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Joint Committee advice on the review of the securitisation prudential framework

Executive summary

1. The Joint Committee of the European Supervisory Authorities (hereafter the "JC") received a call for advice (CfA) from the European Commission (EC) in October 2021 to assess whether the current securitisation framework, including its prudential aspects, is functioning in an optimal manner and to single out potential areas for improvement. In particular, the CfA seeks the JC's assistance to assess the recent performance of the rules on capital requirements (for banks, insurance and reinsurance undertakings) and liquidity requirements (for banks) with respect to the framework's original objective of contributing to the sound revival of the EU securitisation framework.

2. The JC welcomes the opportunity to assess the capital and liquidity framework for securitisation and have thoroughly reviewed the aspects on which the EC has requested feedback. This advice includes targeted recommendations to support the securitisation market in a prudent manner and to promote the issuance of resilient securitisations qualifying for a more beneficial capital treatment, without jeopardizing investor protection and financial stability.

3. Securitisation has played a limited role in Europe since the aftermath of the 2008 crisis. The introduction of a comprehensive set of requirements in the EU[1], the Simple, transparent and Standardised (STS) securitisation framework through Regulation 2402/2017 (the Securitisation Regulation or SECR) and the associated beneficial capital treatment included in Regulation 2401/2017 which amended the Capital Requirements Regulation (CRR) for banks was an important step forward. Its introduction allowed for a consolidation on sound and resilient basis of the European securitisation around the STS label, accounting for 21% and 45% of new issuance in 2021 for traditional and synthetic respectively[2].

4. Overall, the current market is smaller, but of a higher quality and more prudently regulated, and the pre-crisis levels have been unhealthy and unsustainable and do not serve as a benchmark to be targeted. However, the JC considers that the introduction of the SECR and the amendments to Chapter 5 of the CRR in 2019 has not yet produced all the expected results as development

[1] This includes in particular the introduction of the detailed transparency and due diligence requirements (Articles 7 and 5 of SECR), the ban on resecuritisations (Article 8 SECR), originate-to-distribute securitisations (Article 9 SECR), securitisations without risk retention (Article 6 SECR), investments without proper due diligence (Article 5 SECR), selling of securitisations to retail investors (Article 2 of SECR) and the introduction of geographical requirements for SSPEs (Article 4 SECR).

[2] As of 21/10/2022, **588** (547 present in ESMA STS Register and 41 synthetic deals) deals are labelled as STS in the EU.

of the market has been limited against the original objectives to generate between EUR 100-150bn in additional funding for the economy.

5. The state of the securitisation market in the EU seems to come from the combination of low supply and low demand, due to a lack of interest from investors and originators. This lack of interest is closely linked: on one hand investors perceive securitisations as a complex product with extensive due diligence requirements; on the other hand, originators had access to cheaper alternative sources of funding and a limited investor base. Focusing only on the prudential framework or the assumptions of barriers to entry for both issuers and investors or the distort incentives across capital market instruments and players does not allow to take account the interlinked and complex nature of the factors in play including the role of the due diligence and transparency requirements.

6. The ESAs consider that the current review of the European securitisation framework offers an opportunity to improve its efficiency and risk sensitiveness. In particular, solutions are proposed in relation to the capital framework for banks. Some of them could be implemented over the short term while others request further considerations and possible discussion at the Basel Committee level.

7. This advice consists of two parts – the review of the securitisation prudential framework for banks and the review of the securitisation framework in Solvency II applicable to (re)insurers.

Banking regulatory framework

8. At this stage, the JC considers that re-calibrating the securitisation capital framework for banks would not be a solution that would ensure the revival of the securitisation market.

9. In this context, the ESAs wish to highlight that any changes to the capital framework may have a limited impact because investor demand may remain subdued in the foreseeable future.

10. The significant risk transfer (SRT) market – and in particular synthetic securitisations which are eligible to the STS label since April 2021 – seems to be an exception, where the capital framework may have a more important role while investor demand seems less of a constraint. The SRT market is different and much better regulated than the one before the Great Financial Crisis (GFC). Recently, the SRT market has showed positive trends reflecting trust by market participants, at least as consequence to recent regulatory actions. Acknowledging this, the proposal contained in the EBA advice has been calibrated to target this market.

11. The ESAs consider that amendments to improve the risk sensitiveness of the prudential framework for securitisation should be introduced only if based on targeted measures with appropriate safeguards. Such measures improving the risk sensitiveness in the prudential framework is likely to further stimulate the origination of securitisation by credit institutions on a sound basis

12. As detailed in the advice on banking, the JC makes the following recommendations with respect to the prudential framework for banks:

- **Technical fixes to the prudential framework** aiming at improving its consistency and clarity in the framework [see section 3.2 of the advice on banking].

- **A more substantial, but still targeted, recommendation aimed at improving the risk sensitiveness of the framework** by recognising the reduced model and agency risk associated to originators [Section 3.3.1. of the advice on banking]. The JC advice elaborates on why a reduction of the risk weight floor for senior tranches retained by originators may support further growth in the SRT market in a prudent manner, if accompanied by a set of appropriate safeguards. This would in particular promote the issuance of resilient securitisations, which can qualify for a more beneficial capital treatment, without jeopardising financial stability.

- **General issues on the securitisation risk weight formulas** that underpin the framework [section 3.3.2 of advice on banking]. These however require further work which should be potentially brought for discussion to the Basel Committee on Banking Supervision (BCBS).

13. As regards the liquidity framework, in particular on whether securitisations should be categorised as a highly liquid asset in the Liquidity Coverage Ratio (LCR) framework, the JC considers that the current framework should be kept [see Section 4 of the advice on banking].

14. As detailed in the advice, the share of securitisations, including STS securitisations, in the LCR stress buffers has been negligible since the inception of the LCR which, coupled with LCR levels well above the minimum regulatory requirements, indicates that credit institutions do not rely on securitisations to face liquidity stress periods. Moreover, there is no new evidence on performance under a LCR stressed scenario, including the period covering the COVID-19 pandemic, to justify any prudent recalibration of the LCR.

<u>(Re)insurance regulatory framework</u>

15. The CfA also seeks the JC's assistance to assess the recent performance of the rules on the capital requirements of Solvency II with respect to the framework's original objective of contributing to the sound revival of the EU securitisation market. In particular, the CfA requests the JC to look into the issue of low investment levels by analysing various elements such as: the impact of Solvency II as a driver to securitisation investments; the assessment of the current calibration under Solvency II and the extent that the current framework is risk sensitive. In addition, the CfA also requests to identify possible improvements which can be made to the existing framework as well as ways that Solvency II could be elaborated further in a manner more consistent with the Capital Requirements (CRR) securitisation framework.

16. Overall, the JC supports the objective of reviving the EU securitisation markets on a prudent basis with regards to the insurance sector. However, despite the introduction of the STS regime in 2019, insurance and reinsurance undertakings' participation in the EU securitisation market remains low. Nevertheless, based on the input received and the analysis performed, the JC does

not advise changes to the current framework of Solvency II with regards to the prudential treatment of securitisation.

17. The 2019 Solvency II amendments sought to introduce the treatment for the new STS securitisations which increased the number of the categories treated within the framework of Solvency II for this asset class. The aim of this revision was to boost investments in securitisation by insurers in a prudent manner. Therefore, stress factors were adjusted by replacing the previous categorisation according to type 1, type 2 and re-securitisations with a new classification of senior STS, non-senior STS, Non-STS and re-securitisations. only three years ago. Exposures to STS securitisations receive a more favourable capital treatment under certain conditions are met (STS eligibility criteria).

18. Three years after the new delegated regulation came into effect, the advice on (re)insurance finds that the introduction of the STS framework had no major impact of their investment decisions. A small increase of 2.5 percentage points in the number of undertakings who invest in securitisation can be observed since the introduction of Solvency II. Within the STS segment a small increase in volumes is also observed within the senior STS category. However, most of European insurers have not been investing in securitisations since the introduction of Solvency II. Of those who invest, the vast majority do so for an amount of less than 5% of their total investment assets. Only a small number of insurers seem to be active players in the securitisation market as investors.

19. The Solvency II framework does not seem to be a significant driver for (re)insurance activity in EU securitisation. Overall, only a few insurers mentioned that the capital charges are one of the reasons that is holding them back from investing in this asset class. Other reasons for the lack of interest from (re)insurers for securitisation exposures include : the fact that each undertaking has a different liability structure and adjusts its investments accordingly ; if an undertaking's solvency position is very robust, the significant driver for investment activity is primarily risk and expected return rather than capital requirements ; other asset classes show better risk-return profiles ; portfolio consists of "hold-to-maturity" bonds for which securitisation investments do not fit ; given the profile and nature of the liabilities, insurers tend to invest in longer duration fixed rate investments.

20. On the impact of the introduction of Senior STS, non-Senior STS and Non-STS provisions on the investment behaviour of (re)insurers, the analysis shows that since the introduction of Solvency II, the majority of the (re)insurance undertakings that apply the standard formula to calculate their capital requirements have not been key investors in the securitisation market. Overall, 12% of the European standard formula (re)insurers have investments in securitisation. Slightly over one-third (37%) of the respondents of the survey mentioned their intention to increase their investments in securitisation in the next 3 years (while 63% foresee no change) [3].

[3] The questionnaire was completed by 98 standard formula solo (re)insurers (both qualitative and quantitative)

21. On the assessment of the current capital requirements for spread risk on securitisation positions in Solvency II for senior STS, non-senior STS and non-STS the analysis shows that there is no sufficient evidence to conclude that the current framework is not fit for purpose. More specifically:

- At this stage, the evidence is not sufficient to justify a change in the calibration for securitisations which meet the STS criteria.

- On the Non-STS segment of the market, it was also found that change in the calibration is not warranted. This is based on the analysis performed by EIOPA on historical spread volatility.

22. On the improvement of the risk sensitivity of the capital calibration as in (i) mezzanine and junior tranches of STS securitisations, and (ii) senior and non-senior tranches of non-STS securitisations as well as to whether the existing calibration method of Solvency II could be elaborated in a manner coherent with the overall Solvency II framework providing with more consistency with the CRR's securitisation framework, EIOPA's analysis concluded that, although some changes could be feasible, their potential effectiveness to the revival of the securitisation market remains, at this stage, uncertain. Therefore, the advice is to propose no changes to the existing framework.

23. Main reasoning behind this recommendation include:

- No need to increase complexity of an already complex framework which was updated only three years ago.

- The uncertainty of effectiveness of measures; the potential cost of changing the existing framework is high given the low investment volumes and the very low participation of the insurance industry as investors in the EU securitisation market.

Concluding remarks

24. Finally, the JC wishes to stress that the impact that may come from the targeted relaxation of the bank capital requirements is however likely to be relatively small when looking at the securitisation market as a whole. The current state of the securitisation market is the result of a combination of factors, some of which are not addressed in this advice. As discussed earlier, investor demand is likely to remain subdued in the foreseeable future, and, hence further analytical work should be conducted to gain a better understanding of the relevant factors, some of which may lie outside the scope of the prudential framework.

25. To that end, an analysis of the following aspects, which are out of the scope of this advice, should at a minimum be considered:

- The impact of the monetary policy on the use of securitisation by banks as source of funding and on its attractiveness as an investment product for all investors, including insurance companies.

- The ability of non-financial corporates to generate future growth for the securitisation market as originators and investors.

- Investigate whether the existing provisions placed to protect investors are well-balanced and proportionate ensuring sufficient market transparency. In particular, to what extent these provisions may prevent the build-up of risks to financial stability while, at the same time ensure not to render securitisation a costly investment ("assessment premium") which may be preventing the growth of the securitisation market. ESMA has initiated the revision process of the disclosure rules for securitisation exposures to better account for the usefulness of the information for investors and regulators.

- To what extent there is a prevailing "stigma", not explained by regulatory or market reasons, attached to securitisation origination or investment that may be affecting the development of the market and what are the causes thereof.

26. In relation to the above, changing economic, market and regulatory conditions are likely to have a significant impact on securitisation in the coming years. For instance, the tightening of monetary policy and the increase of interest rates could make securitisation a much more attractive source of funding for banks and other financial firms than recently.

27. Against this background, it is recommended that the ESAs and the EC pay due attention to all the above-mentioned factors and conduct further monitoring work on additional data as it becomes available. The part of that work that concerns the treatment of securitisation under the banking prudential framework should be brought to the attention of the Basel Committee on Banking Supervision for discussion as appropriate.