
AFME Response to the HM Treasury Call for Evidence: Solvency II Review

18 February 2021

AFME welcomes the Call for Evidence on the Review of Solvency II by H.M. Treasury (“HMT”) and we take this opportunity to set out our position on the regulatory treatment of securitisation under the current Solvency II rules.

We appreciate that the Call for Evidence covers a wide-range of subjects and is not specific to securitisation. However, we believe that the review of the prudential treatment of securitisation under Solvency II is of key importance especially in the context of the UK Government’s objectives to provide long-term capital to support growth across the UK and the Government’s climate change objectives.

Below we set out our concerns about the regulatory treatment of securitisation under the current Solvency II rules. These are concerns which we have previously expressed to the EU authorities up to and including 31st December 2020, and which we continue so to express.

AFME Response to Question 29: *What, if any, areas of Solvency II not covered elsewhere should be considered for review?*

The Call for Evidence is underpinned by three objectives: to spur a vibrant, innovative, and internationally competitive insurance sector; to protect policyholders and ensure the safety and soundness of firms; and to support insurance firms to provide long-term capital to underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the Government’s climate change objectives.

We fully support these objectives and believe that the prudential regulatory regime should indeed help the insurance sector to contribute to them, especially in relation to climate change and providing long-term capital to support growth across the UK. Securitisation, especially as markets for green securitisation develop, can play an important role in contributing to these outcomes.

Securitisation can play an important role in increasing capital allocated to investments, such as infrastructure or sustainable projects and activities. Through tranching of risk, securitisation allows insurer investors to contribute to specific projects and activities in a risk-appropriate manner. It also provides originator banks with a tool for transferring assets out of their balance sheet, thus increasing their capacity for further lending to homeowners, consumers, SMEs and businesses generally as the economy recovers from the Covid-19 pandemic and begins to adjust to meet long-term carbon reduction targets.

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However, the current prudential capital framework for insurance company investors in securitisation remains excessively conservative compared to the treatment of other comparable investments. We therefore urge HMT to review the prudential capital framework for insurance company investors in securitisation. This is essential for the recovery of an investor base that has shrunk considerably since the global financial crisis. The regulatory framework for securitisation in the UK and EU is today both comprehensive and prudent, and has been described by regulators as “best in class”. Therefore a revised calibration for “Simple Transparent and Standardised” or “STS” securitisations, under the UK STS regime (onshored from the EU), should make it more attractive for insurers to invest in UK securitisations. In particular it should level the playing field with “whole loan pool” investment so as to remove the existing (and potentially problematic) incentive for insurers to invest in the same underlying assets in an un-securitised and illiquid format.

Delegated Act on Solvency II (now onshored to the UK)

The Delegated Act on Solvency II (adopted by the European Commission in June 2018) did include some positive changes. However, these do not go far enough in correcting the harsh and disproportionate treatment of securitisation investments under Solvency II. We therefore believe that the current Review of Solvency II is an opportunity to remedy those mistakes.

Under the Delegated Act, the capital calibrations in relation to senior tranches of STS securitisations were reduced to levels comparable to those applying to corporates. However the risk factors remain much too high for the mezzanine and junior tranches of STS securitisations, and for all non-STS securitisations. Furthermore, “whole loan pool” investment remains much more generously treated than even STS securitisation, creating a disparity of treatment which is both unjustified from a prudential perspective and creates an unlevel playing field, to the disadvantage of all securitisation (both STS and non-STS).

Insurance company investors have an important role to play in investment in securitisation, particularly in the mezzanine and junior tranches. Despite their “mezzanine” label, these bonds are of very high quality, mostly rated investment grade (AA, BBB) thanks to the credit quality of the securitised pool and the credit support of the securitisation structure.

These areas of the securitisation market match the risk/return, duration and diversification needs and analytical capabilities of insurers. As a result, they can facilitate better risk management and diversification in the financial system.

We further note the example of the US, where insurance company investors are active investors in the securitisation market, benefiting from securitisation risk weights comparable to those for corporates: uniform for AAA-A risk weights and only marginally higher for BBB, with a steep cliff at BB level. The active participation of US insurers in the US securitisation market allows them to benefit from these risk diversification and yield opportunities and increases their global competitiveness.

Conclusion and recommendation

We therefore urge HMT to reconsider the revision of the risk factors for mezzanine and junior tranches of UK STS securitisations, and for all UK non-STS securitisations, in order to support the recovery of safe and well-regulated securitisation in the UK as a key tool in providing long-term capital to support the UK's growth and progression towards meeting climate change targets, as well as supporting the competitiveness of UK insurance company investors in a world of low yields.

A more risk-sensitive approach would be to align with the capital treatment of covered bonds for senior STS securitisations and with corporate bonds for non-senior STS and, with a shift of one credit quality step, for non-STS. We believe this revised approach would more appropriately reflect the true economic risk of such investments.

Annex 1 sets out our arguments in more detail along with examples which illustrate the disproportionate treatment of non-senior STS tranches, non-STS securitisations and the harsh capital treatment of asset-backed commercial paper ("ABCP") (both STS and non-STS).

Annex 2 sets out a chart demonstrating the cliff-effect in capital charges.

We thank you for the opportunity to contribute to the Call for Evidence and as ever remain at your disposal should you wish to discuss our comments in further detail.

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ANNEX 1

Call for revision of calibration of risk factors for securitisation investments by insurance and reinsurance undertakings under UK Solvency II

We view the following aspects of the current Solvency II regime as falling short of what is required to support the recovery of safe and well-regulated securitisation in the UK as a key tool in supporting the objectives outlined in HMT's Call for Evidence.

The treatment of non-senior STS tranches

While the capital calibrations for senior STS tranches have been set to levels which are comparable to those applying to corporates, the calibrations of non-senior STS tranches remain disproportionately high in both absolute and relative terms, in some cases between three and four times the equivalent charges for corporate bonds.

Practically speaking, yields in ABS are nothing like three or four times those in corporate bonds. The current Euro BBB corporate bond index (Barclays Euro BBB Corporate Bond Index) has a yield of around 1%. Over the last two years, average BBB securitisation yields have been around 0.5% to 0.75% higher than corporates – nowhere near enough of a pick-up to attract investors who will suffer a three to four times higher capital charge.

A further example is the capital charges for a single-A non-senior STS tranche with a duration up to 5 years (4.6% - 23%) which is comparable with a BB-rated corporate of similar duration (4.5% - 22.5%). But the spreads for, say, Volkswagen corporate risk (BBB+) compared with Volkswagen auto ABS (AAA, A) tell a very different story which is not reflected in the proposed calibrations. This is even more difficult to justify given the zero default rate in investment grade auto ABS and the non-zero default rate in investment-grade corporate bonds.¹

Chart: Volkswagen Corporates BBB vs AUTO ABS (AAA and A) spreads



¹ BofA Global Research 2021.

The approach to STS non-senior tranches seems excessively conservative also because the lower credit ratings of non-senior tranches already naturally lead to higher capital charges. This effective ‘double-counting’ creates a large cliff effect between senior and non-senior tranches creating strong disincentives for potential investors as it directly affects the ‘sweet spot’ for insurer investors.

The treatment of non-STIS securitisations

Non-STIS securitisations today carry very high charges as Type 2 securitisations. Many non-STIS securitisations (CLOs, CMBS) have an important role to play in funding the real economy and today’s extremely high calibrations are unjustified in view of the performance of these securitisations through and since the global financial crisis.

For example, we refer to the treatment of the AAA senior part of a CLO where around 35%-40% of the loans in a transaction could default with a 100% write-off before AAA noteholders might suffer a loss. These notes will incur a capital charge almost three times higher than a typical BB-rated constituent loan, and of course yield far less, giving insurers no incentive to invest in them.

The treatment of ABCP, both STIS and non-STIS

The STIS Securitisation Framework contemplates not only medium to long-term, but also short-term STIS securitisation, in the form of STIS Asset-Backed Commercial Paper (“ABCP”).

Unfortunately, the STIS ABCP criteria have been drawn so restrictively that very few, if any, existing ABCP programmes will qualify as STIS. The inevitable result is that most ABCP Programmes will be treated as non-STIS securitisations.

ABCP programmes are funding vehicles financing multiple asset portfolios through the issuance of rated commercial paper with very short (typically 30, 60 or 90 day) maturities. They are used by sponsoring banks to fund the working capital of their clients on a much larger scale than factoring or any another traditional banking financing tool, typically using granular, real-economy underlying assets such as trade receivables or auto and consumer loans. The size of the EMEA ABCP market is USD 89 bn².in terms of outstanding volumes, out of which 17% of assets are located in the UK. Is it therefore a considerable portion of the market.

All commercial paper issued under an ABCP programme ranks senior and pari-passu and is typically fully-supported by a 100% liquidity line provided by the sponsor bank. Investors in the ABCP therefore have dual recourse not just to the securitised assets but also the bank provider of the liquidity line.

Therefore, in light of:

- the high credit quality of the underlying assets;
- the strong structural protections; and

² Source: Moody’s Investor Services (October 2020)

- the difficulty which existing ABCP programmes will have in complying with the STS Securitisation Framework

we ask that fully-supported ABCP programmes benefit from the same regulatory treatment as term senior STS securitisations under Solvency II.

Almost no insurers currently invest in ABCP due to the very harsh capital treatment; encouraging their participation would be in line with the Government's objectives to support long-term growth and help foster real economy funding.

Why have revised Solvency II capital calibrations in the Delegated Act not led to greater investment by insurers in securitisation?

There are aspects of the current Solvency II rules that should theoretically make investment in securitisation more appealing. For example, senior STS tranches and short maturity mezzanine tranches may benefit from some insurer demand. However, any wider positive impact of those rules is subdued for the following reasons.

Insurers are unlikely to be significant buyers of senior tranches

Insurance companies are not typically significant buyers of senior, mostly AAA rated, securitisations - or indeed of covered bonds. These investments simply do not yield enough and are often too short-dated. A representative insurance company's fixed-income credit portfolio will be concentrated towards the mid-to-lower end of the investment grade spectrum, which covers most of the corporate bond market, and perhaps with a bias to longer maturities, where the yields and duration match their risk/return and asset/liability matching investment needs. The reduced calibrations for senior STS tranches introduced under the Delegated Act have therefore had no major impact.

Whole loan pool investment remains much more generously treated than even STS securitisation

A whole loan mortgage pool (unrated, long duration, illiquid with no credit enhancement, where investors will suffer the first and every subsequent loss made on loans in the pool) will carry a capital charge of 3% for say a 30-year life at 80% LTV. A 5 year senior AAA rated STS RMBS (rated, medium duration, liquid, credit-enhanced, protected from first loss) will incur a capital charge of around 5% for the senior tranche and much higher for the non-senior tranche.

This disparity of treatment is unjustified from a prudential perspective and creates an unlevel playing field to the disadvantage of STS securitisation (*a fortiori* non-STS securitisation).

Solvency II maintains other cliff-effects which will discourage investment

The cliff effect between senior and non-senior STS remains high, as does that between senior STS and equally rated non-STS securitisations. We are not aware of any market evidence to justify this, be it for default or spread volatility.

Even with lower capital requirements, return on capital projections for insurers are poor and compare badly with what bank investors can achieve

Projected return on capital calculations, especially compared with bank investors, illustrate how unattractive it remains for insurers to re-engage with securitisation. The table from J.P. Morgan's European Securitised Products Research (2021) set out below for ease of reference illustrates how "For STS senior UK Prime RMBS, the projected return undoubtedly increases with a lower capital requirement, but remains somewhat unappealing on an absolute basis."³

Table: Comparing insurance companies' projected return on capital for holding various securitisation positions under the current Solvency II treatment

Category	Rating	WAL (Yrs)	Spread	STS*	S2 Type*	Insurance Investors				Bank Investors					
						Revised		Previous		Revised			Previous		
						Capital	RoC	Capital	RoC	RW*	Capital	RoC	RW*	Capital	RoC
EZ Auto ABS	AAA	2	22	Y	1	2.0%	11%	4.2%	5%	10.0%	1.3%	17%	7.0%	0.9%	24%
	A	3	127	Y	2	13.8%	9%	49.8%	3%	92.6%	12.0%	11%	20.0%	2.6%	49%
UK Auto ABS	AAA	2	45	Y	1	2.0%	23%	4.2%	11%	10.0%	1.3%	35%	7.0%	0.9%	49%
	A	3	147	Y	2	13.8%	11%	49.8%	3%	92.6%	12.0%	12%	20.0%	2.6%	57%
EZ Consumer ABS	Sr (AA)	2	77	Y	1	2.0%	39%	4.2%	18%	16.3%	2.1%	36%	8.0%	1.0%	74%
Dutch RMBS	AAA	2	18	Y	1	2.0%	9%	4.2%	4%	10.0%	1.3%	14%	7.0%	0.9%	20%
	AAA	5	31	Y	1	5.0%	6%	10.5%	3%	10.0%	1.3%	24%	7.0%	0.9%	34%
	A	9	150	Y	2	32.2%	5%	100.0%	2%	128.3%	16.7%	9%	20.0%	2.6%	58%
	BBB	9	200	Y	2	58.3%	3%	100.0%	2%	242.3%	31.5%	6%	75.0%	9.8%	21%
UK Prime RMBS	AAA	3	25	Y	1	3.0%	8%	6.3%	4%	10.0%	1.3%	19%	7.0%	0.9%	27%
	AA	5	115	Y	2	17.0%	7%	67.0%	2%	66.5%	8.6%	13%	15.0%	2.0%	59%
	BBB	5	200	Y	2	39.5%	5%	98.5%	2%	242.3%	31.5%	6%	75.0%	9.8%	21%
UK NCF RMBS	AAA	3	87	N	2	37.5%	2%	37.5%	2%	17.5%	2.3%	38%	7.0%	0.9%	96%
	AA	5	153	N	2	67.0%	2%	67.0%	2%	114.0%	14.8%	10%	15.0%	2.0%	78%
UK BTL RMBS	AAA	3	77	N	2	37.5%	2%	37.5%	2%	17.5%	2.3%	34%	7.0%	0.9%	85%
	AA	5	150	N	2	67.0%	2%	67.0%	2%	114.0%	14.8%	10%	15.0%	2.0%	77%
Spanish RMBS	ECB Sr (AA+)	4	65	Y	1	4.8%	14%	12.0%	5%	13.8%	1.8%	36%	8.0%	1.0%	63%
	Non-ECB Sr (A+)	5	105	Y	2	8.0%	13%	15.0%	7%	30.0%	3.9%	27%	10.0%	1.3%	81%
	Mezz A	7	195	Y	2	27.6%	7%	100.0%	2%	128.3%	16.7%	12%	20.0%	2.6%	75%
Italian RMBS	ECB Sr (AA)	4	82	Y	1	4.8%	17%	12.0%	7%	18.8%	2.4%	34%	8.0%	1.0%	79%
Portuguese RMBS	ECB Sr (A)	6	63	Y	1	9.6%	7%	18.0%	4%	40.0%	5.2%	12%	12.0%	1.6%	40%
EZ CMBS	Sr (AAA)	5	145	N	2	62.5%	2%	62.5%	2%	20.0%	2.6%	56%	7.0%	0.9%	159%
CLO	AAA	7	87	N	2	87.5%	1%	87.5%	1%	20.0%	2.6%	33%	7.0%	0.9%	96%
	AA	9	143	N	2	100.0%	1%	100.0%	1%	114.0%	14.8%	10%	15.0%	2.0%	73%
	A	9	233	N	2	100.0%	2%	100.0%	2%	171.0%	22.2%	10%	20.0%	2.6%	90%
	BBB	10	330	N	2	100.0%	3%	100.0%	3%	294.5%	38.3%	9%	75.0%	9.8%	34%

³ Source: J.P. Morgan

Conclusion

Solvency II should aim to encourage UK insurers to invest in mezzanine and junior tranches of securitisation both to help them meet their risk/return, duration and diversification needs and more broadly to help can facilitate better risk management and diversification in the financial system. Yet under the current calibrations, apart perhaps from some shorter maturity mezzanine tranches, this is not the case.

Therefore, we argue that the calibration of risk factors for securitisations should be reviewed: a more risk-sensitive approach would be to align with the capital treatment of covered bonds for senior STS securitisations and with corporate bonds for non-senior STS and, with a shift of one credit quality step, for non-STs. We believe this revised approach would more appropriately reflect the true economic risk of such investments.

ANNEX 2

The cliff-effect in capital charges under Solvency II

	AAA	AA	A	BBB	BB	B and below
Credit quality step	0	1	2	3	4	5 and 6
Corporate Bonds	0.90%	1.10%	1.40%	2.50%	4.50%	7.50%
Covered Bonds	0.70%	0.90%	-	-	-	-
Residential mortgage loans			e.g. 3% for life at LTV=80%			
Senior STS securitisation position	1.00%	1.20%	1.60%	2.80%	5.60%	9.40%
Non-Senior STS securitisation position	2.80%	3.40%	4.60%	7.90%	15.80%	26.70%
Other securitisation (non-STs) positions	12.50%	13.40%	16.60%	19.70%	82.00%	100.00%
Cliff STS senior securitisation vs. Corporate Bonds	0.10%	0.10%	0.20%	0.30%	1.10%	1.90%
Cliff STS senior securitisation vs. Covered Bonds	0.30%	0.30%				
Cliff STS non-senior securitisation vs. Corporate bonds	1.90%	2.30%	3.20%	5.40%	11.30%	19.20%
Cliff non-STs securitisation vs. Corporate Bonds	11.60%	12.30%	15.20%	17.20%	77.50%	92.50%
Re-securitisation position	33.00%	40.00%	51.00%	91.00%	100.00%	100.00%
Cliff Re-securitisation vs. Corporate Bonds	32.10%	38.90%	49.60%	88.50%	95.50%	92.50%

source: Bank of America Merrill Lynch