afme/ Finance for Europe

Article 5 of EU Securitisation Regulation: Impact Analysis

Analysis in support of AFME's response to the Commission's Targeted Consultation on the functioning of the EU Securitisation Framework

December 2024

Finance for Europe

Contents

Preamble - The investor base today

- Direct investors in EU securitisation consist of a broad range of institutional types, including banks, multi strategy asset managers, specialist credit funds, pension funds and insurance companies, located across the world and investing down the capital structure from AAA to first loss across a broad range of products, including traditional securitisation for funding balance sheet growth, risk transfer and fund leverage.
- The EU asset manager universe for the most senior ABS looks very different both to the non EU equivalent and also to the universe in the EU of comparable EU fixed income products with similar credit risk profiles - both in terms of number and type of investor.
- The universe of EU asset managers consists today of less than 20 institutions (cf. data provided to the Commission by AFME in 12/24 reviewing investor appetite across fixed income in EU)
- The few asset managers investing in senior ABS today invest from AAA down the ABS capital structure (AAA down to BB) on behalf of multiple clients typically as part of a broader fixed income mandate or via dedicated mandates.
- AFME's sample appropriately represents the EU asset manager ABS investor universe.

afme/
Finance for Europe

Preamble - Restoration to a normalised investor universe for tomorrow.

- AFME's asset manager members have first-hand experience of the investment barriers created by Article 5, EUSECR. They remain convinced that the provisions of this article create important impediments to the development of a fully functioning market.
- Article 5, as currently drafted, caps growth in the investor base; "if it were simply a matter of credit risk and not regulatory compliance, investors would start to invest as part of their broader fixed income portfolio and grow AUM as they see fit. A lack of comfort in taking regulatory risk means that investors must draw up additional sets of specific policies, reporting and oversight regardless of exposure- which realistically means it's only worth doing if you are going to invest in size." *
- A functioning market relies upon access to a diversified, granular investor base scaling a deep pool of capital. A functioning European ABS market will benefit from a more atomized investor base made up of a relatively small number of asset managers investing in scale along side a large number of investors investing as part of a balanced investment strategy.
- Whilst difficult to quantify the discrete impact of reforms to Article 5, along side associated reforms advocated by AFME, it is reasonable to expect in time the ABS investor base to grow to levels commensurate with other senior secured and unsecured fixed income products with levels of participation at multiples of 5 to 10 x the number of investors that exist today in securitisation.
- *Contributing investor to study

Objective of Study

Objective of Study:

- To generate a high level understanding of, and substantiate with data analysis, the impact of Article 5, of the EU Securitisation Regulation (EUSECR) on relative value for asset managers in building assets under management (AUM) in ABS compared to other fixed income products when focusing solely on P&L impact arising from internal resourcing costs incurred across front, middle, back office and compliance,

Scope of analysis –surveyed group

- This analysis is based on feedback solicited from asset managers with a presence in Europe that invest in traditional securitization at AAA level and down the capital structure. As an estimation, the sample constitutes c.20% of asset managers by number and up to 50% by ABS assets under management. These institutions are seasoned fixed income investors, most of which had achieved a scale of investment in ABS prior to the implementation of EUSECR. The relationship with end client includes dedicated ABS mandates as well as non dedicated mandates, both internal and external client mandates.
- This analysis is limited in one important way; it does not (and cannot without difficulty) solicit feedback from the universe of investors that do not invest in securitisation and who otherwise likely would if it were not for the non risk sensitive regulatory and prudential frameworks that disincentivize investment.
- They are in effect the principal target audience of Article 5 reforms, being as they are, the universe which will be most affected by implementation of a revised Article 5.
- It is fair to conclude therefore that the findings from this sample are biassed towards a small universe of investors whose scale enables them to generate appropriate returns by investing in ABS despite the challenges created by Article 5. In other words, Article 5 poses significant barriers to entry for smaller institutions that struggle to overcome such challenges given their smaller scale and fewer client mandates.
- The sample includes the only European asset manager that AFME is aware of that has started up a business post 01/2019.
- Bank investor feedback was not solicited.

Scope of analysis – costs

- The issue of costs arising from implementation of Article 5 by investors is evidently complex.
- Costs incurred by investors may be categorised as follows,
    - Economic costs
    - Opportunity costs
    - Frictional costs
- Some of these are firm specific whilst others are more systemic.

- This analysis assesses only the economic costs arising from additional resourcing requirements. Furthermore, the analysis does not consider costs that are typically contracted for ABS, such as;
    - Legal counsel – providing guidance and opinions relating to Policies & Procedures mapping to EU regulation
    - 3rd party advisory (upfront and ongoing)
    - Systems / IT – data capture and MI generation

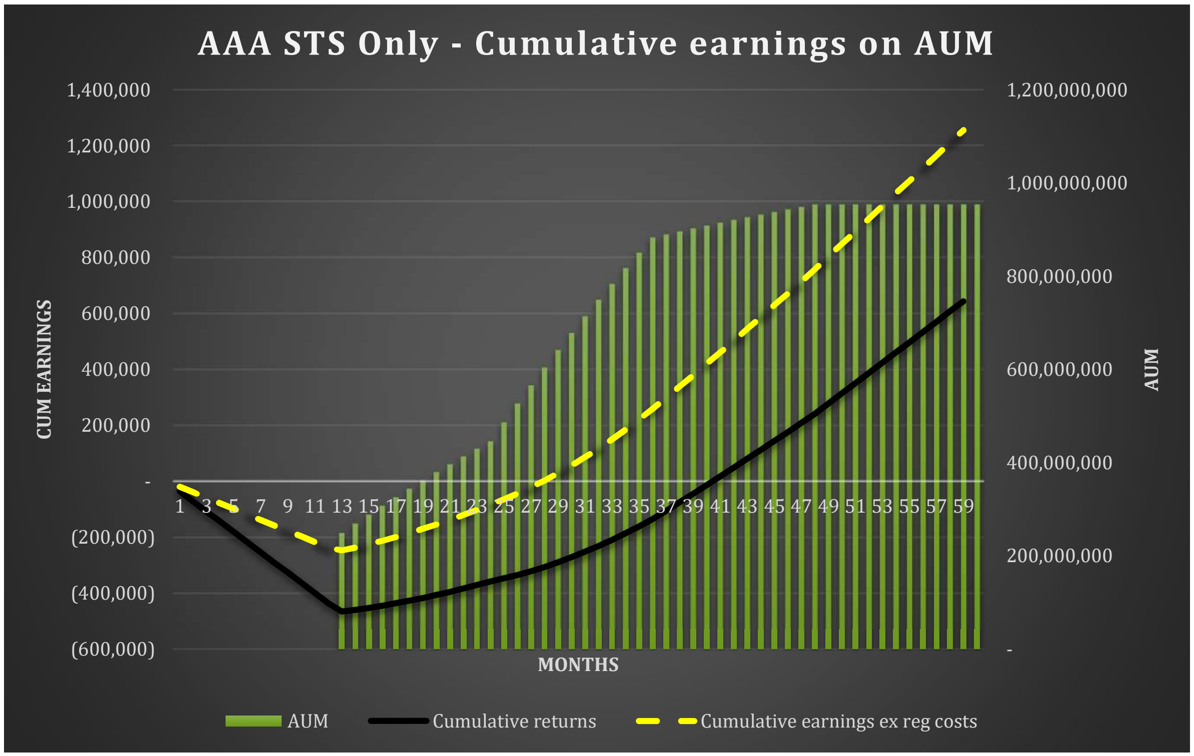
Overview of analysis

- The analysis takes into account cumulative earnings projected for 6 investment strategies over a 5 year period. These investment strategies are;
    1. AAA STS only
    2. Investment Grade ABS
    3. Sub Investment grade ABS
    4. Covered Bonds
    5. Investment Grade Fixed income
    6. High Yield Fixed income
- AUM growth is more or less held constant across the 6 strategies in order to focus on P&L comparisons. The reality is that AUM build up in ABS will be slower given lower supply in the product;
- High level revenue and cost assumptions are stated along side each chart and at end of deck
- Resourcing cost estimates from the group have been used as inputs into the P&L.

Preliminary Findings

- Over 20% of internal resources in setting up an ABS business from scratch is dedicated to Article 5 implementation
- When investing in ABS, Article 5 related costs as a percentage of total costs increase the higher the credit quality of the exposure;
    - AAA STS ABS: estimated that 45% of resourcing costs are Article 5 related
    - Sub IG ABS: estimated that 25% of resourcing costs are Article 5 related
- When monitoring an ABS portfolio, Article 5 related costs as a percentage of total costs are higher than when investing in new assets
    - AAA STS ABS: estimated that 60% of resourcing costs are Article 5 related
    - Sub IG ABS: estimated that 30% of resourcing costs are Article 5 related
- Asset manager Article 5 related estimated costs are wide ranging. This is likely due to several reasons;
    - Simplifying assumptions when estimating costs for each provision within the Article.
    - Challenges the group has encountered in disaggregating these costs from total costs.
    - % costs will vary significantly, depending upon the nature of the analysis (cf. slide 14)

Findings: AAA STS ABS only



Considerations

- A manager running a AAA STS only strategy will likely take c. 3 years and require AUM around EUR 1bln before business break even.
- Set up of the business from scratch will likely take up to 9 months, 2 months of which will relate to Article 5 compliance.
- Time to breakeven should reduce by c. 30% as a result of introduction of proportionality within Article 5.
- Adoption of a AAA STS only strategy may be deemed unfeasible in light of the costs for the business today

Assumptions:

- Management fees: 0.07%
- Av tickets: EUR10mm

Findings: AAA STS ABS only

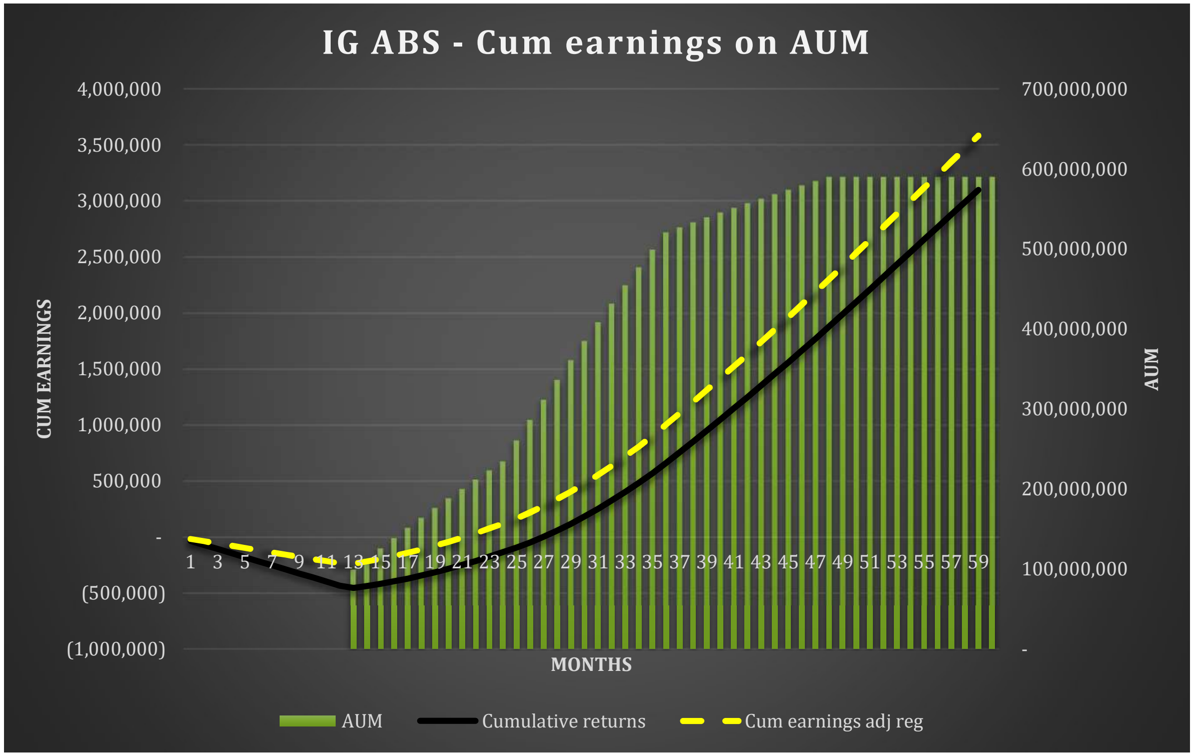
If it were simply a matter of credit risk and not regulatory compliance, investors could start investing in Senior ABS as part of the broader credit team and grow as they see fit.

Currently, the understandable lack of comfort in taking regulatory risk means that new investors have to put a whole additional set of specific policies, reporting and oversight in place - which realistically means it's only worth doing if you are going to invest in size.

The majority of Compliance/ Legal/ Mid/ Back office costs are typically loaded towards upfront or project related costs and not costs incurred on an ongoing basis.

Functions within well established business lines are often highly integrated into broader fixed income mandates. It is therefore challenging to identify ABS specific costs in any meaningful way.

Findings: Investment Grade ABS



Considerations

- A manager investing in Investment grade ABS (AAA – BBB), depending on the product mix and portfolio weighted average rating, will take c. 2 years and AUM greater than EUR 500mln before the business breaks even.
- Set up of the business from scratch will take up to 9 months, 2 months of which will relate to Article 5 compliance.
- Time to breakeven should reduce by c. 50% as a result of introduction of proportionality within Article 5

Assumptions:

- Management fees: 0.25%
- Av tickets: EUR5mm

Findings: Onboarding new ABS programs / issuers

	New Issuer	Repeat Issuer
New vs Repeat %	33%	67%
Analyst Hours/ Investment		
AAA STS	15	7
IG ABS	15	9
HY ABS	15	11
Securitisation Regulatory Workload		
AAA	33%	75%
IG ABS	33%	50%
HY ABS	33%	40%
Analyst Seniority %		
Senior	50%	50%
Junior	50%	50%
Ongoing Monitoring Hours (per investment/ per yr)	2	2

This table illustrates the differences in analytical manhours across risk categories / familiarity of issuer as well as the % of regulatory work required.

The analytical approach differs substantially depending upon the following;

- Have we invested in Issuer / Program before?
- Is the exposure Senior or Junior?
- Is it Investment grade or Sub IG?

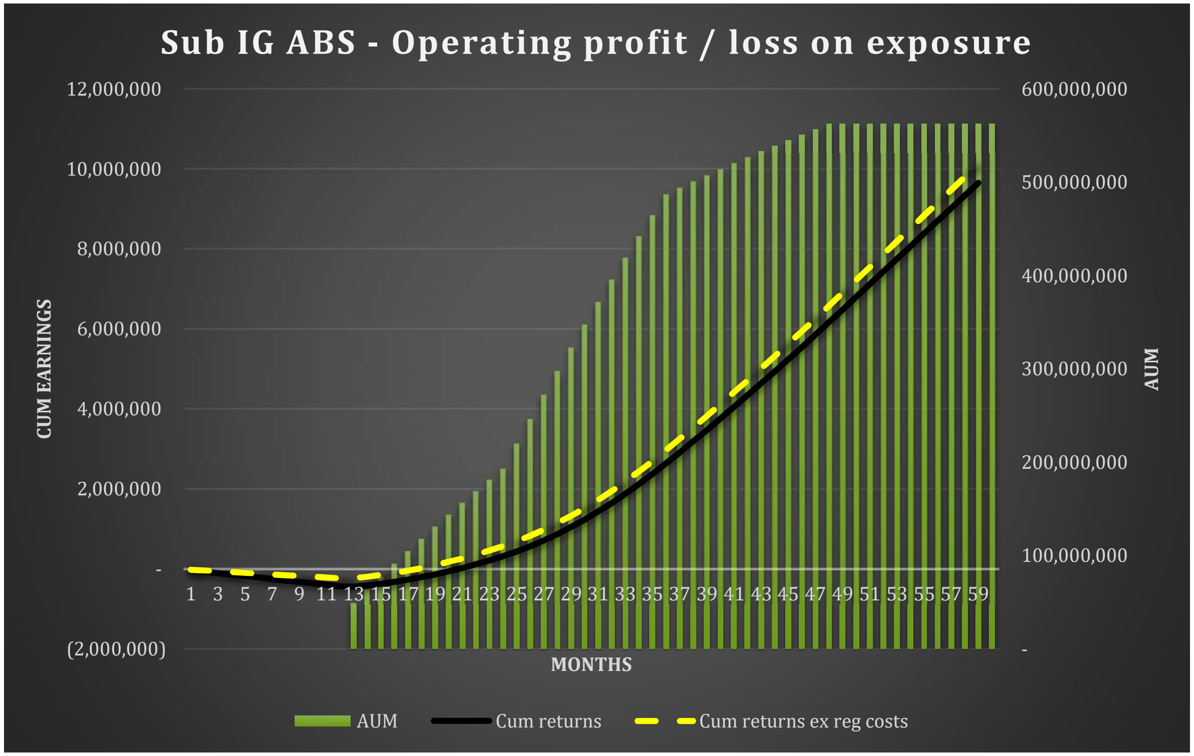
The regulatory analysis in this deck assumes repeat issuers

Findings: Investment Grade ABS

As discussed, the high barriers to investment arising from provisions within Article 5 limit the universe of investors in Senior ABS to only the largest institutions. The benefits of scale and multiple client mandates, give these investors a significant advantage over investors only interested in a smaller bid on the Class A; upon a transaction being announced, with the flexibility to buy bonds across the capital structure in size ie. Classes A through E (AAA to BB), they will analyse the transaction as a whole and submit bids across the structure if they like it. This ability to invest in size across the capital structure reduces the impact of Article 5.

It also means that when they are onboarding a new issuer, the analysis is conducted at originator / transaction level rather than at tranche level and so the amount of Article 5 related work is the same across the capital structure.

Findings: Sub IG ABS



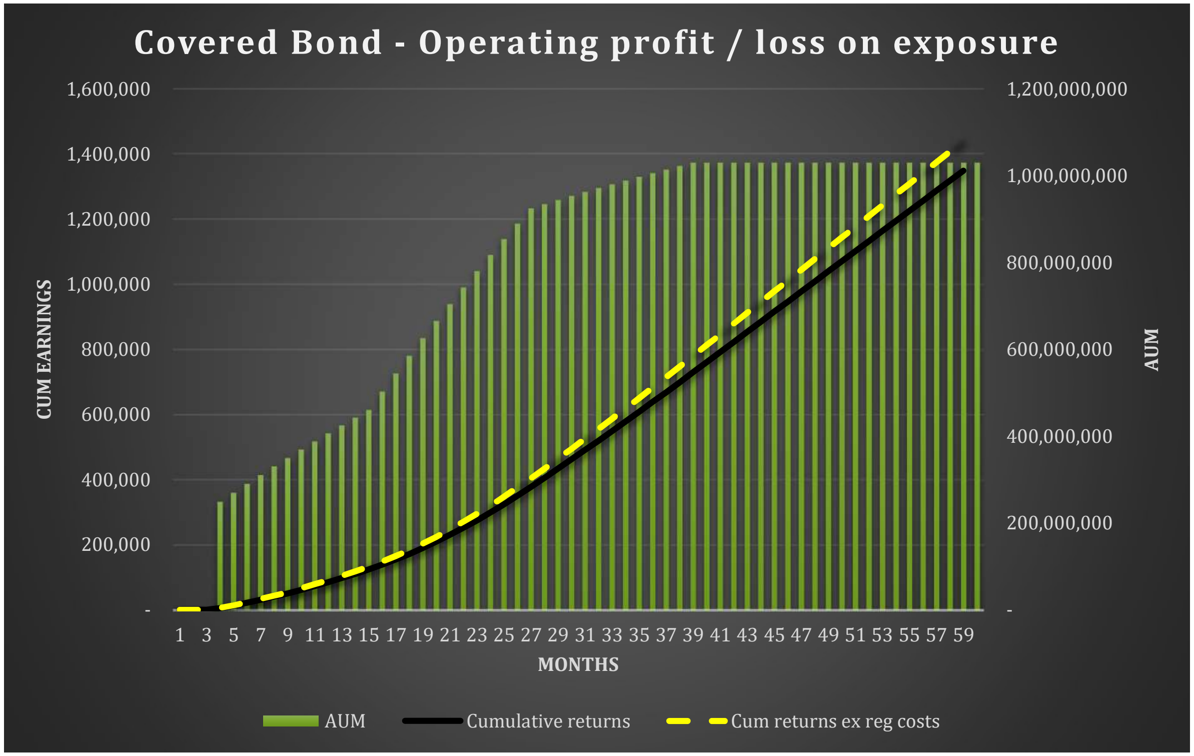
Considerations

- A manager investing in sub Investment grade ABS (BB and below), depending on the product mix and portfolio weighted average rating, will take c. 1 year before the business breaks even.
- Set up of the business from scratch will take up to 9 months, 2 months of which will relate to Article 5 compliance.
- The incremental costs to the business arising from Article 5 are significantly smaller than the previous 2 strategies as a result of the increased focus on scenario analysis and reporting as part o the credit due diligence process.

Assumptions:

- Management fees: 0.70%
- Av tickets: EUR5mm

Findings: Covered Bond only



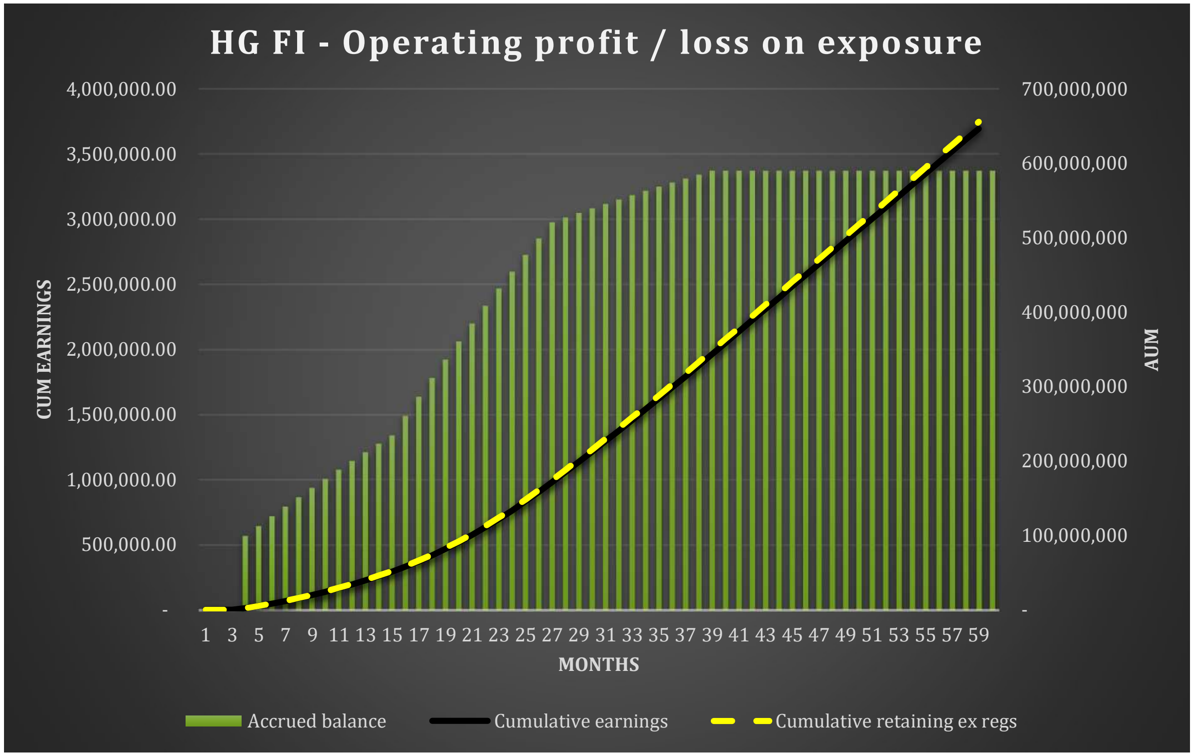
Considerations

- No product specific regulatory due diligence requirements exist for Covered Bonds

Assumptions:

- Management fees: 0.06%
- Av tickets: EUR10mm

Findings: Investment Grade Corp FI



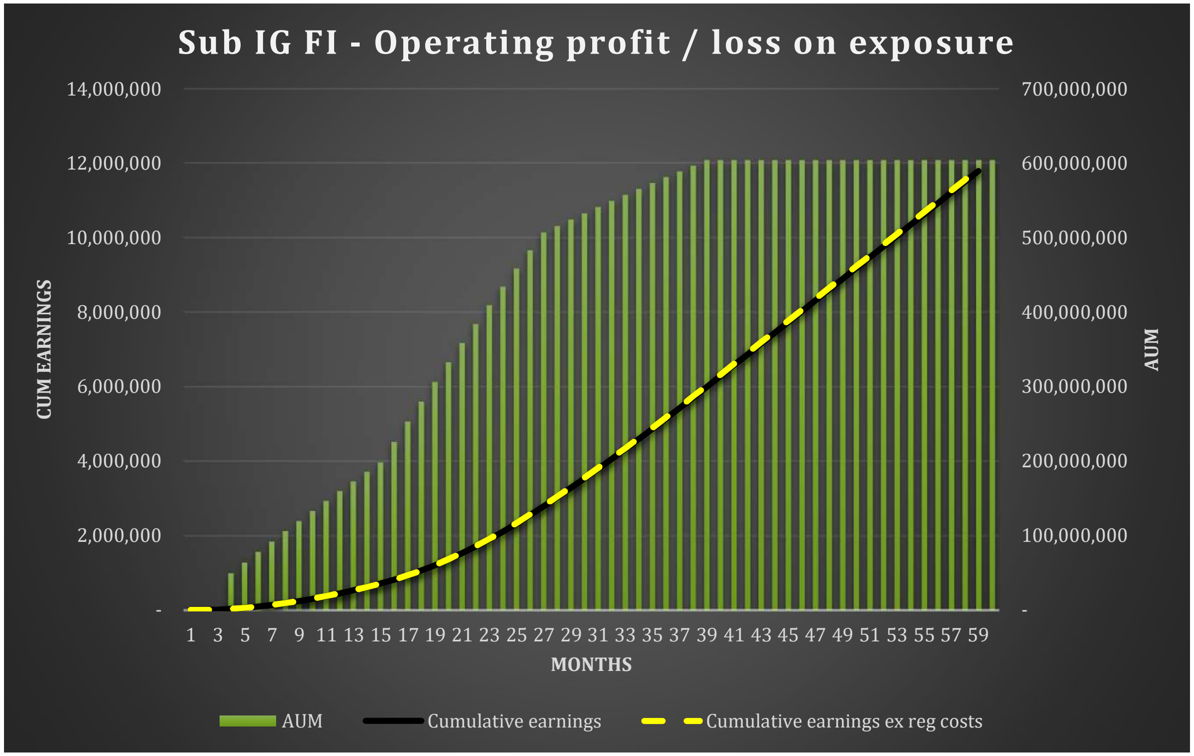
Considerations

- No product specific regulatory due diligence requirements exist for Investment grade fixed income

Assumptions:

- Management fees: 0.20%
- Av tickets: EUR10mm

Findings: High Yield credit



Considerations

- No product specific regulatory due diligence requirements exist for Investment grade fixed income

Assumptions:

- Management fees: 0.60%
- Av tickets: EUR10mm

Methodology

1. Survey resources required (Front office, Middle office, Back office) to a) underwriting processes to invest and monitor an exposure and the additional work required to satisfy obligations under EU regulation across 6 different strategies;

   1. AAA STS ABS only
   2. Investment grade ABS
   3. Sub investment grade ABS
   4. Covered bonds
   5. Investment grade corporates
   6. High yield corporates

2. Draw up 5 year P&L for each of these strategies

3. Assess relative value for asset managers of each of these businesses.

Methodology – Stage 1: Assessing resourcing costs across business

frequency	not ABCI	Article 5	Strategies (Time spent due to regs in hours)						Strategies (Time spent due to credit in hours)					
			1	2	3	4	5	6	1	2	3	4	5	6
			AAA STS	HG ABS	HY ABS	AAA CB	HG FI	HY FI	AAA STS	HG ABS	HY ABS	AAA CB	HG FI	HY FI
		1. Prior to holding a securitisation position, an institutional investor, other than the originator, sponsor or original lender, shall verify that:												
upfront	Yes	(a) where the originator or original lender established in the Union is not a credit institution or an investment firm as defined in points (1) and (2) of Article 4(1) of Regulation (EU) No 575/2013, the originator or original lender grants all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply those criteria and processes in accordance with Article 9(1) of this Regulation;												
upfront	Yes	(b) where the originator or original lender is established in a third country, the originator or original lender grants all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply those criteria and processes to ensure that credit-granting is based on a thorough assessment of the obligor's creditworthiness;												
ongoing (monthly)	Yes	(c) if established in the Union, the originator, sponsor or original lender retains on an ongoing basis a material net economic interest in accordance with Article 6 and the risk retention is disclosed to the institutional investor in accordance with Article 7;												
3rd Country	Yes	(d) if established in a third country, the originator, sponsor or original lender retains on an ongoing basis a material net economic interest which, in any event, shall not be less than 5 %, determined in accordance with Article 6, and discloses the risk retention to institutional investors;												
	Yes	(e) the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article;												
upfront	Yes	(f) in the case of non-performing exposures, sound standards are applied in the selection and pricing of the exposures.												
upfront	no	2. By derogation from paragraph 1, as regards fully supported ABCP transactions, the requirement specified in point (a) of paragraph 1 shall apply to the sponsor. In such cases, the sponsor shall verify that the originator or original lender which is not a credit institution or an investment firm grants all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply those criteria and processes in accordance with Article 9(1).												
upfront	Yes	3. Prior to holding a securitisation position, an institutional investor, other than the originator, sponsor or original lender, shall carry out a due-diligence assessment which enables it to assess the risks involved. That assessment shall consider at least all of the following:												
upfront	Yes	(a) the risk characteristics of the individual securitisation position and of the underlying exposures;												
upfront	Yes	(b) all the structural features of the securitisation that can materially impact the performance of the securitisation position, including the contractual priorities of payment and priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers, and transaction-specific definitions of default;												
upfront&ongoing	Yes	(c) with regard to a securitisation notified as STS in accordance with Article 27, the compliance of that securitisation with the requirements provided for in Articles 19 to 22 or in Articles 23 to 26, and Article 27. Institutional investors may rely to an appropriate extent on the STS notification pursuant to Article 27(1) and on the information disclosed by the originator, sponsor and SSPE on the compliance with the STS requirements, without solely or mechanistically relying on that notification or information.												
upfront	no	Notwithstanding points (a) and (b) of the first subparagraph, in the case of a fully supported ABCP programme, institutional investors in the commercial paper issued by that ABCP programme shall consider the features of the ABCP programme and the full liquidity support.												
	Yes	4. An institutional investor, other than the originator, sponsor or original lender, holding a securitisation position, shall at least:												
upfront&ongoing	Yes	(a) establish appropriate written procedures that are proportionate to the risk profile of the securitisation position and, where relevant, to the institutional investor's trading and non-trading book, in order to monitor, on an ongoing basis, compliance with paragraphs 1 and 3 and the performance of the securitisation position and of the underlying exposures.												
ongoing (monthly)	Yes	Where relevant with respect to the securitisation and the underlying exposures, those written procedures shall include monitoring of the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, recovery rates, repurchases, loan modifications, payment holidays, collateral type and occupancy, and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitisation positions, as permitted under Article 8, institutional investors shall also monitor the exposures underlying those positions;												
ongoing (monthly)	Yes	(b) in the case of a securitisation other than a fully supported ABCP programme, regularly perform stress tests on the cash flows and collateral values supporting the underlying exposures or, in the absence of sufficient data on cash flows and collateral values, stress tests on loss assumptions, having regard to the nature, scale and complexity of the risk of the securitisation position;												
ongoing (monthly)	no	(c) in the case of fully supported ABCP programme, regularly perform stress tests on the solvency and liquidity of the sponsor;												
ongoing (monthly)	Yes	(d) ensure internal reporting to its management body so that the management body is aware of the material risks arising from the securitisation position and so that those risks are adequately managed;												
ongoing (monthly)	Yes	(e) be able to demonstrate to its competent authorities, upon request, that it has a comprehensive and thorough understanding of the securitisation position and its underlying exposures and that it has implemented written policies and procedures for the risk management of the securitisation position and for maintaining records of the verifications and due diligence in accordance with paragraphs 1 and 2 and of any other relevant information; and												
ongoing (monthly)	no	(f) in the case of exposures to a fully supported ABCP programme, be able to demonstrate to its competent authorities, upon request, that it has a comprehensive and thorough understanding of the credit quality of the sponsor and of the terms of the liquidity facility provided.												
ongoing (monthly)	Yes	5. Without prejudice to paragraphs 1 to 4 of this Article, where an institutional investor has given another institutional investor authority to make investment management decisions that might expose it to a securitisation, the institutional investor may instruct that managing party to fulfil its obligations under this Article in respect of any exposure to a securitisation arising from those decisions. Member States shall ensure that, where an institutional investor is instructed under this paragraph to fulfil the obligations of another institutional investor and fails to do so, any sanction under Articles 32 and 33 may be imposed on the managing party and not on the institutional investor who is exposed to the securitisation.												

Each investor considers, across the 6 strategies identified, every provision within Article 5 or the relevant regulation and attributes estimated manhours required for upfront and ongoing analysis arising from 1) its fundamental credit work and 2) additional work arising from Article 5 provisions

Methodology – Stage 1: Assessing resourcing costs across business

AAA STS only BP (EUR only)			**Staffing costs**					
Primary EUR STS AAA net investment pa				**Front office**	**Middle office**	**Back office**	**Compliance**	
Margin over benchmark			Senior	250,000.00	150,000.00	150,000.00	150,000.00	generic assumption
Portfolio amortisation pa	25%		Junior	100,000.00	50,000.00	50,000.00	50,000.00	generic assumption
Management fees	0.07%		Senior hrs/transaction	9	1	1	1	use Article 5 analysis tab
Average deal tickets	10,000,000.00		Junior hrs/transaction	9	2	2	2	use Article 5 analysis tab
Days in month	20		hrs / transaction monitoring/month	5	-	-	-	use Article 5 analysis tab
hours in day	10							
Months in year	12							
hours in year	2400							

Mixed BP (EUR&GBP)			**Staffing costs**					
Primary EUR HG ABS net investment pa				**Front office**	**Middle office**	**Back office**	**Compliance**	
			Senior	250,000.00	150,000.00	150,000.00	150,000.00	generic assumption
Portfolio amortisation pa	20%		Junior	100,000.00	50,000.00	50,000.00	50,000.00	generic assumption
Management fees	0.25%		Senior hrs/transaction	9	1	1	1	use Article 5 analysis tab
Average deal tickets	5,000,000.00		Junior hrs/transaction	9	2	2	2	use Article 5 analysis tab
Days in month	20		hrs / transaction monitoring/month	5	-	-	-	use Article 5 analysis tab
hours in day	10							
Months in year	12							
hours in year	2400							

Mixed BP (EUR&GBP)			**Staffing costs**					
Primary HY ABS net investment pa				**Front office**	**Middle office**	**Back office**	**Compliance**	
Portfolio amortisation pa	20%		Senior	250,000.00	150,000.00	150,000.00	150,000.00	generic assumption
Management fees	0.70%		Junior	100,000.00	50,000.00	50,000.00	50,000.00	generic assumption
Average deal tickets	5,000,000.00		Senior hrs/transaction	11	1	1	1	use Article 5 analysis tab
Days in month	20		Junior hrs/transaction	11	2	2	2	use Article 5 analysis tab
hours in day	10		hrs / transaction monitoring/month	5	-	-	-	use Article 5 analysis tab
Months in year	12							
hours in year	2400							

Salary assumptions: Source – CK Financial Markets, Year End 2024

Further description of costs incurred by asset managers

- Frictional costs
- These are costs that typically arise from inefficiencies arising from regulation. For instance, arising from repetitive acts by multiple parties such as verification of obligation compliance
- Opportunity costs
- ABS issue windows cause issuers to issue in groups meaning that investors are presented with periods of limited activity interspersed with windows of high activity. The resourcing demands exacerbated by Article 5 force investors to choose which ABS to analyse which is suboptimal.
- Bids Wanted in Competition (BWICs) announce / settle within windows that are shorter than the time it takes an EU ABS investor from conducting a full regulatory due diligence
- Article 5.1.(e) constrain EU investor competitiveness by limiting their ability to diversify product exposure globally
- Economic costs
- Costs incurred to resource internal staffing across front, middle, back office and compliance
- Costs incurred engaging legal counsel, external advisory, Systems IT

Contacts

Securitisation

Shaun Baddeley
Managing Director, Securitisation
Shaun.baddeley@afme.eu
+44 (0)20 3828 2698

Maria Pefkidou
Associate Director, Securitisation
maria.pefkidou@afme.eu
+44 (0)20 3828 2707

Raag Pathak
Graduate, Securitisation
Raag.Pathak@afme.eu
+44 (0)20 3828 2759

Advocacy

Remi Kireche
Director, Advocacy
Remi.Kireche@afme.eu
+32 2 883 55 53

Jim Rusagara
Manager, Advocacy
Jim.Rusagara@afme.eu
+32 479 02 97 00

Martina Torelli
Graduate, Public Policy & Advocacy
Martina.Torelli@afme.eu
+32 2 883 55 54

London Office
39th Floor
25 Canada Square
London E14 5LQ
United Kingdom
+44 (0)20 3828 2700

Brussels Office
Rue de la Loi, 82
1040 Brussels
Belgium
+32 (0)2 788 3971

Frankfurt Office
Große Gallusstraße 16-18
60312 Frankfurt am Main
Germany
+49 (0)69 710 456 660

Follow AFME on Twitter
@AFME_EU

Association for Financial Markets in Europe
www.afme.eu