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FRANCO-GERMAN POSITION PAPER ON SECURITISATION

Regulatory impediments to the development of securitisation in the EU

Introduction

The purpose of this paper is to present the French and the German banking industry's views on the regulatory impediments for the development of securitisation in the European Union.

The European Commission has recently expressed its will to further develop the Capital Market Union ("CMU") with the creation of a *High Level Forum* in charge of this initiative in October 2019. The FBF and GBIC are strongly supportive of the CMU and of the recommendations regarding securitisation included in the *High Level Forum* final report. They believe that securitisation is a major element of the CMU and has an important role to play in the financing of the European Economy, especially in the current stressed environment. The ongoing discussion at the level of the Council of the EU on targeted amendments to financial regulation applying to securitisation in order to facilitate economic recovery post-COVID- 19 crisis, are also very positive developments. The aim of the present paper is to contribute actively to this reflections at the European level.

Current situation

Securitisation enables the financing and risk-sharing of real-economy assets originated by banks, finance companies and corporates:

- Pools of loans to households and individuals such as mortgages, car and consumer loans, credit cards
- Pools of claims or credits on corporates and SMEs: trade receivables, vehicle and equipment leasing (car, trucks, tractors, forklifts).

Through the securitisation market, the financing and the risk-sharing of such asset pools are transferred to institutional investors, i.e. asset managers, pension funds, insurance companies and other institutions. The securitisation market is essential for the European economy by:

- Enabling corporates, non-bank lenders and challenger banks to benefit from attractive funding rates reflecting the quality of their originated assets.
- Allowing banks to free up their balance sheets hence providing them with more opportunities to extend funding to their retail and corporate clients.

Banks play key roles in securitisation:

- Originating and securitising their own assets for funding purposes
- Risk-sharing with non-bank investors in which case banks retain senior tranches
- Enabling corporates and non-bank clients to access capital markets funding via issues of ABS or ABCP sold to non-bank investors; in this case banks deliver structuring and placement services, through ABS sold to term investors or ABCP issued by their sponsored conduits sold to

short-term funds or corporate investors. As ABCP sponsor banks, by providing fully supported liquidity lines, take the senior risk in the financing of client's asset pools.

- Market-making in the secondary securitisation market to allow liquidity for investors

Given the many and essential roles played by banks, it is crucial that the regulatory rules applying to banks are reviewed to allow the development of the EU securitisation market.

Acting either on their own account or for their clients, French and German banks have securitised assets such as residential mortgage loans, automotive loans, consumer loans, trade receivables, leasing and factoring assets for many years. However, securitisation issuance in France and Germany, and more generally in the EU, is still very small compared to the USA and comparably less than in the UK. According to French and German sponsors and originators, securitisation remains costly to put in place and operate and there are only a limited number of investors in the market.

Other factors limit the use of securitisation as a funding source: for example, banks may favour cheaper alternatives; furthermore, the current economic environment and monetary policy of the ECB (negative interest rates and quantitative easing) do not incentivise banks to issue securitisation for funding purposes (except retained ABS eligible to central bank funding).

Furthermore, the very limited support of the ECB for securitisations under the ABSPP, PEPP and repo operations (Euro system) during the Covid 19 liquidity stress has created a disproportionate reduction of liquidity for securitisation transactions, including on the secondary market. Indeed, this support has been limited in scope so far, slow in its implementation and subject to more stringent criteria than those prevailing for other fixed income products. In addition, while the US FED has included ABCP as eligible assets under its various facilities to support market participants liquidity (Commercial Paper Funding Facility, Money Market Mutual Fund Liquidity Facility and Primary Dealer Credit Facility), the ECB has not included ABCP as eligible assets under its facilities.

Even though there are many securitisations issued in France, Germany and elsewhere in the EU that qualify as STS (simple, transparent and standardised) according to the corresponding EU regulation, the recent evolution of the market does not show that the STS regulation (EU 2017/2402) has stimulated the securitisation market beyond what would have been issued regardless. On the contrary, sponsors and originators consider that this regulation has increased operational complexity, constraints (for both issuers and investors), execution costs and risks. The new regulation has also failed in attracting new investors; on the contrary onerous due diligence requirements and potentially very high penalties have a disincentive effect on investor appetite. In addition, the lack of liquidity in the market has a negative impact on spreads, hence a detrimental effect and negative spiral on primary issuance. However, the possibility to use the services of a third-party certification agent for the STS certification makes the due diligence requirement easier for investors and supports the investors' interest for STS transactions.

Why is the right time to adapt the regulatory framework for securitisations now?

Banks expect an increase of their Risk Weighted Assets (RWA) linked to the transposition of Basel IV, despite their advocacy to limit this increase. This makes it even more important to develop securitisation as a means to transfer risk to investors and reduce RWA.

In addition, in the current context of the pandemic crisis, the amount of loans on banks' balance sheets has significantly increased to support corporate clients through the crisis and as a result of credit deterioration the capital to be allocated to these loans has substantially increased (under the current capital rules). Bank financing will also play an important role after the crisis, making it all the more necessary for banks to be able to obtain long term funding and transfer credit risk.

The current regulatory framework is very constraining and is a disincentive to investors and originators. Some investors, discouraged by the European regulatory framework for securitisation, ask that banks propose alternative risk transfer solutions, for example by selling loans to an investment fund.

<u>Regulatory impediments for originators</u>

Transparency requirements in the Securitisation Regulation (2017/2402)

Transparency requirements (Art. 7) are burdensome and costly, and reduce, thus, the cost-efficiency of securitisation transactions for SMEs, and banks as sponsors or originators. From our point of view, **transparency requirements are not useful and can be completely dispensed with in the case of private securitisations**, as they are redundant with the bespoke reporting that has been agreed with the investor. This opinion was supported by the French authorities during the level 1 negotiations of the STS Regulation. They proposed amendments to the regulation to exempt private securitisations from the transparency requirements. Unfortunately, the legal departments of ESMA and the European Commission have considered that the Regulation's transparency requirements do not clearly exclude private securitisation. The issues relating to the transparency requirements are described in more detail in Annex 1.

Significant Risk Transfer recognition (Capital Requirements Regulation, Art. 244-245)

Several banks that have recently securitised their own assets complain about the **lengthy and unpredictable process of the *Significant Risk Transfer*** ("SRT") approval by the ECB, due to the systematic use of additional tests that are not specified in the CRR, in order to check that the RWA reduction is commensurate with the risk transfer. In the current level 1 text, and given that specific criteria are set by the legislators to meet the SRT test, a systematic ex-ante review of the commensurateness of the credit risk transfer ("CRT") is unnecessary. Given the excessive and extensive interpretation by the Competent Authorities of their CRT assessment mandate, the French and German Industries recommend that the level 1 text be clarified notably with regards to the specific cases where a CRT assessment is necessary. The EBA report on SRT, when finalized based on a constructive dialogue with the industry, could usefully serve as a basis for determining such cases. With regards to the SRT process, the French and German Industries further recommend that the Competent Authorities carry out SRT/CRT assessments in a reasonable period of time (one to two months depending on the complexity of the transaction), as time-to-market is essential for the well-functioning of the securitization market. Such assessment should be provided on the basis of the final documentation as available before closing, as no bank would issue a securitization transaction without sufficient certainty on whether the SRT test is passed or not. The level 1 text should also make explicit that the SRT/CRT tests are due to be met at closing only, and not repeated during the life of the transaction, unless the structure is amended, or tranches are sold or bought back by the issuing bank.

Furthermore, originators of traditional securitisations often use the full deduction method pursuant to Article 244 (1) (b) of the CRR because it is much easier to apply than to demonstrate SRTCRT. This is particularly true for originators using the Standardised Approach for credit risk. It is therefore important that originators can continue to use the full deduction method without the complex task of demonstrating SRT/CRT. The application of the full deduction method is very conservative and prudent, because its application requires that the originator institution applies a 1.250 % risk weight to all securitisation positions it holds in the securitisation or deducts these securitisation positions from Common Equity Tier 1 items. However, based on a discussion paper of EBA from 2017, supervisory authorities have started to require the proof of SRT/CRT even in case of the application of the full deduction method if the securitization transaction contains a structural feature such as excess spread which is typically the case. This new approach deters originators from securitisation.

Traditional securitisations typically contain an excess spread which comprises either all future interest on securitised assets when the receivables are transferred at nominal value or the margin after deduction of refinancing costs and a standard servicing fee. In the latter case, this is done by discounting the expected future incoming payments, taking into account the refinancing rate and a standard market fee for managing the receivables. Such excess spreads have never been a problem nor challenged by supervisory authorities for capital relief in the context of the application of the full deduction method in the past. It would therefore be helpful to clarify in the recitals that proof of a SRT/CRT is not necessary in any case, if the traditional securitisation contains no fixed (pre-determined) level of excess spread or artificially inflated excess spreads. Such clarification would significantly increase legal certainty for originators and be prudent as well, because as to excess spreads only pre-determined level and artificially inflated level are a matter of supervisory concern as stated by EBA.

Risk weighted assets of securitisations (Capital Requirements Regulation)

- The current capital treatment of securitisation is punitive and flawed because instead of distributing the risk weighted assets across the tranches, commensurately with the distribution of risk, it considerably increases the capital charge after securitisation compared to the capital charge of the loan pool before securitisation. In risk transfer securitisations, when the bank is originator and/or sponsor, and consequently has a very good knowledge of the underlying assets (as originator) or has the full expertise to assess and monitor the risks involved (as sponsor), it would make sense to ensure that **retained senior securitisation tranches benefit at least from the preferential "STS" risk weight formula** (preferential RW currently granted to STS true sale tranches and to senior tranches of certain synthetic securitisations of SME loans). Please refer to Annex 2 for more details.

- **An unlevel playing field with the USA:** American banks do not use the same formula to calculate the RWA of their securitisation tranches. In the IRBA approach, they apply the former *Supervisory Formula Approach* (SFA) which leads to lower risk weights, whereas European banks are required to use the new and more conservative SEC IRBA formula which is in line with the BCBS framework. In the Standard Approach, American banks also apply lower risk weights to securitisations.

- **Under Basel IV**, some banks will experience the difficulty that securitisations transferring risk and providing regulatory capital relief in the *internal rating based approach* (IRBA) will be inefficient in the *standard approach* (SA) weighted assets calculation and, as a result, will have the **unwanted effect of increasing the output floor**.

Consistency between the regulations applying to banks

Securitisation sponsors point out that it is cumbersome to verify the compliance with criteria stemming from the STS regulation, the CRR, the LCR delegated act and the ECB eligibility criteria, and that it would be **useful to harmonise the criteria**.

<u>Regulatory impediments for investors</u>

LCR Delegated Act

- **Eligibility to the LCR liquidity buffer**: STS securitisation senior tranches only qualify as HQLA 2B, even when they have a AAA rating. This is a disincentive for bank investors that tend to favour HQLA assets. [1]

Solvency II regulation

Insurance companies have almost completely stopped investing in securitisations originated by banks to transfer their own risks, due to the Solvency II regulation. The French and German banking industry considers that a review of the calibration of the securitisation capital, and notably a more favourable regulatory treatment of investment grade mezzanine tranches of STS securitisations would encourage insurance companies to invest again in risk transfer securitisations originated by banks.

Currently, in Solvency II, a direct investment into a loan/a loan portfolio is even better treated than the investment into the best-rated senior tranches of an STS securitisation on the same underlying loan/portfolio. For instance, a residential mortgage loan has a more favourable regulatory treatment than a AAA rated 5yr STS Residential Mortgage Backed Security/Asset Backed Security, which explains insurance companies' preference for portfolios over such securitisation tranches. Please refer to Annex 3 for more detail.

As for investment grade mezzanine tranches, historically insurance companies were the natural investors in these tranches, due to their risk and maturity. A return to a more favourable capital charge, in line with the underlying risk, would increase the investor base on these tranches which is important to further develop the EU securitisation market. For example, in Solvency II, a mezzanine tranche of an Asset Backed Security with a 5 year maturity and an 'A' rating requires 23% capital (if STS) and 83% (if non-STS) versus 7% for a corporate bond with same rating and maturity.

Last, in Solvency II the investment in RMBS of guaranteed residential loans is penalised compared to RMBS of mortgage loans secured by residential property, which is problematic for the French market where guaranteed loans are predominant.

[1] The French banking industry therefore considers that STS securitisation senior tranches should be promoted to HQLA 1B (Residential and Auto loan securitisation, rated no less than AA-) and to HQLA 2A (same type of collateral as Level 1 and SME loans and other consumer loans, both rated no less than A-). In addition, Level 2B should be granted to STS senior tranches rated no less than BBB-, and to non STS tranches rated at least AA-.

Annex 1 – Issues relating to the Disclosure Requirements (Art. 7 of the "STS" Regulation 2017/2402)

- Transparency requirements are not useful in the case of private securitisations, as the information relevant to the investor is already requested by and delivered to investors on an individual basis. An additional standardized layer of information would be redundant and burdensome.
- In the case of an ABCP transaction, the ESMA report and the Commission Delegated Regulation on Transparency do not take into account *"whether it is fully supported by a sponsor"*, even though this proportionate approach is explicitly required in Article 7 (3) of Regulation 2017/2402. Indeed, in the case of a fully supported ABCP, the credit quality of the liquidity provider is more important than the characteristics of the securitised assets.
- Certain securitisation tranches can be purchased simultaneously by an ABCP conduit and a credit institution, or successively by one or the other. Such a securitisation would be simultaneously subject to both the ABCP and the non-ABCP templates, or have to switch from one to the other, which is hardly feasible operationally. Furthermore, certain asset classes that are securitised for the purpose of ABCP programmes, such as trade receivables, can only be reported on an aggregate basis, due to the potentially extremely high granularity and the very rapid turnover of the portfolios (hundreds of thousands of assets and average turnover of a few weeks or months). Hence, even if part of the securitisation is purchased by a credit institution, this institution should have the possibility to apply the ABCP aggregated template, and not be subject to the non-ABCP detailed reporting template.

Annex 2 – Risk weighted assets of securitisations (Capital Requirements Regulation)

The current capital treatment of securitisation is punitive and flawed, because instead of distributing the risk weighted assets across the tranches, commensurately with the distribution of risk, it considerably increases the capital charge after securitisation compared to the capital charge of the loan pool before securitisation. This non-neutrality of the capital regime, intentionally introduced primarily through the supervisory 'p' factor and the risk-weighting floor of senior tranches, is disproportionate and varies across asset classes under both internal models (SEC-IRBA) and standardized models (SEC-SA), depending on asset quality and granularity of the pool.

The capital charges should be recalibrated for STS and non-STS securitisations through the reduction of both:

- the p factor (differentiated target level depending on STS / non-STS);
- the risk-weight floor applying to senior tranches, with a target level of 7% for originating and sponsor banks, regardless of STS / non-STS qualification:
  - Originating banks deserve indeed a more favourable treatment notably as they fully know the underlying assets as they have originated them and often continue to service them.
  - Sponsor banks, similarly to originators, have first-hand knowledge of the credit risk of the pool of assets and constantly monitor the performance of the assets and transactions.
- Under the External Ratings Based Approach (ERBA) risk weights should be reduced.

Such recalibrations should apply to both cash and synthetic securitisations.

Annex 3 - Solvency II regulation

Under Solvency II the 'standardized regulatory capital charges' (i.e. the risk factor stresses) are set up by securitisation tranche's credit quality (rating), seniority, maturity (i.e. modified duration) and qualification as STS or non-STS. There are material differences between the capital charges for senior and mezzanine tranches of STS securitisations of about 3 times, e.g. AAA STS senior stress of 1% vs. AAA STS non-senior stress of 2.8%. The stress factor differential is even larger between STS and non- STS, for seniors the variation is between 7 and 15 times, e.g. AAA STS senior stress is 1.0% vs. 12.5%

for AAA non-STS senior. There is no differentiation in capital charges between senior and non-senior tranches of non-STS securitisations unlike for STS securitisations.

In many cases the risk factor stress for senior securitisation tranches exceeds that for the underlying exposures on a stand-alone basis: for example, the stress factor for a residential mortgage loan pool with 80% Loan To Value is 3%, compared with the senior AAA 5yr STS RMBS/ABS risk factor of 5% and similar senior AAA 5yr non-STS RMBS/ABS risk factor of 62.5%.

Besides, there is a big gap between capital charges under CRR and Solvency II for the same exposures.