EU Securitisation back on track – AFME's 5-point plan

11 June 2024

Executive Summary

At the 2024 April European Council, EU leaders called for a "new European competitiveness deal" by advancing the work on the capital markets union, and by "relaunching the European securitisation market, including through regulatory and prudential changes"[1]. This ambition echoes the ECB Statement that suggests "reviewing the prudential treatment of securitisation for banks and insurance companies and the reporting and due diligence requirements"[2]. The Eurogroup[3] has also identified securitisation as a topic of priority for developing EU capital markets. In April, both the report by Enrico Letta[4] on the Single Market and the proposals on European capital markets by Christian Noyer[5] stressed the benefits of securitisation as a bridge between bank and capital markets-based funding and as a tool offering unique investment opportunities for investors and additional bank financing capacity. Most recently, ESMA in their own Position Paper[6] advocated an approach to reviving the securitisation market.

As policy makers have come to acknowledge the valuable role that securitisation can play, there is increasing recognition that the combined effect of certain provisions within both the EU Securitisation Regulation and the EU Bank and Insurance Prudential Capital Frameworks have disincentivised EU investors and limited utility of the product as a funding tool by EU issuers. This consensus has grown in regard to the contribution securitisation can make to financing EU growth in the ways outlined below.

Through this paper, AFME aims to:

- describe the different ways that securitisation can be used as a tool to achieve the outcomes described in the above statements,
- identify the regulatory hurdles that currently impede its impact
- propose a five-point package of reforms to boost the trajectory of EU securitisation.

These reforms importantly maintain the existing safeguards embedded within the regulation that prevents the proliferation of high leverage products under the banner of securitisation that originated in the US in the run up to the Global Financial Crisis.

[1] https://www.consilium.europa.eu/media/m5jlwe0p/euco-conclusions-20240417-18-en.pdf
[2] https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.pr240307~76c2ab2747.en.html
[3] https://www.consilium.europa.eu/en/press/press-releases/2024/03/11/statement-of-the-eurogroup-in-inclusive-format-on-the-future-of-capital-markets-union/
[4] https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf
[5] https://www.tresor.economie.gouv.fr/Articles/e3283a8f-69de-46c2-9b8a-4b8836394798/files/6b8593b5-ca31-45a3-b61c-11c95cf0fc4b
[6] Building more effective and attractive capital markets in the EU (europa.eu)

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This package proposes measures that, when combined, should increase both the supply and demand for the product by:

1. Increasing risk sensitivity within the bank prudential framework;
2. Reviving demand from the insurance sector;
3. Adjusting the treatment of securitisation within the Liquidity Coverage Ratio;
4. Introducing proportionality for investors conducting regulatory due diligence; and
5. Fine-tuning regulatory reporting requirements and simplifying STS criteria for both traditional and synthetic securitisations.

The package of policy recommendations should be implemented early in the next mandate to deliver on the European Council's ambition.

The technical details are set out later in this paper (see page 20 onwards).

In this executive summary, we therefore focus on the benefits that the package would provide to the EU.

Enhancing competitiveness for the EU

- An efficient securitisation framework in the EU will improve access to cost effective credit for both consumer and wholesale market segments. For the consumer, this is relevant across the social demographic and for wholesale borrowers, whilst relevant across the corporate credit spectrum, it is particularly important to the SME segment.
- Build out of a highly investible asset class will incentivises EU investors to finance EU economic growth. It can do this through its versatility of offering; provision of conservative, stable returns for risk averse investors or equity like returns for those with greater risk appetite and everything in between, meeting the needs of EU pension funds, insurers and institutional investors.

Building an alternative source of funding to fuel growth for European companies

- Securitisation is used more widely outside Europe[7] to finance corporates directly via the capital markets across an array of sectors. In the EU, securitisation is used to a lesser extent by banks as part of their lending relationships to finance corporate clients, ranging from SMEs to highly rated corporates regardless of their ratings (from *speculative* up to *high grade*).[8]
- Securitisation can be particularly helpful to SMEs by supporting a greater choice of funding at lower cost, thereby supporting long-term growth for smaller companies. Early-stage companies, often with a focus on innovation and digitalisation, can also benefit from the product, gaining access to finance with beneficial terms when they need it the most, namely whilst they are in a phase of early-stage growth.

[7] https://www.paulweiss.com/media/3394089/jsf_winter_2016_paulweiss-2.pdf

[8] European Benchmarking Exercise for Private Securitisations, the "EBE Report"

Provision of long-term credit to underserved wholesale and consumer market segments

- Provision of credit to certain wholesale and retail segments relinquished by banks to other lenders remains important. These lenders do not have access to retail deposits. Thismakes securitisation a very important tool to fund growth of the segments they serve.[9]
- These lenders are likely to play an even more important role in financing the real economy in the future as banks once again reconfigure client relationships as a result of the impact on Basel IV on banks' cost of capital. As this segment grows, securitisation will become increasingly important as a funding tool.

A developing contribution to financing the transition

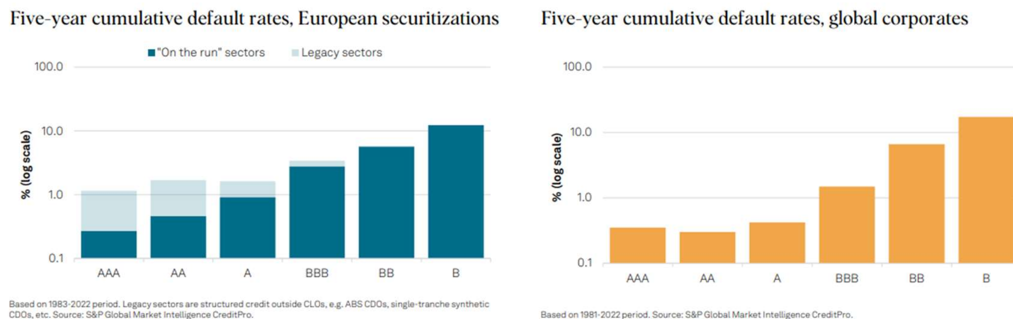
- The burden on the banking sector to play a critical role during the transition is well understood. According to the Commission, the scale of funding required is estimated to be €620 billion in additional investment per year over this decade to meet the 2030 emissions-reduction target in energy systems alone, alongside the €130 billion Europe will need for other environmental goals.[10]
- The green and digital transition is a journey taken both by wholesale and consumer segments. Securitisation disclosure and reporting gives investors and supervisors much needed transparency on securitised loan portfolios when investing in the financing of ESG transition for both these segments.

An alternative asset class that can meet the needs of EU based savers and investors across the spectrum of risk

- Securitisation, through its structures, can create a full spectrum of credit risk from AAA to equity like risk, to meet the respective risk appetite of the EU investor base. This range of risk, evidenced by data over the last forty years, has performed in line or *better* than fixed income asset classes perceived as more "vanilla".

[9] https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230523~22f6621da7.en.html
[10] https://commission.europa.eu/system/files/2023-07/SFR-23-beautified-version_en_0.pdf

Figure 1: Five-year Cumulative Defaults Rates



S&P Global
Ratings

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- Since the Global Financial Crisis (GFC), the same European Asset Backed Securities (ABS), have exhibited comparable market liquidity[11] to other fixed interest products, such as secured and unsecured bonds, that have exhibited rapid growth over the past decade and greater liquidity than market traded whole loan portfolios.

- Securitisation exhibits low correlation with other fixed income asset classes and is therefore a useful product to diversify credit risk both for issuers as well as savers and investors. A resilient EU economy will not only benefit EU citizens, but it will also reinforce the EU's global competitiveness and strategic and economic autonomy. Investors have access to unique opportunities in terms of exposure type and in terms of risk/reward spectrum. They can gain exposure to sectors of the economy that can otherwise be challenging, such as SME and consumer lending as well as infrastructure finance and be highly selective as to the level of risk they want to be exposed to through the concept of tranching.

Facilitating the sale of Non-Performing Exposure (NPE) portfolios to non-bank investors specialising in distressed debt assets

- Securitisation has been used in a couple of ways to facilitate NPE portfolio sales to specialist credit funds with specialist loan servicing capabilities. Via guarantee schemes in Italy and Greece, for example, approximately €100 billion of non-performing loans have been removed from the Italian banking system and in Greece, non-performing loan ratios have halved from 43% at the end of 2019.
- Securitisation is also used in non-guaranteed form, facilitating the flow of NPE portfolios off bank's balance sheets and thereby supporting more bank financing to the real economy.

[11] RCL research report commissioned by AFME, "Comparing ABS and Covered Bond Liquidity" (here) and RCL research report commission by AFME, "Comparing CB, ABS and Corporate Bond Liquidity (here)

It can support the much needed shift from a European economy relying primarily on financing through banks' balance sheets to one that is able to mobilise the full potential of capital markets[12]

- If allowed to do so, it will catalyse the transformation of an EU economic ecosystem financed primarily by banks' balance sheets to one that leverages the resources of a capital market. It does this by acting as a transmission mechanism, enabling borrowers to have indirect access to the capital market and enabling investors to indirectly gain exposure to the EU economy.

It efficiently releases capital and transfers credit risk through Significant Risk Transfer (SRT) outside the banking sector, enabling banks to lend more to the real economy[13]

- As we identify in this paper, asset rotation by banks will be central to their ability to support the private sector finance the transition. Their capital management strategies over the next decade will rely on asset rotation. Asset rotation, risk transfer and capital release can be achieved by banks through securitisation without negatively impacting the experience of the wholesale and retail client base. In particular, securitisation maintains the benefit of banks' unique originating ability, both in terms of expertise and quality, and in terms of production capacity. The capital released can then be reinvested into financing the real economy.

Reflecting on the evolution of EU Regulation and Prudential Frameworks over the last decade, it is clear that many of the foundation stones of the regulation safeguard the scope of its use to one that finances the real economy. However, certain areas of Level 1 framework legislation and Level 2 measures combined with the development of the relevant Prudential Frameworks have deviated, sometimes materially, from the apparent intent of global standards. These deviations typically manifest within the EU regulation through an amplification or "gold plating" of criteria set out in these standards. The combined effect of these regulatory and prudential reforms has had the effect of suffocating any revival of the EU securitisation market.

The intent of this paper is therefore to identify some of these deviations, highlight areas of the regulation and prudential frameworks that lack risk sensitivity and proportionality and propose a package of reforms to boost the trajectory of EU securitisation, whilst maintaining the existing safeguards embedded within the regulation that prevents the proliferation of high leverage products under the banner of securitisation that originated in the US in the run up to the Global Financial Crisis.

The measures within this package are designed to work together to grow the market. That is to say, implementation of the package will be that much greater than the sum of its parts.

[12] 'The refinancing function does provide a means of diversifying funding sources. Securitised assets can also serve as collateral for central bank refinancing, a particularly useful function during quantitative easing programmes.' (cf. Noyer's report)
[13] The other key benefit of securitisation is the ability to deconsolidate the bulk of bank assets and related risk, which means banks can use capital more efficiently. Removing assets from the balance sheet means banks can maintain constant leverage, while increasing loan issuance volumes. Unlike covered bond issuances, securitisation transfers risk away from banks, which frees up resources to meet solvency ratio requirements' (cf. Noyer's report).

In the table below, we summarise this proposed package of reforms required to achieve this outcome.

Package of measures				
Delivering capital to the real economy	**Problem drivers**	**Problem description**	**Solution**	**Legislative fix**
Increasing risk sensitivity for bank Prudential Framework	lack of risk sensitivity of the bank capital framework Shortcomings of prudential capital formulae Prudential capital calibrated on a non representative dataset	Prudential framework not reflective of the underlying risks	Introduce adjustments to p factors and risk weight floors Long term : review of Pillar 1	Amendments to the CRR in 2025 (level 1) CRR amendments (2027)
Delivering funding to the real economy	**Problem drivers**	**Problem description**	**Solution**	**Legislative fix**
Reviving demand from the insurance sector	Miscalibration of the prudential framework for securitised products	Substantive reduced demand for investment grade publicly offered securitisation	review the prudential calibration of non-STS and of non-senior STS securitisation	Review of Solvency II delegated act (level 2)
Liquidity provision from the banking sector	Unwarranted treatment of securitisation (STS and non STS) within LCR within Basel Standards Unfaithful implementation of Basel standard	Substantive reduced demand for Senior tranches of publicly offered securitisation	Improve treatment under the LCR ratio, to include; Haircut adjustment for STS securitisations Extend ratings down to AA- Non STS with increased haircuts Remove duration cap of [5] years	LCR delegated act amendment (level 2)
Additional demand side measures	Regulatory due diligence requirements source of disproportionate high costs to institutional investors	Disincentivises investors purchaing AAA, AA, single A tranches of securitisation vs. asset classes with similar risk profile. 3rd country issuers	Guidelines of proportionate Due Diligence requirements reflecting level and type of risk taken	Amendment to article 5 of Securitisation Regulation (level 1)
Additional supply side measures	Transparency & Disclosure requirements	No distinction between private and public transactions Transparency requirements not proportionate to investors' needs	A proportionate transparency regime	Amendment to article 7 of Securitisation Regulation (level 1)
	Highly granular STS criteria	STS label overly conservative impacting the take-off of STS securitisation	Simpler STS criteria taking into account the STC standard	Amendment to chapter 4 of Securitisation Regulation (level 1)

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The importance of Securitisation in financing future EU economic growth

The importance of Securitisation to the success of the Capital Markets Union (CMU)

1. At the Special European Council of April 2024, the heads of State and governments call for "advancing work in the Council and the Commission without delay on all identified measures that are necessary to create truly integrated European capital markets [...] especially on relaunching the European securitisation market, including through regulatory and prudential changes." Fixing the European securitisation markets has also been identified in various reports by Enrico Letta[14] on the Single Market and the proposals on European capital markets by Christian Noyer. **The absence of a deep and liquid securitisation market has been recognised as a contributing factor to the EU's stagnating growth over the last decade and has been a long outstanding hurdle to the achievement of the capital markets union project started in 2015.** It has been acknowledged that a rebalancing of the EU's funding sources toward market-based financing, channelling individual savings into productive investments and integrating national capital markets to create a unified EU market, has failed to materialise.[15]

2. The Capital Markets Union does aim, in fact, to create deep and liquid equity and debt capital markets which will facilitate capital flows and support risk-sharing between banks and other market participants in the EU, channel individual savings into productive investments, and ultimately allow the EU to remain globally competitive. Almost 10 years after the first CMU action plan, numerous legislative proposals have been adopted to deliver on the CMU. However, the EU still falls short of building a genuine and seamless European capital market able to compete globally. For this to happen, substantive structural changes will need to be implemented across the EU affecting a range of issues from national legal to tax regimes at the very least. Those reforms are necessary but would require a structural transition likely to unfold over the course of several years. In the meantime, there is vital need to better support borrowers' access to untapped private capital in the short term. **Securitisation has a crucial role to play in helping bridge this structural transition.**

3. Moreover, the current economic environment poses significant challenges which government funding and bank lending alone cannot tackle sufficiently. The demographic crisis faced by the EU[16] puts pressure on public budgets and state pension systems, while inflation, higher interest rates and the ongoing war in Ukraine create additional strain. At the same time, the green transition requires an enormous amount of funding, estimated in 2023 at €620 billion in additional investment per year over the next decade for the EU alone, to meet the 2030 emissions-reduction target in energy systems, and an additional €125 billion for digital finance.[17] It will therefore be crucial for all sources of capital and liquidity to be deployed across the full array of financial products. Borrowers and lenders must have

[14] https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf
[15] AFME, Capital Markets Union: Key Performance Indicators – Sixth Edition (here).
[16] Eurostat data (here).
[17] https://commission.europa.eu/system/files/2023-07/SFR-23-beautified-version_en_0.pdf

unfettered access to all funding and capital raising channels to meet these targets. **Securitisation can play an important role in funding both channels.**

What is securitisation?

Securitisation enables a lender or a creditor – typically a credit institution or a corporation – to refinance and/or transfer credit risk of loan portfolios, exposures or receivables typically originated by that party, [18]by transforming them into (tradable) securities. [19]

The lender references or sells a portfolio of its loans, and through a structuring process arranges them into different risk categories for investors, thus giving the latter access to investments in loans and other exposures to which they normally would not have direct access. Returns to investors are generated from the cash flows of the underlying loans and the level of return references the level of risk category the investor assumes.

The lender will achieve its objective of both / either refinancing its balance sheet and / or transferring credit risk to a third party.

Why is Securitisation helpful?

The development of securitisation in the US between the mid 1970's and the mid 2000s was one of the main pillars of the transition in that region from one that was substantially driven by the banking sector to one that was a more market-based financing model[20]. The aim of securitisation was not to derisk the banking sector, but rather to increase the velocity of asset rotation, enabling banks to deconsolidate their assets from their balance sheet and to give investors access to underlying asset classes originated uniquely by banks and enable them to take exposure to these asset classes across the credit spectrum. By giving investors access to a new asset class across the spectrum of credit risk, it has contributed to the development of a vibrant financial ecosystem that is necessary for deep and integrated capital markets which in turn fosters economic growth by increasing the rate of flow of capital to the economy.

The absence in the EU of a developed securitisation market has the effect of "blocking" EU banks' balance sheets, preventing them from rotating their balance sheets effectively and thereby impacting the flow of capital to the real economy.

As identified in the European Securitisation Regulation[21], securitisation is an important element of well-functioning financial markets. Soundly structured securitisation is an important channel for diversifying funding sources and allocating risk more widely within the Union's financial system. It allows for a broader distribution of financial-sector risk and can help free up originators' balance sheets to allow for further lending to the economy. By breaking the link between the originator's financial standing and the risk of the securities offered to investors (which is referenced to the underlying pool of assets), it also offers alternative refinancing options to some corporates that would otherwise have difficulties in accessing bank financing at good conditions. Overall, it can improve efficiencies in the financial system and provide additional investment

[18] Such as residential loans, auto loans or leases, consumer loans, credit cards or trade receivables.
[19] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402
[20] Asset Securitization (treas.gov)
[21] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402

opportunities. Securitisation can create a bridge between credit institutions and capital markets with a corollary benefit for businesses and individuals.

Whilst the engine of economic growth in the EU continues to be driven by lending provided by the banking sector[22] it is critical that banks have at their disposal a fully functioning securitisation market. If so, securitisation may thus serve on the one hand as a bridge, facilitating indirect access by borrowers to the capital markets and on the other hand, a transmission mechanism, allowing risk to be sold and traded via the capital markets, in this way enabling savers and investors to have a stake in financing the real economy,

Why now more than ever?

1. **Building an alternative source of funding to fuel growth for European companies**

- Securitisation is used more widely outside Europe[23] to finance corporates directly via the capital markets across an array of sectors. In the EU, securitisation is used to a lesser extent by banks as part of their relationship lending to finance companies, ranging from SMEs to highly rated corporates of any rating (from "speculative" up to "high grade").[24]
- Securitisation can be particularly helpful to SMEs by supporting a greater choice of funding at lower cost, thereby supporting long-term growth for emerging corporates. Early-stage companies often with a focus on innovation and digitalisation can also benefit. Given that securitisation enables the lender to take exposure to the underlying security rather than the counterparty itself, these early-stage companies can access finance with beneficial terms when they need it the most, namely whilst they are in a phase of early-stage rapid growth.
- At the time of writing, there has been much discussion around the potential implementation of a pan-European guarantee scheme to mirror such schemes that exist in regions, such as the US, Canada, Japan and Saudi Arabia and the support it may give to banks through release of capital and funding. The idea of a pan-European guarantee scheme as envisaged by the Noyer report as a means to deepen the EU's capital markets and increase the issuance of safe assets merits further consideration. Whilst AFME is engaged in these discussions, further analysis is needed and therefore it is not envisaged within this paper, which is focused on the reform of the existing regulatory and prudential frameworks for securitisation.

2. **Provision of long-term credit to underserved wholesale and consumer market segments**

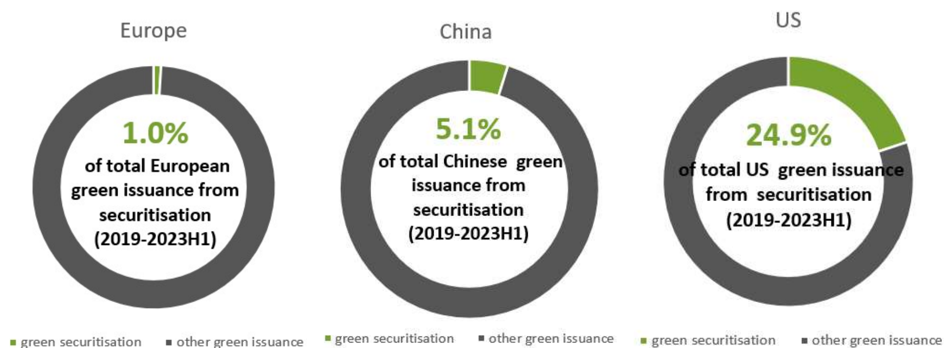
- Provision of credit to certain wholesale and retail segments relinquished by banks to other lenders remains important. These lenders do not have access to retail deposits which makes securitisation a very important tool to fund growth of the segments they serve.[25]
- These lenders are likely to play an even more important role in financing the real economy in the future as banks once again reconfigure client relationships as a result of the impact on Basel IV on banks' cost of capital. As this segment grows, securitisation will become increasingly important as a funding tool.

[22] AFME CMU KPI report: Data is showing c.75% of financing provided by banks.
[23] https://www.paulweiss.com/media/3394089/jsf_winter_2016_paulweiss-2.pdf
[24] EBE report
[25] https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230523~22f6621da7.en.html

3. A developing role in financing the transition

- The burden on the banking sector to play a critical role during the transition is well understood. According to the Commission, the scale of funding required is estimated €620 billion in additional investment per year over this decade to meet the 2030 emissions-reduction target in energy systems alone, alongside the €130 billion Europe will need for other environmental goals.[26]
- Asset rotation[27] into the capital markets will be central to banks' capital management and funding strategies to achieve these aspirational targets. Securitisation is crucial to implementing this strategy.
- The green and digital transition is a journey taken both by wholesale and consumer segments. Securitisation disclosure and reporting gives investors much needed transparency on securitised loan portfolios and their ESG characteristics when investing in the financing of both these segments.
- Securitisation's potential in the EU to contribute to financing the green and digital transition to a more sustainable economy is striking, especially when one compares the size of the EU green securitisation market against other economic blocs. As noted by the European Banking Authority ("EBA"), in Q1 2021 securitisation only accounted for 1% of green bonds issuance in the EU, compared to 50% in the US and 11% in China.[28] The difference is equally staggering if one also looks at data from a longer period, namely 2019-2023H1. Green securitisation issuance represents only 1% of total European green issuance, whereas it stands at 5.1% in China and 24.9% in the US.[29]

Figure 2: Green securitisation (2019 – 2023H1)



[26] https://commission.europa.eu/system/files/2023-07/SFR-23-beautified-version_en_0.pdf
[27] AFME CMU KPI Report, Loan Transfer Indicator metric
[28] EBA report on developing a framework for sustainable securitisation (here).
[29] European data includes the UK. US data includes agency issuance.

- According to recent research, securitisable green lending in respect of residential mortgage loans on energy-efficient properties, loans for green home renovations and electric vehicle financing alone could exceed €300 billion annually by 2030.[30] It is also worth noting that the Capital Markets Recovery Package in April 2021 correctly identified securitisation as "an additional tool to foster economic recovery in the aftermath of the COVID-19 crisis".[31] Green lending portfolios, such as projects financing wind and solar plants, SME lending and consumer finance can be refinanced through securitisation; in addition, banks may choose to reinvest regulatory capital released through securitisation to support their lending to clients and projects contributing to the sustainable transition.

4. It gives EU savers and investors unique access to a product rooted in prudently underwritten banking credit risk, uncorrelated to corporate credit risk.

- Securitisation, through its structures, can create a full spectrum of credit risk from AAA to equity like risk, to meet the respective appetites of an array of investors. This range of risk, evidenced by data over the last forty years, has performed in line or *better* than fixed income asset classes perceived as more "vanilla".

- Since the Global Financial Crisis (GFC),the same European Asset Backed Securities (ABS) have exhibited comparable market liquidity to other fixed interest products, such as secured and unsecured bonds, that have exhibited rapid growth over the past decade and greater liquidity than market traded whole loan portfolios.

- Securitisation exhibits low correlation to other fixed income asset classes and is therefore a useful product to diversify credit risk both for issuers as well as savers and investors. A resilient EU economy will not only benefit EU citizens, but it will also reinforce the EU's global competitiveness and strategic and economic autonomy.

5. It facilitates the sale of Non-Performing Exposure (NPE) portfolios to non-bank investors specialising in distressed debt assets.

- High NPL ratios in banks' balance sheets can adversely affect the soundness of the banking system and its ability to lend to the real economy through three main channels. First, high nonperforming loans reduce bank profits. They do so because they require higher provisions, they lead to lower interest income, generate higher expenses associated with their monitoring and management and lead to an increase in funding costs, as risk adverse investors are less willing to lend to institutions with a low credit quality. Second, non-performing loans feature higher risk weights, leading to higher capital needs. To maintain or boost capital adequacy, banks may thus deleverage, which may lead to a contraction in credit supply. Finally, the management of large NPL stocks can divert important managerial resources away from core and more profitable activities.[32]

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[30] AFME, European Green Securitisation Regulatory State of Play (here).
[31] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0557
32 https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2411~839bc74726.en.pdf

- Securitisation has been used in a couple of ways to facilitate NPE portfolio sales to specialist credit funds with specialist loan servicing capabilities. In Italy, there is a guarantee scheme to facilitate the securitisation of non-performing loans (Fondo di Garanzia sulla Cartolarizzazione delle Sofferenze - GACS). The GACS scheme, since its being into force, had removed approximately €100 billion (gross book value) of non-performing loans from the Italian banking system.
- In Greece, a similar asset protection scheme (known by the name of 'Hercules') has enabled Greek banks to make significant progress in reducing the stock of their non-performing loans. In particular, as a result of the introduction of the scheme, the non-performing loans ratio have halved from 43% at the end of 2019.
- Securitisation is also used in non-guaranteed form, facilitating the flow of NPE portfolios off bank's balance sheets and thereby supporting more bank financing to the real economy.

6. It facilitates the much needed shift from a European economy relying primarily on financing through banks' balance sheets to one that is able to mobilise the full potential of capital markets.

- If allowed to do so, it will catalyse the transformation of an EU economic ecosystem financed primarily by banks to one that is financed by a capital market. It does this by acting as a transmission mechanism, enabling borrowers to have indirect access to the capital market and enabling investors to indirectly gain exposure to the EU economy.

7. It frees up capital and transfers credit risk outside the banking sector, enabling banks to lend more to the real economy.[33]

- As we have identified, asset rotation by banks will be central to their capital management strategies over the next decade. Asset rotation, risk transfer and capital release can be achieved by banks through securitisation without negatively impacting the experience of the wholesale or retail client. The capital released can then be reinvested into financing the real economy.

33 The other key benefit of securitisation is the ability to deconsolidate the bulk of bank assets and related risk, which means banks can use capital more efficiently. Removing assets from the balance sheet means banks can maintain constant leverage, while increasing loan issuance volumes. Unlike covered bond issuances, securitisation transfers risk away from banks, which frees up resources to meet solvency ratio requirements' (cf. Noyer's report).

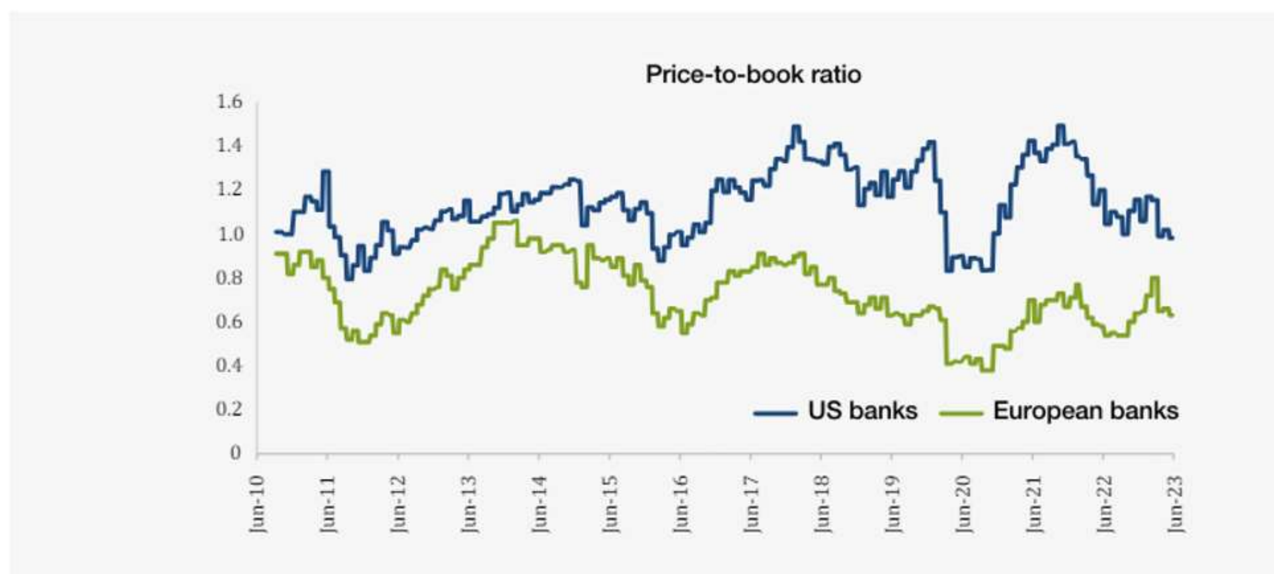
The concept of asset rotation and its relevance for the EU economy

This section elaborates on the concept of asset rotation, how it benefits the consumer and wholesale borrower and finally how it is delivered through securitisation.

To finance their lending, banks must rely on a variety of funding sources: mainly equity, deposits and bonds. This allows the banks to play their unique and useful role for the economy, converting – often – short term liabilities (such as deposits) into long-term assets (loans).

To increase bank lending to the real economy, banks have an array of capital instruments available, including Common equity (CET1), Additional Tier 1 (AT1), Tier 2, etc. The effect of capital raising through CET1 issuance will reduce Return on Equity (ROE) for banks, putting further pressure on their international competitiveness, as measured through their Price to Book ratios, which in Europe remain at lower levels compared to those of international peers.

Figure 3: Price to book ratio of US banks and European banks



Source: Refinitiv Eikon

Therefore, capital solutions that both support banks' ability to meet increasing financing needs of the real economy without impacting bank Returns on Equity (ROE) is key to meet the needs of retail and wholesale borrowers as well as shareholders (a large component of which are EU savers and investors). This can be achieved through utilisation of instruments that are both non-dilutive and capital efficient. In the context of

these needs, capital strategies that make full use of the suite of often lowly correlated instruments improve access to capital in differing market conditions. [34]

Approaches to release capital via Significant Risk Transfer (SRT)[35]

Banks use securitisation to transfer risk and release regulatory capital through SRT transactions. This is achieved via the sale of subordinated or junior tranches referencing or collateralised by loan portfolios originated by the bank to third party investors. In doing so, banks transfer the risk of incurring portfolio expected and / or unexpected losses from their balance sheets, whilst continuing to consolidate these assets within the bank from an accounting perspective.

Utility of Synthetic vs. "Traditional (True-sale)" securitisation to achieve SRT

"Traditional (True-sale" or cash) securitisation: This is the process of pooling together a large number of loans (such as mortgages, loans to purchase cars, loans to SMEs, etc.) held on the balance sheet of a bank or other financial institution (the "originator") and selling them to a newly created and legally separate entity (the "Securitisation Special Purpose Entity" or "SSPE"). This SSPE finances the purchase of the loans by issuing bonds to investors. The loans generate cashflows (for example, monthly mortgage payments from homeowners), which are used to repay the investors. Investors have recourse only to the underlying securitised loans and have no claim on the originator for credit losses. In the event that the originator wishes to achieve SRT, it must sell a significant proportion of the riskier junior or mezzanine tranches and will sometimes dispose of the full capital stack of bonds from AAA down to most speculative rating (CCC) if/when still eligible to be rated.

Synthetic or on balance-sheet securitisation: there is no "traditional" securitisation of the underlying assets and often no SSPE. Instead, the risk of an identified portfolio of assets is transferred through the purchase by the originator of credit protection from a third-party investor (in the form of a guarantee or derivative), who promises to reimburse the originator should any of the assets default. The credit protection may or may not be collateralised.

The synthetic approach has been favoured by banks and supranational investors (e.g. EIB[36]) over the past decade for several reasons. First, because the synthetic approach has been more capital efficient for banks given the greater cost associated with true-sale securitisation[37] ,second because surplus liquidity for banks has limited the need to generate funding through sale, or use as collateral (if retained of the senior tranche) and third, because synthetic securitisation is especially helpful to facilitate securitisation of corporate, SME, and project finance loans, which are capital intensive and more difficult to securitise through traditional means due to the complexity associated with asset true sale of these portfolios. Without this mechanism, banks

[34] https://www.spglobal.com/ratings/en/research/articles/230323-swiss-regulator-s-statement-on-credit-suisse-at1-confirms-impact-of-documentation-and-legislative-powers-12678742
[35] Articles 244 and 245 CRR Regulation
[36] https://www.eib.org/en/press/all/2023-534-france-eib-group-and-bnp-paribas-sign-new-securitisation-transaction-to-support-small-businesses-and-mid-caps
[37] In a traditional securitisation, a special purpose vehicle is required. This is not the case for synthetic securitisation, which increases simplicity and is cheaper.

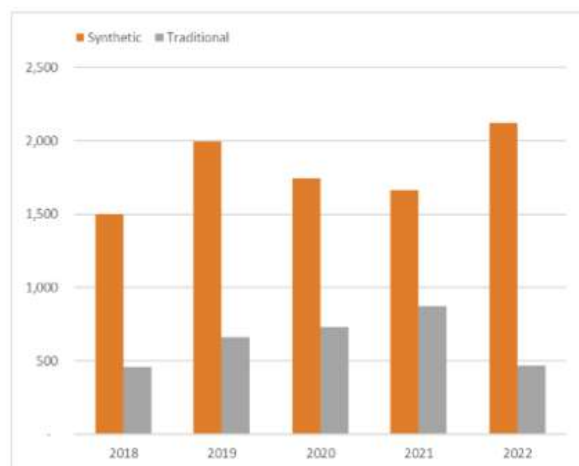
would be more constrained in their capacity to lend and consequently SMEs and other corporate borrowers would be less able to obtain financing they need to develop and grow their businesses.

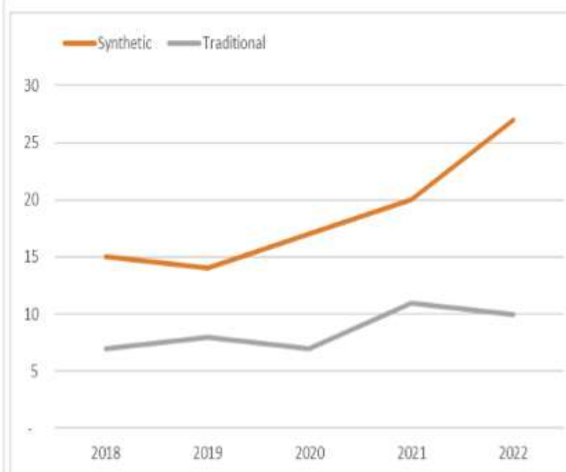
Whether executed in a traditional or "synthetic" structure, the purpose of securitisations is to finance real economy assets and manage risks. The chosen structure will depend on which objective – financing and / or risk transfer - is sought.

Impact of SRT for the economy

Over the past decade, use of SRT has conservatively transferred over EUR600bn[38] notional of risk from EU banks' balance sheets and released over EUR20bln of regulatory capital. Around 90% of these transactions have been synthetic SRT.

Figure 4: SRT performing transactions per year





Source: ECB data.

Following the current trend of issuance, by 2030, SRT has the potential to free up an additional amount of more than EUR60bln of bank capital[39].

Whilst this has been an important capital contribution tool for banks to date, **the potential is significantly greater**. The percentage of portfolios referenced via SRT makes up less than 5% of EU banks' eligible balance

[38] https://www.esrb.europa.eu/pub/pdf/occasional/esrb.op23~07d5c3eef2.en.pdf
[39] Assumption: steady state growth of 5%YoY from 2025, Average RWA density @60%, 80% release

sheets.[40] Moreover, 90% of SRT issuance has been originated by banks using IRB models. IRB lending however constitutes only 60% of total bank lending.

While the use of the Simple Transparent and Standardised (STS) label for synthetics has improved the economics for Standardised Banks for certain transactions, only a more appropriate calibration of Securitisation Standardised Approach (SEC SA) will enable these banks to fully take advantage of the tool.

With appropriate changes to SEC SA calibration, it is not inconceivable that Standardised banks could make up more than 30% of issuance volumes in the EU. By 2030, this could mean that IRB and Standardised lenders could be releasing over 6bln and 3bln of capital per year respectively[41], to be redeployed in more than EUR200bln of additional lending per annum.

Synthetic SRT investors consist of specialist credit funds, pension funds, multi asset fixed income managers, multilateral development banks and insurers domiciled around the world. This constitutes an investor base that brings additional capital investment to the wider economy. This not only serves the purpose of broadening and deepening the investor base investing in bank capital but also supports the overarching objectives of Capital Markets Union of broadening and deepening the capital markets. It also attracts new non-EU investors to the EU bank capital market, thereby mitigating the build-up of risk by EU institutional investors.

Constraints to asset rotation

Lack of risk sensitivity of the bank capital framework

As identified by the European Banking Authority (EBA) in their December 2022 advice to the European Commission, the securitisation capital framework for credit institutions does not differentiate between the roles of credit institutions as investors or originators in a transaction. The agency[42] and modelling risk of a credit institution investing in securitisations originated by other credit institutions or retaining tranches of its self-originated securitisation may be quite different.

When an originator retains tranches in its securitisations (i.e. securitisation of exposures originated during the regular lending activity of the originator), the agency risk is marginal. Moreover, model risk, in case of an originator, is reduced to the model risk implicit in securitisation which uses inputs from credit risk models, whereas for investors to this it is added the risk of dealing with external data and, in case they use SEC-IRBA of developing ad-hoc models. [43].

The same logic is true in distinguishing levels of modelling and agency risk between public and privately offered securitisations given that the execution process of these two transaction types is so very different. Private transactions are typically executed over several months, over which period, substantial data is shared, extensive due diligence is conducted, and the transaction is modelled by the investor. This process reduces substantially the model and agency risk inherent in such a transaction.

[40] https://www.esrb.europa.eu/pub/pdf/occasional/esrb.op23~07d5c3eef2.en.pdf
[41] Assumption: steady state growth of 5%YoY from 2025, Average RWA density @60%, 80% release
[42] Agency risk refers to a situation in which a principal mandates an agent to act on its behalf, but the interest of both parties is not aligned.
[43] Joint Committee advice on the review of the securitisation prudential framework

Basel Capital calibration using data relating to transactions prohibited under current EU Securitisation Regulation

Firstly, Basel capital calibrations were derived from a dataset built from the performance of US securitisations whose loss performance was materially different from EU securitisation performance data. Secondly, a large segment of transactions referenced in the source data is now prohibited under the current EUSECR. This layering of conservatism has since been exacerbated by the EU's implementation approach of the Basel Framework.

The EU Securitisation Regulation and the STS framework have adopted a super-equivalent version of the Standard or in other words, have augmented the criteria outlined in the BCBS Framework. The effect of these two actions results in the EU Prudential Framework for securitisations applying capital charges that in no way represent the risk of the EU Securitisation product.[44] A few examples highlighting the EU's "gold-plated standards" can be found below:[45]

- Through the implementation of EUSECR (and not CRR), the Basel Standards that are applicable to banks only, have necessarily been adopted by a much broader group of stakeholders than prescribed by Basel.
- Prohibition of re-securitisation: applicable to all EU securitisations vs Basel for STC only.
- Disclosure and reporting: applicable to all EU securitisations (private and public) vs Basel for STC only and far less detailed and prescriptive.
- Investor Due Diligence obligations: for EU investors for all securitisations vs Basel targeted and proportionate.
- STS criteria: EU criteria are far more numerous and prescriptive than the Basel Framework's STC equivalent.
- SRT tests: EU banks need to comply with a prescriptive set of tests with no equivalent under Basel framework.
- Treatment of Synthetic Excess Spread for SRT: EU originators are required to risk weight excess spread with no explicit equivalent under Basel Framework.

Moreover, it is important to recognise that the US has not fully implemented the Basel calibrations for the p factor, whereas these are applicable in the EU today:

P factor calibrations	EU	US[46]
SEC SA	1 for non-STS, 0,5 for STS	0.5 for all transactions – Simplified Supervisory Formula Approach (SSFA)
SEC IRB	Floor of 0.3 for STS and non-STS And max ranging from 0.75 for STS to 1.5 for low-risk mortgage pools for non-STS	The Supervisory Formula Approach (SFA) is still in use. While the p-factor is not an explicit input in the SFA formula, it is understood to be close to 0.

[44] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Paper_%20Securitisation%20Adjustments_CRR3%20(final).pdf

[45] Ibid.

[46] The US is currently consulting on implementing the final Basel standards. This consultation proposes to increase the p factor to 1. At time of writing, the decision of the US authorities on final calibration is not known.

Following agreement on the CRR3 package, the EBA is due to deliver a report on the appropriateness of the non-neutrality factor by the end of 2026 and the Commission to possibly propose a legislative proposal by the end of 2027. The timeline for any response and correction of the prudential formula would therefore be medium term, at best. In the meantime, the potential for the SRT tool to free up regulatory capital will remain constrained.[47][48] We thus believe it is necessary to anticipate the review of the prudential treatment which should be included in the package of measures necessary to relaunch the Securitisation market with no delay.

Shortcomings of the prudential capital formulae

According to the EBA[49], legislators targeted different goals and effects when designing the formula-based approaches. First of all, the objective was to reduce cliff effects[50]; second, to ensure a deduction of capital as high as the capital before securitisation; third, to avoid an unreasonable level of capital non-neutrality.[51] This represents a conflict of objectives, as only two out of these three goals can be achieved within the current design leading to the last objective being compromised in order to achieve the first two.

Realising synthetic SRT's full potential

AFME has identified a package of measures which will support growth of the wider EU securitisation market and support stable long-term growth in the EU. In relation to the use of SRT as a tool to transfer risk and release regulatory capital, these measures are primarily focused on the supply side, i.e. increased risk sensitivity for borrowers rather than investors.

Improving the risk sensitivity of the Bank Prudential Framework in relation to Securitisation Standardised Approach (SEC SA), Securitisation Internal Ratings Based Approach (SEC IRBA), Internal Assessment Approach (IAA) and Securitisation External Ratings Based Approach (SEC ERBA) formulae design and an appropriate design of risk weight (RW) floor levels will support broader usage of SRT by the EU banking sector.

Priorities and policy actions

To relaunch securitisation in the EU, we believe that implementation of a package of measures is necessary.

None of these changes will likely be effective in isolation. They must be delivered as a package. Some of these changes will take longer to have effect than others and some will have a greater impact than others but if delivered discretely, they risk having little impact.

[47] Temporary adjustments to the p factor agreed in trilogue negotiations provide a medium-term solution for IRB banks.

[48] In the UK, the PRA currently favours an approach of recalibrating SEC SA under Pillar 1 without requiring revisions at Basel.

[49] Joint Committee advice on the review of the securitisation prudential framework – Banking, see section 3.3.2 "Medium to long-term considerations on the formula-based approaches'

[50] A small estimation error could mean that the risk of such a tranche is as low as that of a senior tranche or as high as that of a junior tranche (https://www.bis.org/publ/qtrpdf/r_qt1412f.pdf)

[51] According to the Basel Committee, "the non-neutrality of the framework refers to the fact that the total capital required for a securitisation (ie the sum of the capital required for all securitisation tranches) is greater than the amount of capital required for the underlying assets". It is captured via a parameter in the formula for calculating capital requirements for securitisations known as the "p factor".

Given the above and that there is apparent momentum to implement key legislative proposals that have a transformative impact, potentially a single regulation amending the relevant legislative acts (CRR and SECR) could be the appropriate vehicle.

A focus on financing the real economy

1. Increasing Risk sensitivity for Banks

In order to give force to the European Council's call for relaunching the European securitisation market,[52] it is necessary for the Commission and co-legislators to consider and agree on immediate set of measures, without prejudice to a potential comprehensive review to be considered in the long-term. The measures outlined below are of a nature to contribute significantly to an improved functioning of the securitisation market:

Recommendations

- **For banks securitising standardised portfolios, revisions in Articles 261 and 262 of CRR3 (rather than just within the output floor calculation, per the CRR3 agreement) to (p) factor of 0.25 for STS securitisations and to 0.5 for non-STS securitisations for banks acting in the role of originator, investor and sponsor.**
- **For banks with IRB portfolios, recalibrating in Articles 259 and 260 of CRR3 the fixed parameters that are components of the (p) factor for SEC-IRBA with a floor of 0.1 and maximum of 0.3 for STS securitisations, and a lowered floor of 0.25 and maximum of 0.75 for non-STS securitisations for banks acting in the role of originator, investor and sponsor.**
- **Adjustment to Risk Weight Floors. AFME supports the re-introduction of a 7% RW floor in all approaches for STS securitisations (cash and synthetic), for banks acting in the role of originator, sponsor or investor, and 12% for non-STS transactions for banks in the same role.**
- **A revision to SEC ERBA and IAA in the role of Originator, Sponsor or Investor in order that bank capital charge levels are commensurate with the risks associated with securitisation for banks.**

The above measures would mitigate in large part, the impact of capital non-neutrality for SRT transactions, for which it is widely accepted that agency and model risk are de minimis for many transaction types. These measures are needed in recognition of the complexity of the status quo. These measures would on the one hand support asset rotation into the capital markets whilst on the other hand would give time to conduct a comprehensive review of EUSECR together with the Bank Prudential Framework.

Significant Risk Transfer through traditional securitisation has been used minimally in the past, as a result of regulatory and market constraints. Increased usage by banks of this approach will broaden and deepen the capital markets investor base:

[52] https://www.consilium.europa.eu/media/m5jlwe0p/euco-conclusions-20240417-18-en.pdf

- Synthetic and traditional SRT investors have some but limited overlap, thereby broadening the bank capital investor base. This is also true for Tier 1 and Tier 2 capital investors.
- Investment grade ABS investors differ from Sub Investment grade investors, thereby diversifying the investor base for the banking sector.
- Investment grade ABS investors have some but limited overlap with Covered Bond investors, thereby broadening the senior secured investor base for banks.

The importance of funding diversification for lenders

Banks raise funds from a variety of sources including deposits, senior unsecured debt, subordinated debt, covered bonds and securitisation.

Credit lenders will need to adapt funding strategies deployed over the past decade for a couple of reasons. On the one hand, the expectation for lenders to meet a seismic shift in borrowing needs of the EU economy as noted earlier and on the other hand, the impact of quantitative tapering on banks as central banks unwind over a decade of expansive monetary policy.

The role of non-banks may also become more important as they are called upon to build out their franchises from ones that met the borrowing needs of underserved market segments post-GFC to ones that expand scope of business to include clients and products relinquished by banks as a result of the need to change lending models in the context of Basel IV risk weighting adjustments.

In this context, both banks and non-bank lenders will need to finance growth in lending using all funding channels. A diversified funding strategy is critical for a couple of reasons and is a supervisory expectation for banks in particular:

- Excessive usage of specific funding instruments to the exclusion of others introduces micro prudential risks for banks[53] that a diversified funding strategy conversely mitigates. For example, sole reliance on one funding instrument may introduce risks for depositors, investors and ultimately for the issuer in a deteriorating credit climate[54].

- The more funding instruments available to the borrower, the broader access to capital and increased financing flexibility at its disposal. Conversely, limited funding channels introduces financing risk to the borrower at times of economic or credit stress.[55]

Non-banks have, by definition, more restricted access to funding and therefore it is all the more important that funding channels available are as deep and broad as can be.

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[53] Committee on the Global Financial System, Asset encumbrance, financial reform and the demand for collateral assets, May 2013 (here)

[54] https://www.eba.europa.eu/sites/default/files/document_library/Risk%20Analysis%20and%20Data/Risk%20Assessment%20Reports/2022/1036110/Report%20on%20Asset%20Encumbrance%202022.pdf

[55] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/credit-suisse-at1-bond-wipeout-highlights-dangers-of-holding-banks-risky-debt-74894988

Traditional, (true sale or cash) securitisation was used primarily by banks pre-GFC as a secured funding capital markets instrument, forming part of banks' suite of funding options.[56] Post-GFC, this funding channel for EU banks has significantly reduced.

Securitisation issuance per annum in non-European G20 member states that have active securitisation markets ranges from 1.5% to 4% of Gross Domestic Product (GDP). EU issuance sits around levels less than 0.5%. If securitisation issuance were to contribute at the lower range, issuance volumes would be at levels 3times higher.
A lower quartile contribution of 1.5% as a percentage of GDP would translate to an estimated equivalent of EUR300bln of placed ABS in 2024, 10 x placed STS issuance in 2023. Placed issuance at these levels would require commitment by investors at levels indicated prior to the GFC, as indicated in the chart below.

This contribution is more important than ever given the role securitisation can naturally play in channelling private capital to finance the green transition in Europe, which will only increase the utility of the product.

Figure 5: Financing the Gap

			Demand current pa (€bln) est.		
			Insurers	8	
			Banks	8	
Current Supply (€bln) est.			AMs / PFs	14	
Sold ABS (CLOS exc.)	**30**		**Current demand**	**30**	
ABSPP	5				
Retained ABS	120				
Total current	155				
Potential supply			Additional demand to meet supply		
EU GDP proj 2024	20,000				
Potential	300	1.5%	Insurance	110	6%
Current Sec contrib	30	0.2%	Bank Treasuries	92	6%
Delta pa	270		AMs / PFs	70	
Additional supply to place	30		Additional demand	271	
Additional est. supply to place	**300**		**Total target demand**	**301**	

NB: These numbers are illustrative of the pressing need for increased investor demand. Numbers referenced do not factor in the contribution securitisation can make to financing the EU structural transition.

What were the reasons for collapse in use of traditional securitisation?

- In the aftermath of the GFC, a wholesale collapse in confidence of the global securitisation market caused investors to disinvest, limiting borrowers use of the product as security to repurchase agreements (Repo) with Central Banks.
- Whilst investors saw strong relative value in secondary markets post-GFC, primary market activity was very limited due to the high cost to banks relative to other funding instruments.

[56] Originators wishing to obtain funding from such a transaction, and not SRT, would limit the sale of bonds to investment grade, often only selling AAA bonds.

- Recalibration of prudential frameworks for insurers and banks[57] were set at levels that discouraged previously important market segments from ever investing again because punitive capital charges meant that returns generated on the increased risk adjusted capital (RORAC) post revision, compare unfavourably with other fixed income asset classes.
- Alternative funding channels were needed to meet the financing gap left. Covered Bonds, portfolio sales and Central Bank liquidity have since become important sources of liquidity for banks.
- Bank and insurance investors that previously constituted up to 40 to 60% of the investment grade public ABS investor base will not return until prudential capital frameworks are proportionate and specific elements of the EU Securitisation Regulation are adjusted.
- Bank issuers will only revert to using this funding channel if investor demand is restored and AAA, AA, Single A funding costs normalise.

What reforms are needed?

AFME has identified a package of measures focusing on improved risk sensitivity and proportionate guidance will support growth of the traditional securitisation market. As both a funding and risk transfer tool, the primary challenges currently facing traditional securitisation in the EU relate to the demand side, i.e. revival of the investor base largely for AAA rated tranches, but also for AA and Single A publicly placed ABS. Conversely, there is strong demand for the non-investment grade tranches, which has enabled growth of the synthetic SRT product, whose investor base is less acutely affected by the challenges faced by investment grade investors.

2. Reviving demand from the insurance sector

Solvency II standard formula capital calibrations for securitisation are mis calibrated[58]

- Specifically, calibrations of STS non-senior tranches, non-STS senior and non-senior tranches.[59]
- We welcome the recent agreement on Solvency II inviting the Commission to reassess the calibration of securitised products. This should provide the opportunity to have an evidence-based revision of the calibration of non-STS securitisation and of non-senior STS.
- Recent academic work highlights that the risks associated with investments in these types of securitisation are significantly lower than the risk weights currently accorded to such investments by insurers. [60]
- This miscalibration also has an affect for many Internal Model users, but directly impacts Standard Model users. It is therefore relevant to many insurers domiciled in the EU.

Recommendation:

- **AFME advocates for a review of Solvency II capital calibration of the risk-weights associated with securitisation investments under Solvency II in 2024.**

[57] Solvency II and Capital Requirements Regulation respectively
[58] https://www.bis.org/publ/cgfs49.pdf ,page 8
[59] RCL research report commissioned by AFME, "ABS and Covered Bond Risk and Solvency II Capital Charges" (here).
[60] Ibid.

3. **Liquidity from the banking sector**

Liquidity Coverage Ratio - Eligibility criteria and treatment.

Once more, a super-equivalence or amplification (6 x (or >20 x if STS criteria included[61])) by the EU of Basel criteria has the effect of reducing asset eligibility for banks vs. other asset classes. The most significant deviation from the Basel framework limits eligibility to STS only, reduces the scope of eligibility to 21% of total European issuance in 2023[62]. In light of the aforementioned criterion, the expansion of eligible underlying asset classes has limited positive effect. Below is a selection of differences;

- Number of LCR eligibility criteria: EU = 30[63] (or >100 if STS criteria inc.) vs. Basel Framework = 5[64]
- LCR eligibility: EU STS securitisations only. Basel Framework, no stipulation.
- LCR eligibility: EU limited to AAA rated bonds only,[65] Basel framework, AA or above.[66]
- LCR eligibility: EU limited to < 5-year WAL[67], Basel framework, no stipulation.
- LCR eligibility: EU assets (RMBS, SMEs, Auto, Consumer), Basel Framework, RMBS only.

It is unsurprising therefore, as the EBA cites that "the share of securitisation positions, including STS securitisation positions, taken into account in the LCR stress buffers has been negligible since the inception of the LCR and remains so today" Whilst this is true, it goes on to say "The EBA considers that there is a reasonable assumption that credit institutions have very small appetite to use securitisation positions as part of the LCR stress buffers or perceive a low marketability of securitisation positions during a LCR stress scenarios".[68]

This assumption is, however, incorrect. Credit institutions have the appetite[69] but the regulatory cost of compliance outweighs the benefit of investing. Regulatory costs include LCR haircuts, STS verification, Article 5 investor due diligence, regulatory cost of capital.[70] These costs of participating in the product are weighed up against the opportunity to participate in low eligible supply.

Elevated haircuts applied from 25% (RMBS) to 35% (consumer credit and SME loan ABS) are examples of such costs which disincentivise banks considering asset selection when short liquidity and close to asset buffers. Haircut levels are not commensurate with either the market liquidity observed in the product[71] or as exhibited recently in stressed liquidity scenarios within Europe.[72]

[61] https://www.bde.es/f/webbde/INF/MenuHorizontal/Normativa/guias/EBA-GL-2018-09-EN.pdf
[62] https://www.afme.eu/publications/data-research/details/securitisation-data-report-q3-2023
[63] Commission Delegated Regulation (EU) 2015/ 61 - of 10 October 2014 - to supplement Regulation (EU) No 575/ 2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions (europa.eu)
[64] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (bis.org)
[65] Joint ESAs report recommends down to AA-, but not yet implemented.
[66] Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (bis.org)
[67] Weighted Average Life
[68] Joint Committee advice on the review of the securitisation prudential framework
[69] AFME LCR Survey on Securitisation, 4 June 2024(here)
[70] STS ABS capital charges are higher than those imposed on Covered Bonds.
[71] RCL Research Report commissioned by AFME, "Comparing CB, ABS and Corporate Bond Liquidity"
[72] https://www.blackrock.com/uk/professionals/solutions/fixed-income/liability-driven-investing/talking-points-november-2023

If LCR eligibility were more closely aligned to the Basel framework and haircuts commensurate with the risk applied, bank treasuries would be better positioned to access diversified liquidity resulting from equitable regulatory treatment of the asset class.[73]

Recommendations:

- **Eligibility for non-STS as well as STS ABS.**
- **Eligibility for securitisations rated down to AA- (recommended by the Joint Committee of the ESAs in its advice to the European Commission of December 2022 on the review of the securitisation prudential framework (the banking report) in recognition that earlier amendments to the LCR Regulation did not intend to limit the eligibility to AAA rating only;[74])**
- **Removal of the Weighted Average Life limit.**
- **Eligibility of Asset Backed Commercial Paper (ABCP), a product that shares characteristics such as "dual recourse" with covered bonds.**
- **Eligibility for securitisations Senior STS tranches, currently classed as Level 2b, should be upgraded to Level 2a, while senior non-STS securitisations, such as CLOs, should become eligible at Level 2b.**
- **Commensurate, risk sensitive adjustments to realign haircut treatment both for STS and non-STS bonds with other fixed income asset classes such as covered and corporate bonds.**

4. Additional demand side measures

Due Diligence Requirements for Institutional Investors - Targeted adjustments to Article 5 of EU SECR:[75]

AFME has set out in a recent publication[76], specific provisions within Article 5 that create confusion, impose duplicative obligations across multiple parties, inhibit investment in practice and generally impose disproportionate obligations upon investors and in doing so, unnecessarily inhibit investment in the product. AFME looks forward to engaging with ESMA via a response to their pending consultation on the topic, scheduled for Q3 2024.

Recommendations

- **Short term Level 3 Guidance resulting from the Article 5 Consultation undertaken by ESMA to be followed by Level 1 review to provide legal clarity and certainty. Should legislators consider a level 2 act is needed to specify the due diligence requirements, the mandate to ESMA should explicitly refer to actual investors' needs and their own expertise reflecting the application of the principle of proportionality.**

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[73] AFME LCR Survey on Securitisation, 4 June 2024 (here)
[74] Joint Committee advice on the review of the securitisation prudential framework, section 4.3
[75] Regulation (EU) 2017/ of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (europa.eu)
[76] Article 5 Issues Report: Due-diligence requirements for institutional investors under Article 5 SECR | AFME

5. Additional supply side measures

Disclosure templates

The issue of dealing with the Article 7 templates and especially their interaction with private securitisations following the Commission's strict interpretation of Article 5(1)(e) is urgent and continues to cause serious disruption in the markets. While we acknowledge the informal consultation on the issue undertaken by ESMA already as well as the formal consultation paper it published in December, a quicker pace of change towards a reasonable final position is much needed.

In the interim, some supervisory assistance to help minimise the transitional disruption is urgently required. Longer term reform should focus not only on risk but also on the international competitiveness of the EU as compared to other markets, failing which the EU will risk suffering further market attrition to the benefit of more efficiently regulated markets.

Recommendations:

AFME has most recently submitted a response to ESMA's consultation[77] outlining the preference of AFME members:

- **Introducing a single dedicated template for private securitisations addressing the supervisors' needs, thus removing burdensome regulatory reporting on private securitisations and also removing compliance challenges faced by EU investors when seeking to invest in third country securitisations; and**

- **If any changes are to be made to the "public" reporting templates, we would support only a very limited number of targeted amendments to such templates that are justified by a cost-benefit analysis – for example, by replacing unnecessary loan-by-loan reporting for certain highly granular and revolving asset classes, such as credit card receivables, and by making certain other targeted improvements that take into account previous industry feedback to ESMA on the field-by-field review of the reporting templates.**

Simple, Transparent, Standardised (STS) criteria

Implementation of the STS label in Europe has not yet proved a success if measured by issuance volume and impact on pricing. Whilst adoption rates for those transactions that meet eligibility criteria are high, public ABS STS issuance remain very low. This is principally for the following reasons;

[77] Joint Associations Response to the ESMA Consultation of December 2023 on the review of SECR Article 7 templates (here)

- The investor base that would impact pricing of primary issuance are banks and insurers – two market segments that have been disincentivised from investing as a result of reforms to their prudential frameworks.

- The complexity of the label and the incremental burden of regulatory due diligence required of institutional investors investing in STS assets further disincentivises investors. In respect of the latter, it would be helpful to have clear guidance about the ability to take a proportionate approach to applying the rules.

- This complexity also introduces challenges for originators to comply with the criteria, eg, in the securitisation of SME exposures.

- The universe of STS issuers would increase dramatically if more banks elected to use RMBS as part of a diversified funding strategy, which in turn would create critical mass in STS issuance and initiate a positive feedback loop. This will not occur however, unless and until investors see relative value in the product.

The creation of the STS label is helpful, but it has been outweighed by the complexity of that label and the heavy burden of regulatory due diligence required of institutional investors which creates a need for additional compliance systems and layers of procedure.

At present, there is limited improvement in pricing even for STS securitisations against other asset classes, such as unsecured debt and covered bonds. This is largely because the regulatory/prudential treatment of even STS securitisations is still overly conservative, and the eligible universe of STS issuance is so small that there is no potential to create a deep market which could assist in meeting the EU's significant investment needs in the context of the current regulation.

Recommendations:

- **AFME members are of the view that STS criteria could be simplified, so that sell-side entities could follow a more efficient process checking for asset eligibility and buy-side entities could more efficiently review compliance with the criteria.**
- **It would, in particular, be helpful for criteria to be articulated in a way that would allow parties to take account of commercial/market realities. The status quo leads to additional cost and administrative burden.**
- **Likewise, the need to diligence STS criteria from the investor's perspective requires adaptations to existing systems to "tick the box" even where the institutional investor in question is not relying on the STS status of the deal.**

Non Performing Exposures (NPE)/ Unlikely to Pay (UtP)

Despite certain improvements, recent EU reforms on NPEs securitisation still miss the general goal of encouraging originators to securitise their NPEs portfolios and to consider the specific characteristics of this type of assets when capital requirements are determined.

Recommendations:

- **A further review of NPEs securitisation prudential treatment is therefore necessary to increase risk-sensitivity (in particular reviewing the 100% RW floor, the corridor 50%-100% for senior tranches, the treatment of UTPs in the determination of the non-refundable purchase price discount).**

- **Furthermore, a significant number of NPE securitisations are private transactions; it would be beneficial to make the disclosure requirements/templates more flexible, having in mind the peculiarity of such portfolios and the circumstance that the notes issued on NPE are usually subject to limited trading activities on the secondary market.**

Conclusions

As illustrated in this paper, Securitisation is a tool that can be used to deliver many outcomes, sometimes more than one outcome can be delivered within the same transaction and other times, transactions are expressly structured to achieve a single outcome.

All these outcomes are important contributors to the success of Capital Markets Union.

The ability of the product to deliver each of these outcomes depends on specific supply and / or demand side dynamics which are in turn affected by certain provisions within EUSECR and the relevant Prudential Frameworks. Whilst the use of SRT by banks referencing IRB portfolios has grown over the last ten years, the utility of this product to rotate assets and support more lending can be more effective with appropriate capital treatment and is currently limited for standardised portfolios due to non-risk sensitive supply side constraints.

Conversely, the use of traditional securitisation to finance the real economy has stagnated over the past decade primarily due to demand-side constraints. This stagnation has been less important to date due to the impact of a decade of expansionary monetary policy. However, it will without doubt be an important financing channel to reopen in order to meet the next decade's needs.

This paper recommends a package of measures that will support all these outcomes and therefore optimise the product's contribution to economic growth in the EU for the future.

About AFME

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

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