Finance Watch

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Introduction to Securitisation

Structures, regulation and market for asset-backed securities in the EU

A Finance Watch Position Paper

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Introduction

This position paper gives a brief overview of the mechanics of securitisation and the market for securitisations in the EU. It should provide a factual basis for evaluating recent proposals by EU policymakers to 'revive' securitisation as a way for the EU to meet the twin challenges of funding the green and digital transitions, and improving the competitiveness of its economy at a time of heightened geopolitical tensions and fraying international cooperation.

Key Takeaways

1. Securitisation is not a funding instrument for the real economy, but a mechanism for banks to (i) refinance loans they already carry on their balance sheets, (ii) reduce regulatory capital requirements, (iii) transfer credit risk to non-bank entities; and/or (iv) generate collateral to obtain liquidity from the central bank. It does not reduce the dependency of the EU economy on bank financing but only deepens it further.
2. By design, securitisation is comparatively expensive, limiting its practicality. It requires large pools of similar assets and large issue volumes, which favour large banks.
3. Securitisation increases leverage throughout the financial system by encouraging higher leverage of collateral, and shifting credit exposures to the non-banking sector, which is less tightly regulated and prone to accumulating systemic risk.
4. By transferring loans from the bank to a separate corporate vehicle, securitisation severs the relationship between lenders and borrowers. Features of the European 'relationship banking' model, such as forbearance and loan restructuring, become more difficult to apply and the enforcement of collateral more likely.
5. Securitisation competes with proven, high-quality European capital instruments, such as covered bonds, especially in mortgage financing. Large, liquid markets (e.g. German Pfandbriefe) are likely to lose depth and liquidity if securitisation is promoted, effectively at their expense.

I. Background

A. What is securitisation?

1. General concept

Securitisation is the practice of pooling and repackaging illiquid assets (loans) and issuing debt securities (asset-backed securities, ABS). Interest payments and the repayment of the principal amount of these debt securities at maturity are made from the payments received from the original borrowers under the terms of the underlying loans. Banks use securitisation to (i) refinance these loans, partially or in full, with external funds from

capital markets investors; (ii) transfer credit risk to external investors and free up regulatory capital for new loans and/or distributions to their own investors; and/or (iii) transform illiquid loans into (more) liquid tradeable securities that can be sold to investors and/or used as collateral to obtain liquidity from the central bank through security financing transactions (SFT or 'repo').

2. Traditional (also 'true sale' or 'cash') securitisation[1]

Traditional securitisation is when a bank selects and pools a number of loans with similar characteristics, which it originated and carries on its balance sheet. These loans are then sold to a special purpose vehicle (SPV), a separate legal entity specially created for this transaction and managed by an external party (see Appendix Chart 1). The originating bank provides comprehensive information and disclosures about the quality of these loans, determining the purchase price of the portfolio. The SPV will then issue asset-backed securities, which are either placed with investors or retained by the originating bank.

The money raised through this issuance is paid by the SPV to the bank for the purchase of the loans. In practice, the bank will issue against the pool of loans several types of securities with different seniorities, including equity ('first loss'), mezzanine, and senior debt ('tranching') (see Appendix Chart 2). Tranching enables the issuer to obtain a higher credit rating for the senior notes, which have a preferential claim on cash flows from the underlying asset pool. Because the SPV is now the legal owner, often without any staff of its own, its responsibilities are contracted out, either back to the originating bank (e.g. loan servicing) or to third-party service providers (e.g. trustees, auditors). The latter, and the cost of establishing the SPV, creates a significant layer of additional expenditure, which is passed on to investors.

The ultimate debtors (i.e. borrowers who took out the underlying loans) need not be aware of the sale. They continue making payments on their loans, but these payments now flow to the new investors. The notes are often rated by credit rating agencies and are either retained by the originating bank as collateral, e.g. for repo transactions with the central bank, or sold to investors. As the loans have been sold, the credit risk has been transferred to investors who bear the risk of loans not being repaid. Traditional securitisation thus provides the issuing bank with additional funding and releases regulatory capital, enabling it to either issue more new loans or make distributions to its investors. There are no legal restrictions on the use of this capital.

3. Synthetic securitisation

In a synthetic securitisation, the originating bank identifies a portfolio of loans on its balance sheet and transfers some or all of the credit risk associated with these loans to a counterparty, usually a hedge fund, pension fund, asset manager, insurance company or another credit institution. This is done by way of a contractual agreement, such as a

[1] Finance Watch, A Missed Opportunity to Revive 'Boring' Finance? A Position Paper on the Long Term Financing Initiative, Good Securitisation and Securities Financing, December 2014.

financial guarantee or a bespoke ('over the counter', OTC) credit derivative contract. The loans remain on the balance sheet of the bank.

As with traditional securitisation, the expected cash flows from the designated portfolio are subdivided into tranches of different seniority. Usually, the contract will cover only the riskier tranches, especially the mezzanine tranche, which account for most of the regulatory capital requirement. This structure does not necessarily involve transferring the loans to an SPV and is therefore less expensive to implement. Nonetheless, the originating bank may remove the assets from its balance sheet, and reduce its regulatory capital requirement, if it can demonstrate to the supervisory authority that it has achieved a 'significant risk transfer' (SRT)[2] by effectively transferring all of the credit risk attached to the designated portfolio to a third party.

Synthetic securitisation is a risk management tool that helps to reduce capital requirements for the originating bank in exchange for a transfer of risk to other banks or institutional investors. By itself, synthetic securitisation does not mobilise additional funding. It merely reduces capital requirements, leaving the originating bank free to decide how they intend to redeploy this freed-up capital, e.g. for granting new loans or to fund distributions (dividends, buy-backs) to investors. Whether synthetic securitisation should be considered as a subset of securitisation at all is open to debate. It lacks the defining characteristic of securitisation in that it does not actually generate 'securities'.[3]

B. What are its practical applications?

1. Categories of assets (loans)

In order to qualify for securitisation, a portfolio of loans should be homogeneous, i.e. the loans should have similar characteristics. especially regarding the type of underlying collateral, their term to maturity, and key contractual terms and conditions, e.g. on early repayment and default.[4] For traditional securitisation, in particular, the portfolio has to be large enough so that the considerable cost of the structure can be amortised over a sufficiently large issue volume in order to make it economically viable and attractive for investors. This implies that only a few categories of loans are suitable for securitisation.

By far the largest category within the securitisation market are mortgage-backed securities (MBS), which are used to refinance either residential (RMBS) or commercial (CMBS) mortgages (see Appendix Chart 3). In the EU, MBS accounted for ca. 60% of the total volume of securitisations, (excluding Collateralised Loan Obligations, CLOs; see below)

[2] European Banking Authority (EBA), "Discussion Paper on the Significant Risk Transfer in Securitisation", EBA/DP/2017/03, 19 September 2017; and EBA, Report on Significant Risk Transfer in Securitisation under Articles 244(6) and 245(6) of the Capital Requirements Regulation, EBA/Rep/2020/32, 23 November 2020.
[3] The Cambridge Dictionary defines a 'security' as an 'investment in a company or in government debt that can be traded on the financial markets and produces an income for the investor.' Financial guarantees and OTC derivatives are usually bilateral contracts and rarely, if ever, traded.
[4] Commission Delegated Regulation (EU) 2019/1851 of 28 May 2019 supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council with regard to regulatory technical standards on the homogeneity of the underlying exposures in securitisation, C/2019/3785, OJ L 285, 06 November 2019, pgs. 1–5.

outstanding at the end of 2023.[5] Other categories of loans that fulfil the requirements for securitisation are leasing contracts (e.g. for vehicles and industrial equipment), consumer loans (e.g. for durable consumer goods), and some corporate loans.

Securitisations based on corporate loans with lower credit ratings, especially leveraged acquisition loans linked to leveraged buy-out transactions (LBOs) are known as Collateralised Loan Obligations (CLOs). Some categories of short-term credit, such as trade receivables and credit card receivables, are also securitised, usually by the issuance of short-dated Asset-Backed Commercial Paper (ABCP).

2. Securitisation in the EU

In 2023, total new issuance of securitisations in Europe was ca. EUR 200 bn, while the total nominal value of outstanding traditional securitisations (including CLOs) was estimated at ca. EUR 1.2 tn.[6] On both metrics the market remains significantly below its peak in 2008. In this context, the Joint Committee of the European Supervisory Authorities (JC) observed that the introduction of the Securitisation Regulation and the prudential framework in 2019 had *"resulted in a market that was smaller but of a higher quality"*. The JC also noted that the pre-crisis level had been *"unhealthy and unsustainable and does not serve as a suitable benchmark to be targeted"*.[7] This finding should be borne in mind when considering calls to 'revive the securitisation market in Europe' with a view to restoring it to pre-crisis levels.

The market for traditional securitisation, in particular, has seen only moderate growth since the downturn. The market for synthetic securitisation, by contrast, has been more dynamic, especially since 2021, when synthetic securitisations in the EU became eligible for inclusion into the simple, transparent and standardised (STS) framework. Securitisations which meet the STS criteria[8] qualify for a more favourable prudential treatment. New synthetic securitisations in the Euro area were ca. EUR 140 bn in 2023,[9] nearly twice the volume of 2021.

Available data from ESMA[10] and the Association for Financial Markets in Europe (AFME)[11] indicate that securitisation markets in the EU are heterogeneous and fragmented along national lines, with 80% of securitisation issuances concentrated in four Member States. For traditional securitisation, asset pools tend to be concentrated in one single country, and the asset classes securitised differ between countries. These differences are

[5] Association for Financial Markets in Europe (AFME), Securitisation Report: Q4 2023 and 2023 FY, 28 March 2024.
[6] AFME, Securitisation Report: Q4 2023 and 2023 FY, 28 March 2024; Financial Stability Board, , Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation. Consultation Report, 02 July 2024. Estimates include the UK.
[7] Joint Committee of European Supervisory Authorities, Joint Advice on the Review of the Securitisation Prudential Framework (Banking). Response to the Commission's October 2021 Call for Advice to the JCs of the ESAs, JC/2022/66, 12 December 2022, pg. 7.
[8] EBA, Guidelines on the STS Criteria for On-Balance-Sheet Securitisation. Final Report, EBA/GL/2024/05, 24 May 2024.
[9] ECB, EU Securitisations: 2023 in Figures, 15 May 2024.
[10] ESMA, The EU Securitisation Market – An Overview, 21 September 2023, pgs. 9-12.
[11] AFME, Securitisation Report: Q4 2023 and 2023 FY, 28 March 2024.

attributable to a variety of factors, including the specificities of national economies and capital markets, different taxation, corporate law and insolvency regimes.

To date, the contribution of securitisation to mobilising additional pools of capital for the real economy in the EU has been modest. Unlike in other markets, EU banks themselves continue to be the largest holders of securitisations by a large margin (more than 80% of total issuance). Most of the volume issued in 2023 was retained by the issuers, mainly for use as collateral in central bank operations.[12] The market is also highly concentrated. According to a 2022 report by the European Systemic Risk Board (ESRB): in the largest segment of the EU market, RMBS, ten banks accounted for two-thirds of the total issuance, while the ten largest holders of RMBS, again banks, accounted for 84% of total holdings,

3. Geographical comparison

With a total volume of ca. USD 13 tn, the US market for securitisation is substantially larger than that in the EU. This difference is attributable primarily to structural specificities, e.g. the availability of alternative funding instruments, such as covered bonds in Europe, and the presence of government-sponsored mortgage financing entities (GSEs) in the US, which stand behind the vast majority (80%) of all MBS issued there. These GSEs buy standardised mortgage loans from commercial banks and issue 'agency-backed' MBS, which enjoy a 'de facto' federal guarantee and therefore a high credit rating.

Excluding agency-backed MBS issuance, the total amount of securitisation outstanding in the US amounts to ca. 8% of all private-sector credit, compared to ca. 4% in the EU.[13] In other words, once the role of GSEs in the US is accounted for, the difference becomes less significant. It is the profound differences in the institutional makeup of both jurisdictions, and especially the role of public agencies, which render any direct comparisons difficult.[14] Property and housing markets in the EU are very different, and so are the ways they are funded. Covered bonds play a key role in funding mortgages in many EU countries.

C. Regulation

The structuring and issuance of securitisations, as well as the prudential treatment of securitisation exposures by banks and insurance companies, is governed largely by international standards. As a member of the Basel Committee on Banking Supervision (BSCS), the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions (IOSCO) the EU has participated in the development and adoption of the post-crisis regulatory framework for securitisation. Drawing on lessons from the role of securitisation in the financial crisis of 2008/09, the framework comprises several safeguards:

[12] ESMA, ibid., pg. 4; ESRB, Monitoring Systemic Risks in the EU Securitisation Market, July 2022, pg. 3.
[13] FSB, Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation. Consultation Report, 02 July 2024, pgs. 15-16.
[14] Levitin, A. J., Report on the Institutional and Regulatory Differences between the American and European Securitization Markets, German Council of Economic Experts Working Paper 3/2023, November 2023.

- Reduced reliance on credit rating agencies (CRAs) and new CRA Code of Conduct
- Granular (loan-level, 'waterfall') disclosures and continuous reporting requirements
- Due diligence requirements for investors
- Risk retention requirements for originators ('skin in the game')
- Regulatory capital requirements for banks and insurers
- Restrictions on re-securitisation

The global framework also contains criteria for the identification of Simple, Transparent and Comparable' (STC) securitisation transactions, which qualify for more favourable prudential treatment, notably lower capital requirements. Moreover, it sets out conditions for SRT, which determine whether a bank has transferred the credit risk related to a particular portfolio sufficiently to claim regulatory capital relief.

Capital requirements for banks are determined on the basis of risk-weights, which are calculated separately for each tranche under the applicable framework (SEC-IRBA for banks authorised to apply internal credit risk modelling, or SA-CA for banks using the Standardised Approach, SA-CR). A risk weight floor of 15% (STS: 10%) applies for the senior tranche. The risk weight for equity ('first loss') and junior tranches is calculated degressively, from 100% to the floor, using a multiplier ('p-factor') which determines the slope of the risk weight curve towards the 'attachment point' where the senior tranche begins to absorb losses (see Appendix Chart 4). The 'p-factor' reflects a capital surcharge which covers specific risks related to securitisation (moral hazard, model risk) that could affect the junior tranches.

The reforms were implemented in the EU with the adoption of the Securitisation Regulation (SECR)[15] in 2017 and several iterations of the Capital Requirements Regulation (CRR),[16] most recently in June 2024. Implementation in the EU broadly follows the international standards but deviates in a number of important aspects:

- 'P-factor' in the capital charge calculation under SA-CR for the purposes of calculating the 'output floor' is 0.5 (STS: 0.25) instead of 1.0 (STC: 05) (transitional, until 2032).[17]
- Synthetic securitisations are eligible for the STS label ('Simple, Transparent and Standardised'), the EU equivalent of STC.
- STS securitisations are eligible as high-quality liquid securities (HQLA) for the purposes of calculating a bank's liquidity coverage ratio (LCR).

Further recommendations for changes to the global regulatory framework on securitisations are expected from the FSB in 2025 following the July 2024 consultation.[18]

[15] Regulation (EU) 2017/2402, OJ L 347, 28 December 2017, pgs. 35–80.
[16] Regulation (EU) 575/2013, OJ L 176, 27 June 2013; amended most recently by Regulation (EU) 2024/1623, OJ L, 2024/1623, 19 June 2024 (CRR III).
[17] The current US framework (SSFA) also uses a 'p-factor' of 0.5 but applies a higher risk-weight floor of 20%.
[18] FSB, Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation. Consultation Report, 2 July 2024.

In the context of the EU political priorities for the legislative mandate 2024-2029, the EU will undertake its own review of securitisation rules, which could lead to further deviations from the global standards. Finance Watch believes that EU policymakers should engage constructively in this process and cooperate with their international partners to maintain regulatory consistency and convergence.

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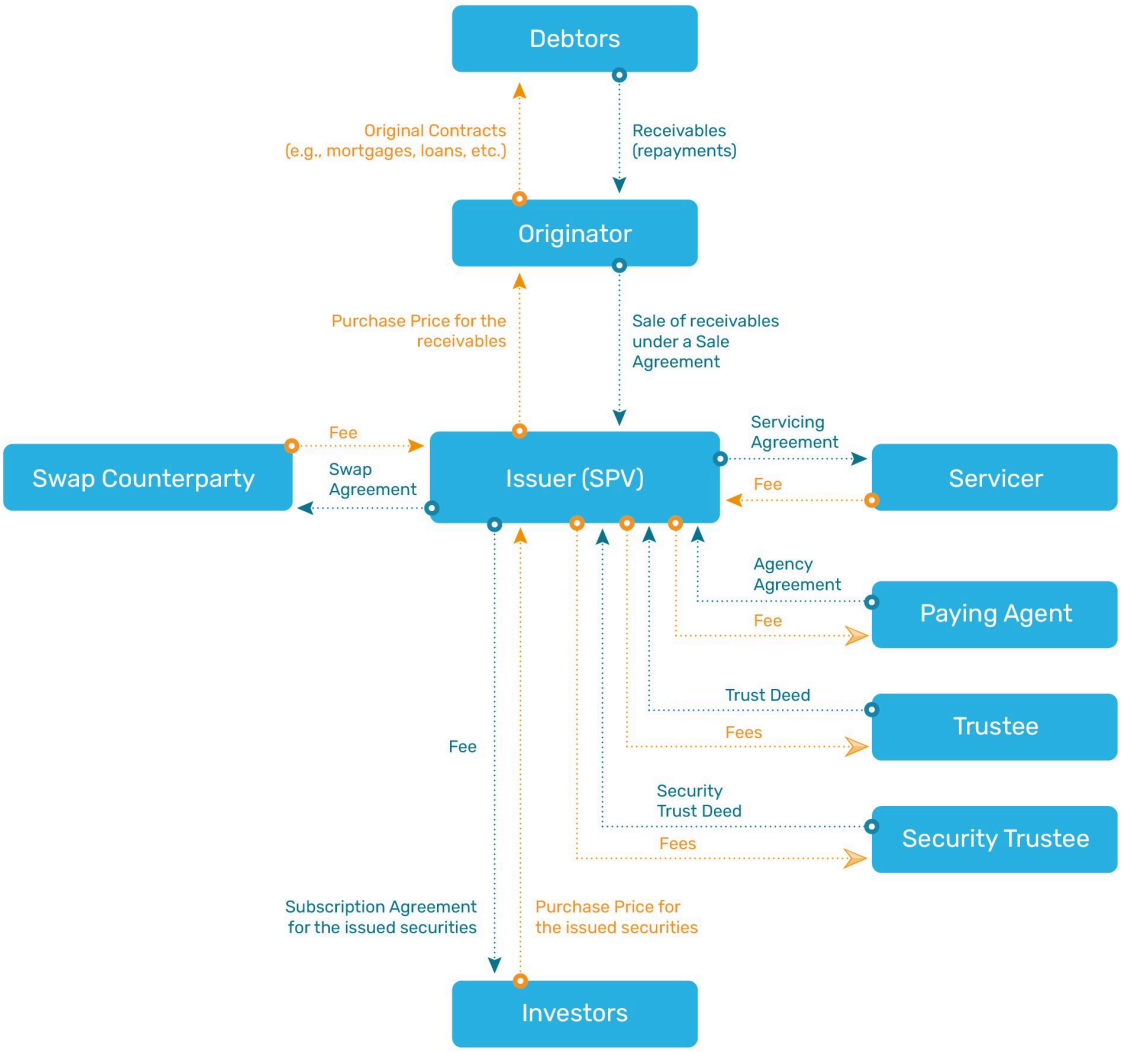
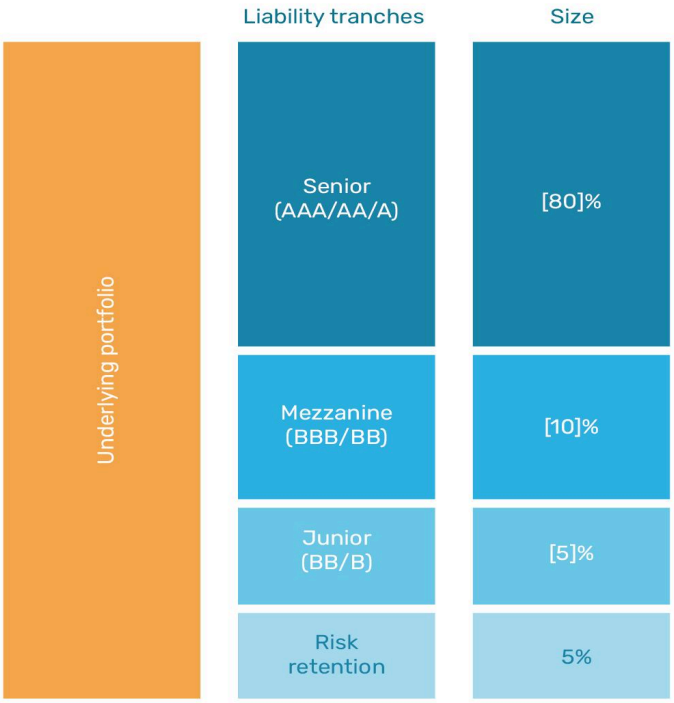
Appendix

Chart 1: Structure of a traditional ('true sale') securitisation



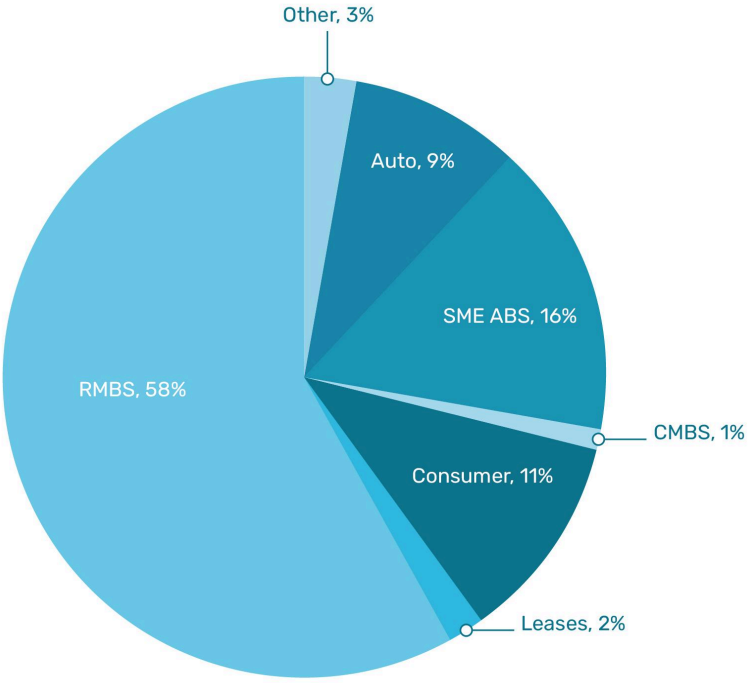
Source: Slaughter & May (2024)

Chart 2: Securitisation 'tranching' (illustrative)



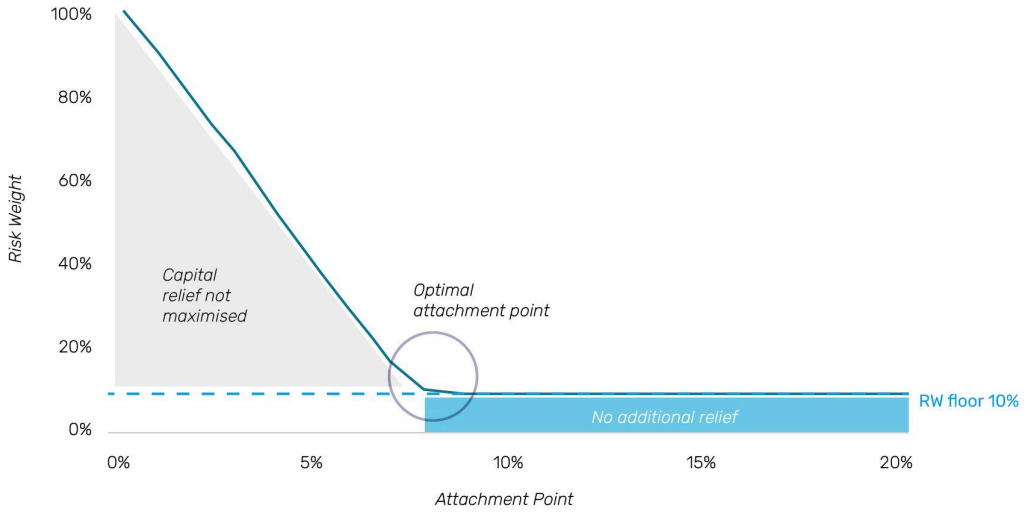
Source: KPMG (2023)

Chart 3: EU securitisation by type of collateral (Q4 2023; excl. CLOs)



Source: AFME (2024)

Chart 4: Calculation of the securitisation risk weight



Source: Finalyse (2024)