressing the consequences of the Covid-19 crisis, by raising liquidity for banks, helping manage their balance sheet exposures, reducing the link between sovereigns and banks given the large volume of sovereign guaranteed loans, and eventually contributing to setting the post-pandemic EU economy."
- In particular, securitisation can also support corporate and SME financing by:
 - freeing up capital to generate new lending in the form of SME loans and leasing
 - providing essential and safe structured financing for trade receivables
 - providing capacity for lending to ESG projects such as mortgage loans financing energy-efficient houses, rooftop solar energy loans or SME loans for sustainable projects

Creating value - restoring the motivations for securitisation

- The reason why securitisation issuance has fallen significantly in Europe is that the economics no longer work for many potential issuers and investors.
- Due to excessive capital requirements, the capital-adjusted cost of funding for banks through securitisation is often too high.
- This lack of viability of securitisation for many banks constrains the European financial system by restricting banks' ability to use their capital to support as much lending as possible. Without well-functioning securitisation, banks are forced either:
 - to stop lending after they have reached full balance sheet capacity, or
 - to sell loans as “whole” (unsecuritised) portfolios to third party investors: such portfolios are illiquid and may be sub-optimal in extracting the best value.
- For securitisation to be cost-effective, the cost of freeing up one unit of capital for issuers must be less than the return on equity which such unit of capital would earn were it invested in funding assets on the balance sheet.

While remaining prudent, the framework should:

- Make it easier and economically attractive for:
 - originators to undertake securitisations
 - investors to provide both funding and risk appetite for securitisation
- Treat securitisation proportionately compared with other fixed income products and "whole loan" investment
- Encourage the development of the ESG securitisation market while not imposing additional constraints

The CMU High-Level Forum report provided well-targeted and prudent recommendations to adjust the framework. These should be implemented to their full extent.

Summary of recommendations

	Issue	Solution
Liquidity Coverage Ratio (LCR)	<ul style="list-style-type: none"> • STS is not properly recognised under the LCR 	<ul style="list-style-type: none"> • Adjust LCR to include all securitisation and better to reflect the quality of STS securitisation
Capital for bank investors	<ul style="list-style-type: none"> • Overly conservative capital treatment for bank investors under CRR 	<ul style="list-style-type: none"> • Recalibrate CRR to reflect the real risk, level the playing field and reduce distortions
Solvency II	<ul style="list-style-type: none"> • Overly conservative capital treatment discourages insurers from taking longer-term mezzanine risk, and instead encourages direct purchase of illiquid portfolios of "whole loans" 	<ul style="list-style-type: none"> • Recalibrate Solvency II to align more fairly with covered bonds and corporates and reduce cliff-effects
Significant Risk Transfer (SRT)	<ul style="list-style-type: none"> • SRT assessment process has in the past been slow, uncertain and inconsistent 	<ul style="list-style-type: none"> • Continue the improvement in review procedures and feedback
Disclosure requirements	<ul style="list-style-type: none"> • ESMA disclosure templates remain challenging for originators with many compliance uncertainties. 	<ul style="list-style-type: none"> • Adopt a more proportionate approach especially for private securitisations
On-balance-sheet securitisation	<ul style="list-style-type: none"> • Risk weighting of synthetic excess spread and the requirement for recourse to excessively high-quality collateral add complexity, reduce efficiency and make the framework more expensive to use. 	<ul style="list-style-type: none"> • Implement a balanced approach for synthetic excess spread and simplify requirements for high-quality collateral
Asset-backed commercial paper (ABCP)	<ul style="list-style-type: none"> • Lack of central bank support and overly strict requirements for STS at ABCP Programme level have led to zero take-up 	<ul style="list-style-type: none"> • Improve central bank support and LCR treatment
ESG Securitisation	<ul style="list-style-type: none"> • If well supported, ESG and green securitisation can make an important contribution to funding the transition to a more sustainable economy. 	<ul style="list-style-type: none"> • Implement common standards and support the nascent market consistently with other financial products
STS criteria	<ul style="list-style-type: none"> • Excessive complexity has discouraged the issuance of new securitisations and prevented their use for certain asset classes (e.g. SME loans) 	<ul style="list-style-type: none"> • Consider if streamlining is possible

What securitisation does and does not do

Does	Does not
<p>Reduce the concentration of risk in the banking sector and enable banks to customise much more effectively the risks they retain or sell. Securitisation converts illiquid loans into liquid and transferable securities that can be sold to specialised investors and traded in secondary markets. As a result, securitisation removes credit risk from bank balance sheets, enabling banks to reallocate capital and strengthen their capital ratios. The credit and maturity tranching process creates both tranches with lower credit and mark to market risk and tranches with higher credit and mark to market risk.</p>	<p>Eliminate risks from the financial system Securitisation does not eliminate risks – it rather helps to distribute and diversify them in a more efficient manner to those investors who are well prepared to hold those risks. Subject to risk retention rules, well-managed and supervisor-approved credit risk transfer away from the banking sector through securitisation benefits the economy and the banking sector, enhances monetary and financial stability, and creates opportunities for fund managers to improve their investment returns.</p>
<p>Provide direct and indirect benefits for SMEs Securitisation can finance not just direct loans to SMEs, but also SMEs’ working capital (in the form of trade receivables) and leases of crucial assets such as vehicles and manufacturing equipment. Synthetic securitisations of SME loans assisted by public guarantee schemes contribute to new SME lending.</p>	<p>Supplant other financing options for SMEs, such as equity SME lending attracts higher capital charges for banks as SME lending is inherently higher risk. Securitisation of SME loans enables banks better to manage capital allocated to SMEs and lend more. However it is not a substitute for equity for SMEs, rather a complementary tool. Securitisation can act as a bridge from bank balance sheets – where most SMEs currently obtain their funding – to the capital markets.</p>

What securitisation does and does not do

Does	Does not
<p>Provide specialised investors with significantly improved choice in their portfolio mix</p> <p>The technique of credit and maturity tranching allows the cash flow from the underlying assets to be purchased by different types of investors with varying investment preferences. Securitisation thus provides investors with exposure to the real economy to improve their ability to fine tune risk and return, or create tranches with particular maturities or currencies.</p> <p>Securitisation is a specialised product suitable for institutional investors who have the resources to understand the transaction structures and carry out all necessary due diligence. The introduction of STS criteria was intended to widen the investor pool by simplifying and standardising transactions based on common and transparent features.</p>	<p>Reduce risk for holders of all tranches</p> <p>The technique of tranching cashflows facilitates the creation of higher or lower risk investments to meet different investors' appetites for risk and return, or particular maturities or currencies. Investors buying the senior tranche receive in priority the cash-flows from 100% of the portfolio, while those buying the non-senior tranches only get paid after all payments owed to the senior tranche are made. It makes no more sense to seek to remove all risk from securitisation than to remove it from government bonds, covered bonds, corporate bonds, consumer lending or equities. Responsible risk-taking is what creates rewards for investors (returns) and issuers (risk-reduction) alike.</p> <p>The natural complexity of securitisation transactions does not mean that they are riskier products in the economic system. European securitisations have a solid track record and are the most highly regulated and transparent fixed income asset class.</p>
<p>Provide an asset that meets liquidity needs</p> <p>In particular during market stress, securitisations that meet applicable eligibility criteria of the relevant central bank liquidity operations (e.g. those of the ECB/Eurosystem) can provide investors and originators with immediate funding and increased liquidity in the primary/secondary markets.</p>	<p>Serve as a panacea for financial sector needs</p> <p>Securitisation is only one of the options in the financing toolkit for originators and investors. It has proved itself as a viable option, including during times of market stress.</p>

Securitisation perceived risks & mitigants

Note: Many of these perceived risks are not unique to securitisation; AFME does not believe all risk control measures noted below are proportionate to the risks of European securitisation

Risk	Mitigant	Reference
Misalignment of interests/risks between issuers and investors	<ul style="list-style-type: none"> 5 % risk retention requirement 	Art. 6 (SR)
Low quality underlying assets (poor underwriting or asset performance)	<ul style="list-style-type: none"> Criteria for credit-granting, including ban on securitisation of self-certified residential mortgages Prohibition on adverse selection 	Art.9 (SR) Art 6(2) (SR)
Complex and opaque structures	<ul style="list-style-type: none"> Ban on re-securitisations (CDO-squared structures are no longer permitted in the EU) 	Art. 8 (SR)
Investors not understanding the risks properly	<ul style="list-style-type: none"> Comprehensive due diligence requirements Prohibition on selling securitisations to retail clients 	Art. 5 (SR) Art. 3 (SR) PRIIPS, MiFID II product governance rules
Use of complex derivatives	<ul style="list-style-type: none"> STS requirements relating to standardisation 	Art 21(2) and (3) (SR) Art 26c(2) and (3) (SR)
Information asymmetry; any disclosure which does not provide investors with sufficient information to evaluate their risk	<ul style="list-style-type: none"> Highly demanding transparency regime unique among fixed income products – template-based loan-level and investor reporting and disclosure of all documents essential to understand the deal for public and private transactions 	Art. 7 (SR)

Securitisation perceived risks and mitigants

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Risk	Mitigant	Reference
Non-compliance, fraud, mis-selling.	<ul style="list-style-type: none"> • Third party verification of STS compliance • Administrative sanctions and remedial measures • Possibility for Member States to impose criminal sanctions 	Art. 28 (SR) Art. 32 (SR) Art. 34 (SR)
Low-quality assets or sub-optimal structuring of transactions.	<ul style="list-style-type: none"> • Assets packaged in an STS securitisation must meet stringent lending, homogeneity and underwriting standards; non-STs securitisations are also highly regulated • STS requirements relating to simplicity • STS requirements relating to standardisation • STS requirements relating to transparency 	Art. 20 (SR) Art. 21 (SR) Art. 22 (SR) Art. 26 (b, c, d, e) (SR)
Accumulation of risks in the financial system arising from securitisation. (AFME does not believe that securitisation, unique among various financial techniques, requires special macroprudential oversight.)	<ul style="list-style-type: none"> • Macroprudential oversight of the securitisation market • Prudential balance sheet and leverage ratio benefits of securitisation for bank originators require compliance with stringent economic as well as documentary, structural and significant risk transfer requirements 	Art. 31 (SR)
Mis-calibrated credit ratings.	<ul style="list-style-type: none"> • Reduced reliance on credit ratings and improved quality of ratings • Various other requirements applying to CRAs 	CRA Regulation

Securitisation perceived risks and mitigants

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Risk	Mitigant	Reference
<p>Tranching lowers the credit risk on higher-rated tranches, and raises the credit risk on lower or unrated tranches.</p>	<ul style="list-style-type: none"> Capital charges for banks and insurance company investors are calibrated very conservatively based on the credit risks of the new securitisation tranches 	<p>CRR Art. 258-270 Solvency II Art. 178</p>
<p>Maturity tranching lowers the price volatility/mark to market risk for tranches with shorter maturities or weighted average lives, and raises this risk for tranches with longer maturities or weighted average lives.</p>	<ul style="list-style-type: none"> For regulated investors such as EU insurers whose investments are subject to mark to market requirements, capital charges must fairly reflect the post-securitisation price volatility of tranches For other investors such as fund managers, investors receive sufficient data to mark their portfolios to market 	<p>Solvency II Art. 178</p>

The European securitisation market remains subdued; heavy regulations constrain growth

- The securitisation market in Europe was disrupted after the 2008 financial crisis and has not scaled up with the STS framework; STS has not delivered an expansion of securitisation beyond a few Member States
- Existing frequent issuers have made use of the STS label, which now represents a significant share of the market (for placed issuance)
- However, non-STS issuance still outweighs STS, and STS has not stimulated new issuers or investors
- Much of the actual use of the STS label has been to apply it retrospectively to existing financings - mainly performing consumer ABS term securitisations and private ABCP transactions.
- The harsh treatment of securitisation compared to other financial instruments, whole loan pools and other fixed income investments makes STS securitisation burdensome, unattractive and costly for many issuers and investors – the upcoming revision of the STS framework is vital to address these concerns
- The regulatory framework in Europe is more stringent than in the US – despite the strong performance of European securitisation through and since the financial crisis
- It is anticipated that the ability of US originators to transfer mortgages to government-sponsored entities such as Fannie Mae (which then engage in risk transfer techniques) will shield US originators from certain adverse changes in the risk-weighting of mortgages under Basel III, contributing to a disproportionate impact in the EU of those coming reforms
- Recent relaxation of the rules for the use of Pools of Additional Credit Claims (PACCS) has led to a decline in the use of both retained RMBS/ABS and covered bonds in the Euro-system

The quality of the STS label has not been recognised; the unlevel playing field remains

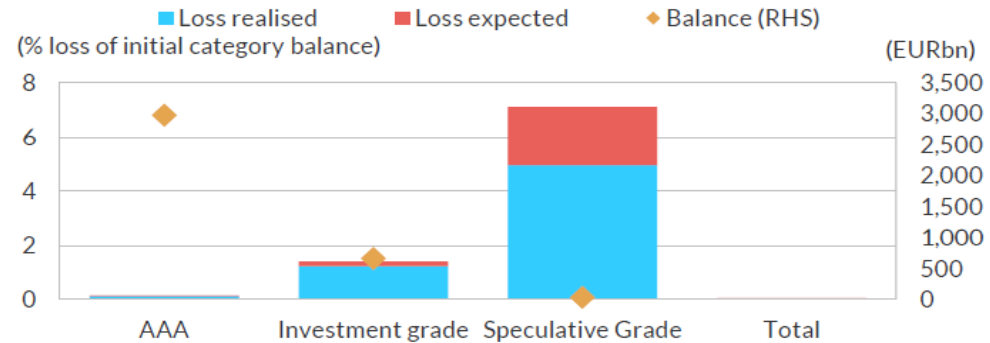
- The Securitisation Regulation introduced tough new requirements:
 - disclosure requirements which were not calibrated for the specific features of the securitisation market – particularly problematic for private transactions
 - due diligence requirements for investors which are excessive and go well beyond what is reasonably necessary for the high credit quality of many securitisations
 - over 100 criteria must be met to achieve the STS label
- The concept of "simple, transparent and standardised" securitisations is widely supported, but the tough new regime has created higher hurdles for both originators and investors, and not been properly recognised in capital and liquidity rules:
 - partial adjustments to Solvency 2 and bank capital calibrations have mostly focused on the very senior tranches but failed to address distortions for mezzanine and junior investment
 - liquidity treatment under the LCR has not improved with STS and has even deteriorated with the new CRR (only AAA rated ABS are now eligible)
 - while improving, Significant Risk Transfer, which is required in order for originator banks to achieve prudential balance sheet and leverage ratio benefits, remains a complex and challenging process
- The 2020-21 targeted initiatives on NPEs and on-balance-sheet securitisation were a step forward, but
- Some existing transactions were penalised by the new framework (e.g. UTP).
- Generally the institutional debate limited the potential for impact of some proposals, so these reforms should be revisited in the future review of the broad securitisation framework

The post-Global Financial Crisis (GFC) credit performance of securitisation is excellent

Losses over the last 20 years have been concentrated in low-rated tranches (originally rated "CCCsf" or below). Very few senior tranches, which predominate, have suffered losses.

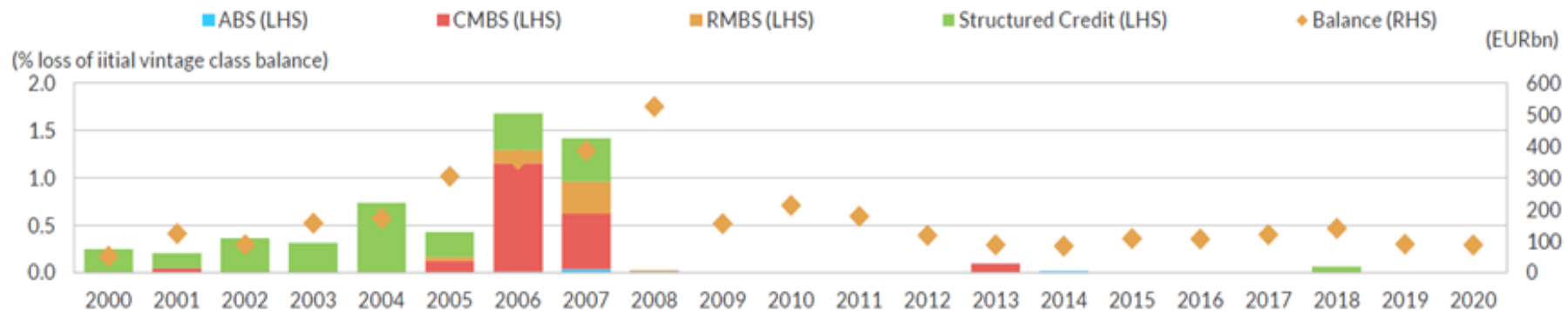
EMEA Total Loss by Original Rating

Issuance 2000-2020



EMEA Total Loss by Issuance Vintage

Issuance 2000-2020



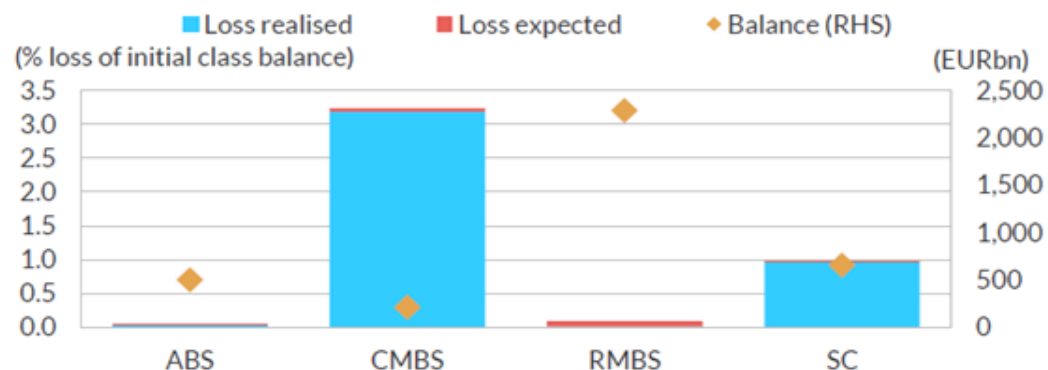
Note: Total loss is the sum of expected and realised loss.

Losses from the financial crisis were concentrated in CMBS and CDOs, which are excluded from STS

Rightly, Commercial Mortgage Backed Securities (CMBS) and Collateralised Loan Obligations (CLOs) have been excluded from the STS framework, which was built after the GFC and which drew on its lessons.

EMEA Total Loss by Sector

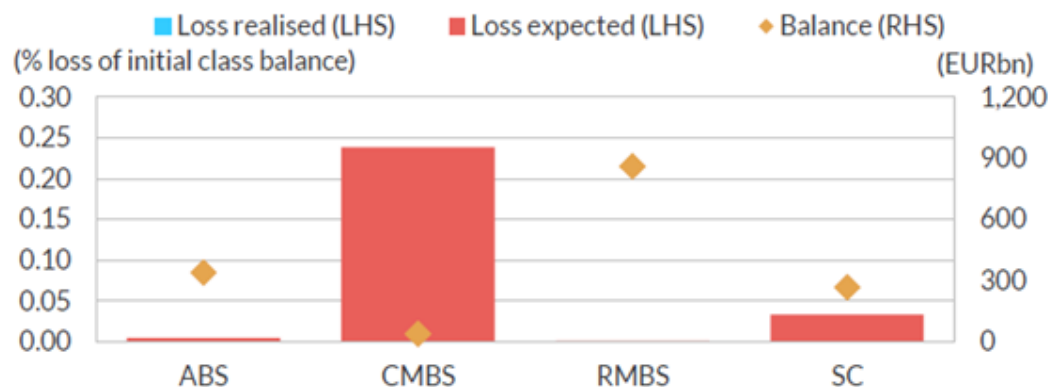
Issuance 2000-2020



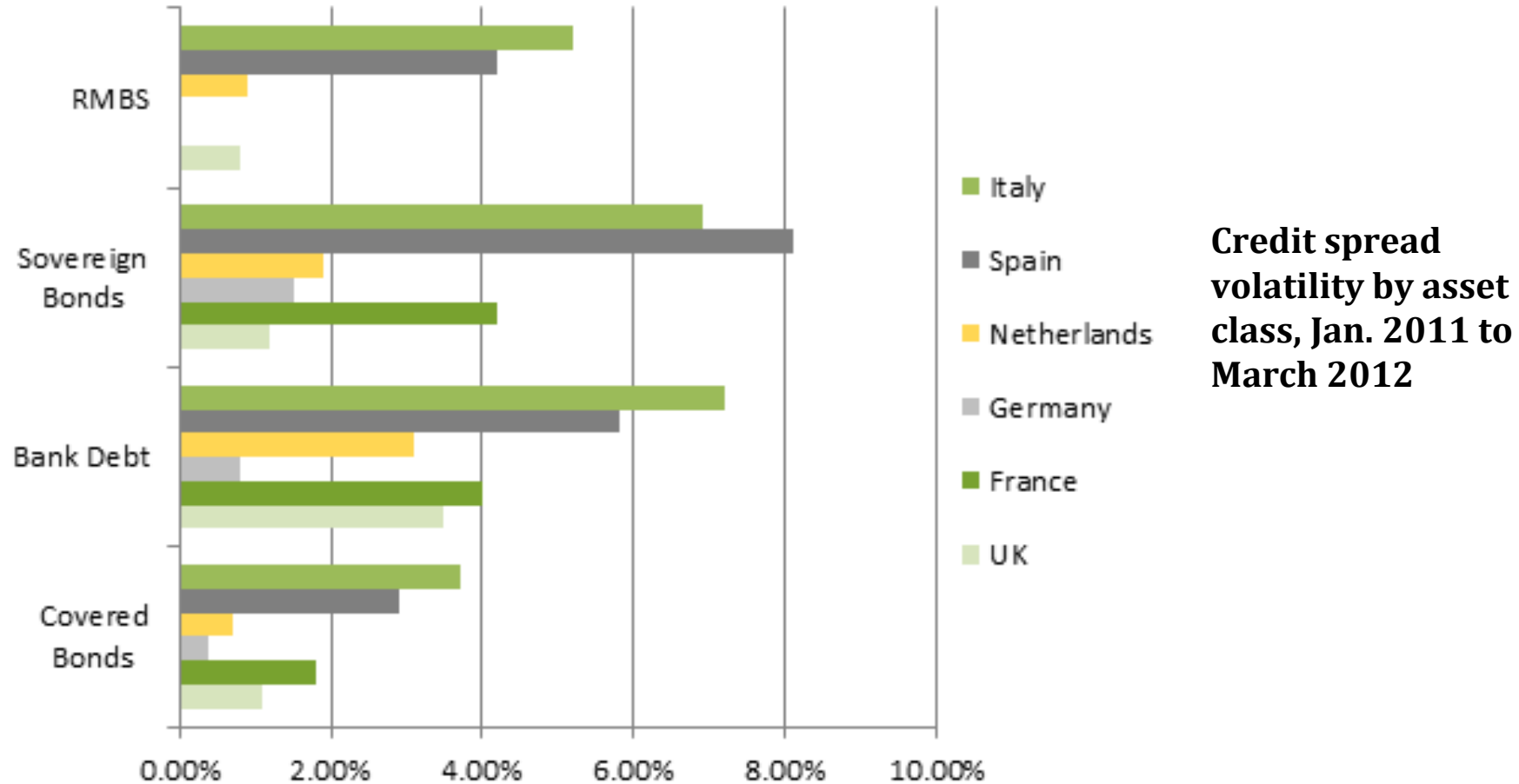
In EMEA post-GFC, RMBS bore minimal losses. Further, all expected losses (0.0007%) relate to tranches originally rated 'CCCs' or below.

Post Financial Crisis EMEA Total Loss by Sector

Issuance 2009-2020



During the "Eurozone crisis" securitisation spreads were less volatile than sovereigns and banks, and close to covered bonds



Credit performance across European structured finance sectors held strong in 2020

European Structured Finance Transition And Default Summary

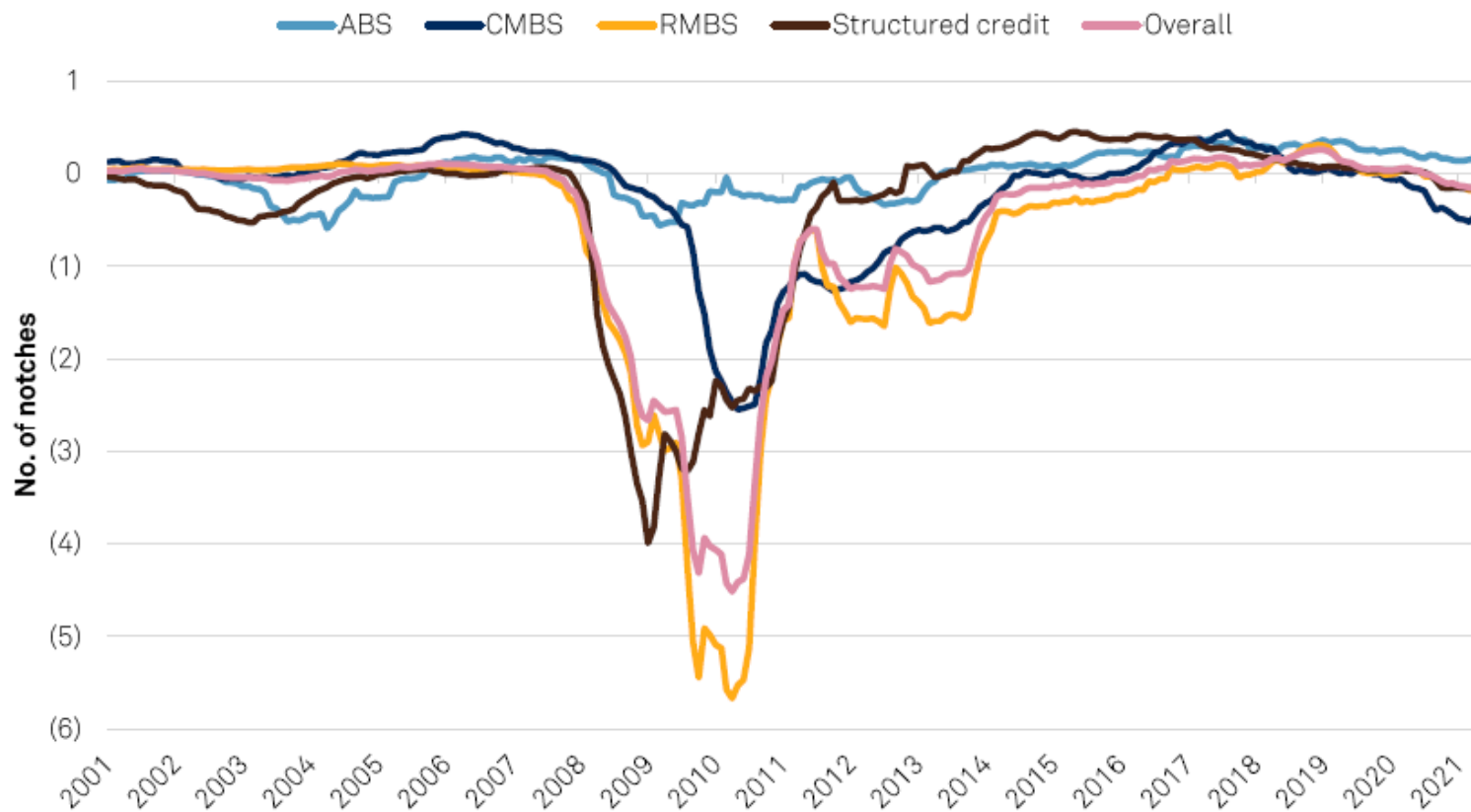
	--2020--						--One-year average--			
	Ratings (no.)	Stable (%)	Upgrades (%)	Downgrades (%)*	Defaults (%)	Defaults (no.)	Stable (%)	Upgrades (%)	Downgrades (%)*	Defaults (%)
Overall	3,266	91.5	4.8	3.6	0.2	8	77.7	7.8	14.5	1.0
Subsector										
Europe RMBS prime	639	88.4	9.9	1.7	0.0	0	82.2	6.6	11.2	0.4
Europe RMBS nonconforming	556	93.7	5.6	0.7	0.0	0	76.0	11.0	13.1	0.1
Europe RMBS other	252	91.7	7.9	0.4	0.0	0	79.0	10.2	10.9	0.1
Europe structured credit CLO	881	96.0	1.0	3.0	0.1	1	74.4	15.3	10.3	0.2
Europe structured credit SF CDO	41	82.9	14.6	2.4	2.4	1	67.6	6.1	26.3	5.1
Europe structured credit other	274	92.3	2.6	5.1	0.0	0	74.8	6.6	18.6	1.4
Europe CMBS	195	81.0	0.5	18.5	3.1	6	74.4	3.6	22.0	3.0
Europe ABS auto	192	94.3	5.7	0.0	0.0	0	91.1	6.2	2.7	0.2
Europe ABS nontraditional	62	82.3	0.0	17.7	0.0	0	81.8	2.6	15.6	0.8
Europe ABS consumer	59	94.9	3.4	1.7	0.0	0	87.5	6.4	6.1	0.1
Europe ABS credit card	44	88.6	11.4	0.0	0.0	0	95.6	2.0	2.4	0.0
Europe ABS other	50	92.0	6.0	2.0	0.0	0	87.0	4.5	8.5	0.0
Europe single-name synthetics	21	42.9	0.0	57.1	0.0	0	81.8	3.7	14.5	0.5

Source: S&P Global "2020 Annual Global Structured Finance Default And Rating Transition Study", 13 May 2021 (Table 7)

- The average change in credit quality remained positive at the end of 2020
- The annual default rate for European structured finance fell to 0.2% in 2020, remaining well below the one-year average of 1%
- The downgrade rate increased to 3.6%, but this is well below the one-year average of 14.5%.
- Almost every European securitisation subsector reported upgrades. Within European ABS, upgrades were the highest in the credit card subsector, where the upgrade rate was 11.4% in 2020, well above the one-year average of 2%.

Compared with past periods of stress, ratings performance through the pandemic has been benign

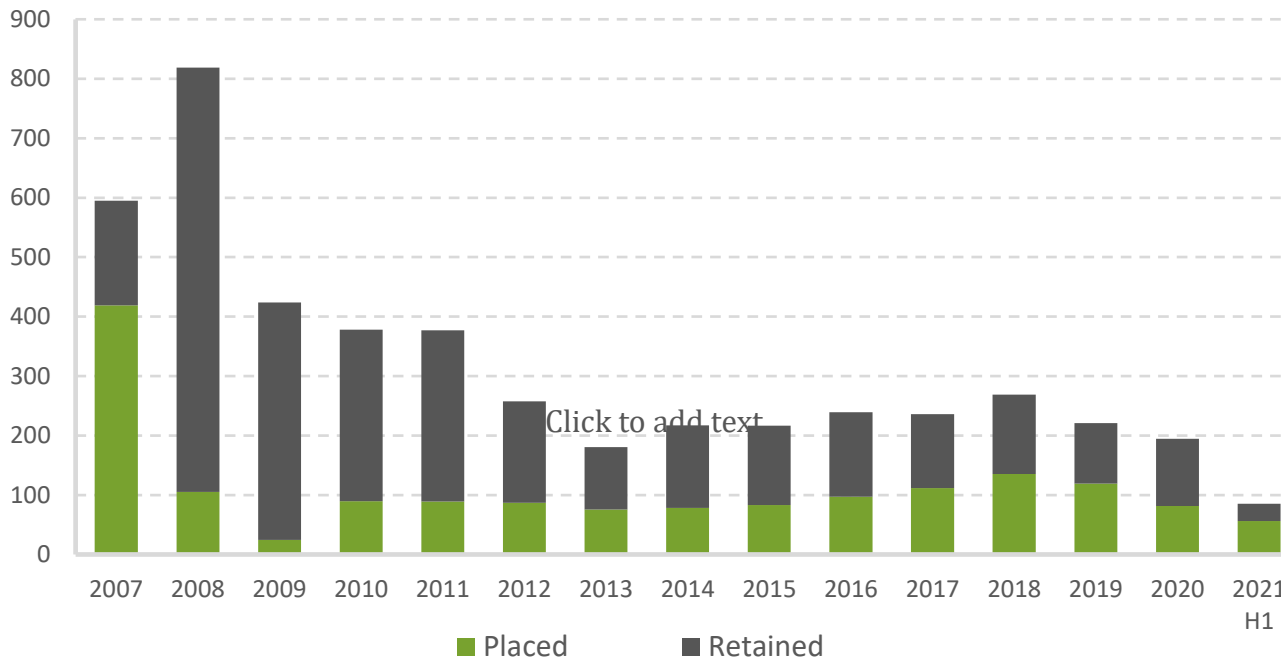
Global 12-Month Trailing Average Change In Credit Quality



- Although net ratings migration for global structured finance securities has turned negative through the pandemic, the scale of rating decline has been limited, averaging only 0.1 notches.
- Ratings have been significantly more stable than in past periods of stress.
- The CMBS sector has seen the most severe downward ratings migration, averaging 0.5 notches, given some exposure to sectors most affected by lockdown restrictions, such as retail and hotels.
- The ABS sector has continued to see net positive rating movements, helped by the effects of policy support on consumer credit performance.

Chart shows the average rating movement over the previous 12 months in terms of rating notches. Securities whose ratings migrated to 'NR' over the 12-month period are classified based on their rating prior to 'NR'. Excludes covered bonds. Source: S&P Global Ratings.

Yet issuance volumes have remained low and 2020 issuance was the lowest since 2013



Issuance has not scaled up since the introduction of STS. It is therefore critical to improve the framework to make it more attractive for issuers and investors.

Values in EUR bn	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021 H1
RMBS	358.4	598.4	226.0	266.3	223.2	137.4	64.9	110.8	102.0	120.5	119.0	113.7	104.1	80.6	32.0
ABS	36.8	68.3	54.5	32.0	74.6	53.1	72.1	48.0	66.6	70.9	52.9	67.4	48.4	70.4	30.9
CLO	62.1	94.5	47.4	28.5	9.6	13.5	9.2	14.8	14.2	21.7	49.2	51.9	39.5	22.1	14.7
CMBS	52.5	10.2	29.1	7.1	3.8	5.0	8.8	6.3	6.0	3.7	0.9	5.8	5.8	2.4	3.7
SME	77.3	47.3	65.1	39.7	62.4	45.2	20.2	33.3	27.1	19.9	14.1	29.5	23.0	7.5	2.0
WBS*	7.9	0.0	1.8	4.5	3.2	3.7	5.4	3.7	0.8	2.9	0.0	0.6	0.0		
CORP*														11.7	1.9
Total European	594.9	818.7	423.9	378.0	376.8	257.8	180.8	217.0	216.6	239.5	236.0	268.8	220.8	194.7	85.2
Placed (% of Total)	70%	13%	6%	24%	24%	34%	42%	36%	38%	41%	47%	50%	54%	42%	66%

Source: AFME Q2 2021 Securitisation Data Snapshot, SIFMA, BofA. Chart includes both placed and retained issuance volumes. *Due to change in source of securitisation issuance data, AFME does not report WBS volumes from 2020, CORP (Corporate) issuance volumes reported thereafter.

Securitisation can help Europe's economy meet its two key challenges

- Funding the Covid-19 recovery
- Mobilising capital for the green transition
- Providing flexibility of funding and capital management for the EU economy and financial system:
 - Economic growth requires financing and capital, both from banks *and* institutional investors
 - New Basel rules will increase the cost of capital for banks, constraining lending
 - Volumes and ratios of non-performing loans will likely increase in the near future; while the financial system remained resilient during the pandemic it also benefited from significant government and central bank support
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- **Securitisation is uniquely placed to address these challenges through its ability to transfer risk while still enabling banks to continue to lend.**

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