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European Financial Services Round Table

EFR PAPER ON SECURITISATION

Introduction

European policymakers need to address two seemingly incompatible challenges in delivering the sustainable finance, digital and energy transitions:

1. There are vast financing needs, which the Governments will not be able to fund alone.
2. Without proper securitisation, which is an important step towards a Capital Markets Union, it will be difficult to meet the financing requirements.

Consequently, if the policymakers wish to deliver on their promises that they have made towards the European population, they must endeavour to address the important topic of securitisation.

European Financing needs and Funding

Current estimates are that between €600 billion[1] and €1 trillion in additional annual financing would be needed in the EU to meet the carbon neutrality objectives by 2050. These estimates significantly exceed the amounts foreseen under the "Investment Plan for a Sustainable Europe" presented by the European Commission in January 2020 (€100 billion per year for 10 years from five different sources of funding[2]).

In comparison, the average annual funding flows (credit loans, debt and equities) to residents of the eurozone amounted to €460 billion[3] between 2015-2019. Covering the needs related to the energy transition would therefore imply between a doubling and a tripling of the annual flows of European funding.

European financing needs should be covered by both market and credit financing. Nevertheless, we are still a long way off target. As an example, in December 2021, outstanding green bonds reached more than €500 billion in the EU compared to around €150 billion in 2018 (+266%). ESG funds outstanding amounted to €1.4 trillion versus around €600 billion in 2018 (+133%). Despite their sustained growth, green bond issues still make up only a small proportion of all bond issues (around 4% of all corporate bond issues in 2020 in the EU).

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1 In a survey ("State of the Union: Questions & Answers on the 2030 Climate Target Plan", 17 September 2020) the Commission estimated that the 55% reduction of GES by 2030 would require financing of around €350 billion per year in energy systems. Moreover, the deficit in financing needs and sustainable investment is estimated at between €100 and 150 billion per year and financing needs in "social investment" (to support the transition) at €142 billion

2 The five sources of funding for the "Green Deal" are, over a period of 10 years:
- the reallocation of existing funds from the EU budget to 'green' projects amounting to 500 billion,
- 114 billion in co-financing by the Member States,
- 279 billion in public and private funding mobilised under the InvestEU programme set up by the previous Commission led by Jean-Claude Junker,
- €25 billion in carbon market revenue (from the Modernization Fund financed by a fraction of the revenue from the European carbon market - emissions trading - separate from the EU budget),
- Just Transition Fund: €7.5 billion allocated by the EU with the aim of raising public and private funding of at least €143 billion over 10 years

3 Average annual net funding flows mobilised by euro area resident agents between 2015 and 2019 (source: ECB; calculation: BNP PARIBAS): Net issuances of debt market (commercial paper, bonds) = €230 billion; Change in outstanding bank loans to euro area residents = €178 billion; Annual net flows of listed share issues = €47 billion.

Securitisation

The envisaged European Capital Markets Union (CMU), whose aim is to diversify the financing sources and uses and create a truly Single Market for capital, has not yet been established. As Europe's financing needs cannot wait, we should now focus on solutions that we know can work quickly towards a CMU - such as facilitating securitisation.

Securitisation is an indispensable tool to develop capital markets as well as to finance the energy transition. Securitisation was identified by the European Commission in 2020 as one of the key actions to complete the CMU.

Compared to the USA, the European market for securitisation is very small: securitised assets represent only 8% of the eurozone GDP, compared with 47% in the U.S. Even by excluding the U.S. agency securitisation market, which represents 70% of the total U.S. market, the U.S. private market is still twice that of the EU.

The persistently lower level of issuance volumes in Europe, following the Global Financial Crisis (GFC), reflects a loss of confidence in securitised products, despite their very resilient credit performance in Europe through the severe economic downturn triggered by both the GFC and the subsequent Eurozone crisis, with considerably fewer defaults than expected and an improvement in overall credit quality: the share of securitisations with an investment grade rating had risen to 96% by Q2 2021, compared to 93% in 2014.

We can no longer afford to neglect funding sources with such potential, because there is an irrational stigma attached to it. In this context, it is important to note that:

- European securitisations have proven to be far safer than American ones (with default rates immensely lower) before 2008.
- Since 2010, CRD3 prevents "exotic securitisations" which had led to the 2008 crisis.

Another key reason for the low securitisation volumes is the lack of risk sensitivity in the EU regulatory treatment of securitisations, for both banks and investors such as insurers. Conversely, the U.S. did not implement the revisions to the securitisation framework issued by the Basel Committee in July 2016.

The Final Basel III standard, currently being implemented via amendments to the EU prudential framework (CRR III), will significantly increase the amount of capital banks need to hold. At the same time, the Output Floor and its use of the Standardised Approach for banks' Risk Weighted Assets (RWA) calculations will make securitisation even less attractive.

In that context, a financial tool such as securitisation which allows banks to free up their balance sheets to provide more credit to their clients, is indispensable. Targeted changes – as detailed in the Annex - are needed to ensure EU securitisation does not become even less attractive after the Final Basel III implementation. These changes are possible already through the ongoing CRR III process.

During the low-interest rate period large institutional investors were less interested in buying securitised products because the yields were too low. With rising interest rates and higher yields, these products are likely to become attractive to institutional investors (pension funds, insurance companies, asset managers). Assurance on those products is also provided through the retention rate that is laid down in the EU securitisation framework.

For smaller and mid-sized European insurance companies which need a minimum amount of diversification of their portfolios, the possibility of buying securitised products might also offer a welcome opportunity for investment. Further, the LCR treatment of securitisations should be enhanced and aligned with that of covered bonds, enabling greater participation by banks as senior investors.

Nevertheless, to enable investors to buy securitised products, banks should be accommodated in order to sell them.

To unlock the potential of the European securitisation market, the EU framework needs to be revised to make securitised assets more attractive to issuers (banks) and investors, in particular by recalibrating the prudential treatment of European securitisation exposures to better reflect their high quality.

Conclusion

While often in international meetings - as well as in bilateral meetings - policymakers and politicians agree that securitisation could play an important role, no significant action has been undertaken mainly due to the stigma that is attached to it.

Therefore, the EFR calls for that action in order to make securitisation an effective instrument for the European financial sector so that savings and assets under management of institutional investors (pension funds, insurance companies, asset managers, etc) can be mobilised and used to invest in Europe instead of other jurisdictions such as the USA.

The European Financial Services Round Table (EFR) was formed in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with head-quarters in Europe. EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

ANNEX

Targeted changes to ensure EU securitisation does not become even less attractive after the Final Basel III implementation.

A good start would be to reduce the negative impact of the introduction of the output floor on the economic viability of securitization in CRR3. This could be achieved by a recalibrating the Standardised Approach (SEC-SA) through the reduction of the "p factor" in CRR Art. 261-262 by half.

That is needed, because with the CRR III Output Floor, both the reference securitised pool RWA and tranche level RWA will increase, through the use of the Standardised Approaches. An uneconomically high increase of the SEC-SA will reduce banks' ability to manage credit risk through securitisations. Conversely, the U.S. Simplified Supervisory Formula Approach (SSFA) applies a p factor of 0.5.

Another change is needed in the Internal Ratings Based Approach (IRBA). Currently the framework applies a risk weight (RW) floor of 10% for Simplified, Transparent and Standardised (STS) securitisations, and 15% for non-STS (CRR Arts.259-260). After the GFC, regulatory reforms have reduced securitisation risks, for instance through risk retention requirements for originators, enhanced credit underwriting standards (Mortgage Directive), ongoing monitoring of securitisations by supervisory authorities, investor due diligence requirements and performance reporting. These changes justify lowering the RW floors.

A proposal would be to reduce also for Sec-IRBA the level of calibration of the so called "p" factor (representing the relative capital surcharge for the securitisation exposures compared to the capital requirement for the underlying pool) and the RW floors by 1/3 for STS and non-STS. For STS, the adjustment would allow the floor to be set at around the previous floor under the Supervisory Formula Approach (SFA). But in the EU non- STS transactions are twice as many as STS ones, so the equivalent change would need to apply also to non-STS and for all bank roles, i.e., originator, investor and sponsor, to ensure consistency in the risk sensitivity.

EFR – European Financial Services Round Table (asbl)
Rond Point Schuman 11 | B-1040 Brussels | Belgium | Tel: +32 2 256 75 23 | Fax: +32 2 256 75 70 | www.efr.be
Siège social: Avenue Marnix 23 | B-1000 Bruxelles | Belgium | RPM BXL 0861.973.276