



24 April 2017

REBUILDING EUROPE'S SECURITISATION MARKETS: FURTHER WORK ON CAPITAL CALIBRATION IS NEEDED

Dear Mr Olivier Guersent
Dear Mr Charles Abela
Dear Mr Othmar Karas

Introduction

The undersigned would like to thank European policymakers and regulators for putting forward the proposals to establish a common securitisation framework in Europe with the Simple Transparent and Standardised (STS) securitisation package. We agree on the need for Europe to have a vibrant and effective securitisation market to help support funding and financing for customers across Europe. The framework for STS securitisation is a tangible example of how EU legislation can broaden financing opportunities for EU companies, foster cross-border investment and ultimately have a positive impact on the EU investment outlook.

As the STS and CRR Trilogue process is now well underway, the undersigned organisations respectfully wish to express some important concerns arising from implementation of the expected new rules on capital and liquidity - across the market, not just in the banking sector. As brought forward by our industry to all EU institutions before and during the legislative process we continue to believe that the prudential approach developed at international level does not adequately reflect the performance of European securitisations or the higher quality of future EU STS securitisations. If implemented in the current form, we estimate that prudential treatment of the new securitisation framework is unlikely to help generate additional financing ranging between €100-150bn, as originally envisaged. Rather, it may further constrain the market and as such the economy in the EU.

The smooth and successful launch of the new STS framework requires, therefore, that the capital calibrations are revisited as a matter of urgency. This is a necessary condition for a revival of the EU securitisation market before it is too late. If the problem with calibration cannot be fixed in the current legislative process, we recommend that the calibrations should be reviewed shortly after the STS framework is adopted, in line with our proposals below.

Our timing and implementation concerns

Viewing the horizon for the next several months, we see the outlook for implementation of the new regulatory architecture for securitisation as follows:

- For bank investors: Article 3 of the CRR proposals provides that the new capital rules for banks will apply from a date yet to be specified (either the date of entry into force of the regulation or a fixed date, perhaps 1st January 2018 to align with the Basel approach). This is subject to certain transitional provisions¹. At this juncture capital calibrations for both “best-in-class STS securitisations” and non-STS securitisations will be significantly increased from today’s levels. The Annex provides examples and analysis of the quantum of increases for certain asset classes which are significant in many cases.
- For bank investors: Proposed mitigants to protect against significant increases in capital are either not yet assured (for example, discussions continue around the hierarchy of approaches) or will require substantial additional work by regulators and possibly national competent authorities (for example, on the subject of wider use of the SEC-IRBA and the “top down” approach). This will take time.
- For insurance company investors: Solvency II already imposes capital requirements which are widely acknowledged to be harsh and in need of revision. Many insurance companies have ceased investing in European securitisations as a result. We understand that the Commission is unable to begin Solvency II revisions until after the entry into force of the new STS / CRR regime. The timetable to completion of this review is therefore unknown to us, but it could take more than a year, and cannot start until the STS and CRR regulations are in force; as a result there will be an implementation mismatch between issuers and investors in the STS market.
- For bank investors: the current LCR regime also treats securitisation unfavourably, as even securitisations that meet all the criteria to qualify as “ Level 2B securitisations within the HQLA buffer have much lower allotments and much higher haircuts than covered bonds and high quality corporate bonds. This creates an unlevel playing field with other financial assets and may discourage STS investment. We understand that no steps have yet been taken to address this. If it does begin it will take time, perhaps a year or more.

The main objective behind the STS framework, as stated by the Commission, was to revive the European securitisation market by increasing issuance by an additional EUR 100-150 billion to support the real economy in Europe. For this to be achieved we must reduce reliance on bank funding and encourage greater participation by non-bank investors through the capital markets. This is particularly important for risk transfer out of the banking system, in which non-bank investors need to play an especially important role as purchasers of mezzanine and subordinated tranches.

Yet, as the timetable outlined above illustrates, on a date to be determined – let us assume this is 1st January 2018, just some 9 months from today:

- Capital requirements for bank investors will increase significantly;
- Existing harsh capital requirements for insurance company investors (not just for senior but also for mezzanine and subordinated tranches) will continue and will not be eased, with no published timetable for revision of the same, despite the urgent need for doing so having already been acknowledged; and

¹ The transitional arrangements should be adjusted to include not “securitisation positions outstanding” but rather “transactions established” and that the specified date of 31 December 2019 should be delayed to take account what has been the much longer than expected progression of the STS and CRR regulations through the European Parliament.

- Existing harsh treatment of securitisation under the LCR will continue.

Our working assumption is that if this sequence of legislative change is followed, with capital calibrations for “best-in-class STS securitisations” being significantly increased for banks and not reduced for insurance companies, not only will the Commission’s goal not be achieved but the securitisation market will continue to be suppressed. This will have a negative impact on the financing of European companies and households.

The risk of unintended consequences

Further, without a holistic approach to implementation of the new regulatory architecture for the market, additional unintended consequences may arise as follows:

Arbitrage and market distortion

There is a risk that regulatory arbitrage may arise as a result of the discrepancies above. Issuers and investors alike may revert to less effective structures. The result will likely be less attractive products which will drive some of the market out of the STS perimeter, thereby undermining the purpose of STS to create a safer and more transparent securitisation market. There is evidence that this has already begun to happen in the context of the very high capital requirements for Solvency II, which encourage insurance companies to invest in “whole loan” portfolios rather than structured securitisations of the same assets. “Whole loan” investments carry more risk, and are less liquid, than investments in securitisation positions, so it is counter-productive that the Solvency II capital regime should create such an incentive.

Issuers, investors and market users such as households and SMEs will suffer

Demand for ABS investments among bank investors will be reduced or its price will rise to compensate for higher capital charges in comparison to alternative investments. This effect will be exacerbated by any delay in implementing RTS (for the use of SEC-IRBA and the top-down approach) that would allow issuers to reach an appropriate capital charge - until then, banks will be required to use the most punitive approaches to capital.

Precedents will be set, existing positions will be hardened and the application of overly harsh requirements will spread

We are concerned that the amended CRR’s overly conservative capital calibrations will set a precedent for, and will be imported into Solvency II when this issue is revisited after the conclusion of the STS discussions. As mentioned above, the existing Solvency II risk weights have already discouraged many insurance company investors from participating in the securitisation market; significantly lower capital requirements will be required to revive insurance company demand for ABS, and to remove the current incentive for insurance companies to purchase whole loan portfolios and take on greater risk.

The unfavourable treatment of securitisation investments under CRR and Solvency II could also influence other investor classes (even though they may not be subject to risk-based capital requirements), such as asset managers and pension funds, thereby reducing demand and/or increasing the price demanded.

Risk transfer will become harder to achieve

As more investors become subject to higher capital rules, demand for junior and mezzanine tranches will dry up, severely curtailing the ability of banks to transfer a portion of their risks to institutional investors via significant risk transfer (SRT) securitisation, raising the cost of bank capital even further, constraining loan demand and driving up the cost of credit for consumers.

Ultimate effect

The ultimate effect will be that borrowing costs for issuers and customers go up and availability of credit to consumers and SMEs goes down.

Our proposed solution

The original objective of the STS proposal was to encourage the financing of the European economy through a safe, robust and transparent securitisation market with levels of issuance sufficient to meet the demands of the real economy. We believe that without a holistic approach to implementation of the new regulatory architecture for STS and non-STS securitisations, there is a high risk that the new proposals will not stimulate the revival of the securitisation market in Europe, the creation of a CMU or the financing of the European economy.

Both the Solvency II and Basel approaches were heavily influenced by the US subprime mortgage experience. This does not reflect the European reality, as can now be seen nearly ten years on from the financial crisis. While the STS initiative attempts to scale down the calibrations to provide some capital relief for STS securitisations, this does not sufficiently address the underlying distortions created by both approaches.

The combination of (a) immediate implementation of higher capital charges on banks, (b) the inability of banks to use the SEC-IRBA approach or the top-down approach until RTS are provided, and (c) any delay in implementing changes to Solvency II and (d) absence of any adjustments to the LCR, will have an immediate downward effect on ABS demand, thereby causing the exact opposite effect on the market that the Commission intended when it launched the STS initiative.

We understand that policymakers and regulators may be reluctant to depart from the Basel recommendations. However, we respectfully point out that this is not entirely without precedent; for example, European regulators have departed from Basel recommendations in other areas of regulation (such as , the treatment of securitisation under the LCR) and continue to consider doing so if rules weigh unduly on the financing of the European economy.

Proposals

1. Against the background of the aforesaid our main proposal is to respectfully but urgently ask the Commission, Council and Parliament to revisit the capital calibrations in the Trilogue negotiations.
2. Alternatively, if due to the Trilogue process remaining provides no scope for doing so, we urge legislators to postpone the implementation of the following parts of Chapter 5, Section 3 of the CRR:
 - Sub-Section 2 [(Hierarchy of Methods and Common Parameters)] and Sub-Section 3 [(Methods to Calculate Risk-Weighted Exposure Amounts)] covering Articles 254 to Article 266 and
 - Sub-Section 4 [(Caps for Securitisation Positions)] covering Articles 267 and 268, Article 269 (Re-securitisations) and Article 270 (Senior positions in SME securitisations)] and to permit the continued use of the current provisions of Regulation (EU) No 575/2013.]

This would allow time for the work set out below to be completed:

- Revisions to Solvency II;
- Completion of RTS for the use of SEC-IRBA and proxy data;
- Completion of RTS on the use of the top-down approach;
- Completion of new LCR rules for STS securitisations;
- Completion of a further discussion with the European Commission and the EBA regarding new calibrations following adoption of STS, in order to adapt them to the European market reality, seeking to address:

- The “p” factor which unduly punishes high quality assets;
- The negative bias of the SEC-IRBA approach against high margin assets such as consumer loans, auto loans and leases and equipment leases;
- The negative bias of the SEC-ERBA approach caused by sovereign rating caps;
- The ability of ABCP programme sponsors to continue using the IAA approach
- The tranche maturity definition which is not representative of the actual tranche maturity;

We urge policy makers to take decisive action to implement the recommendations set out within this letter. Doing so will contribute to the success of the STS framework, support recovery in the European securitisation market, deliver funding to Europe’s consumers and businesses and strengthen our banking system.

Yours faithfully,

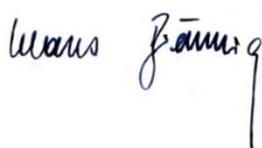
SIGNATURES



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Director General
Leaseurope/
Eurofinas



Wim Mijs
Chief Executive
European Banking
Federation



Klaus Bräunig
Managing Director
Verband der
Automobilindustrie



Dr. Hartmut Bechtold
Managing Director
True Sale
International



Dr. Peter Renkel
Managing Director
Banken der
Automobilwirtschaft

C.C.

Mr Christian Moor, European Banking Authority
Mr Claudiu Moldovan, European Central Bank

Annex

Introduction

We believe that overly harsh regulatory capital requirements for STS securitisations will make its success less, rather than more, likely.

The inherent higher quality of STS securitisations, and the major improvements already made in the European securitisation market, should be recognised.

It is important to stress that far from reducing capital weightings, the capital weightings of STS securitisations will rise significantly compared to the current Basle 2.5 calibrations (which of course apply to the entire market). This is despite:

- A proven track record of superior performance of European STS eligible asset classes.
- The enactment of new regulations and market standards designed to assure greater transparency, alignment of interests and best market practices.
- Industry initiatives: Organisations such as PCS, TSI and the DSA have been founded by industry stakeholders to set standards reflecting best market practices for securitisations that exhibit asset quality, transparency and standardisation criteria. Many of these market-based criteria are reflected in the proposed STS criteria.
- Skin in the Game: introduction of a minimum 5% retention requirement to align originator and investor interests, which has worked well.
- Transparency: under ECB auspices, a group of stakeholders founded the European Data Warehouse, a data depository for loan level data using standardised templates, providing investors with detailed and comparable information on most securitisations in the market. Similar templates have been developed by the Bank of England. STS will require originators of public securitisations to provide access to loan level detail through such data depositories.
- Qualifying transactions: the STS criteria specifically exclude re-securitisations, transactions with embedded maturity transformation (CMBS), subprime assets and complex instruments (arbitrage CDOs).

In light of the above, we believe that STS securitisations merit lower capital charges than those applied to today's securitisations, as they will represent the higher quality sector of the future market.

In particular, the actual new formulas should be revisited: it is these which present the biggest challenge to structuring efficient, cost-effective transactions for banks.

Vital areas for review include the need at least to revisit the capital floors for senior tranches, to ensure that auto loans, leases and consumer loans ABS are not unfairly penalised by the hierarchy, and that ABCP sponsors continue to be able to utilise the IAA.

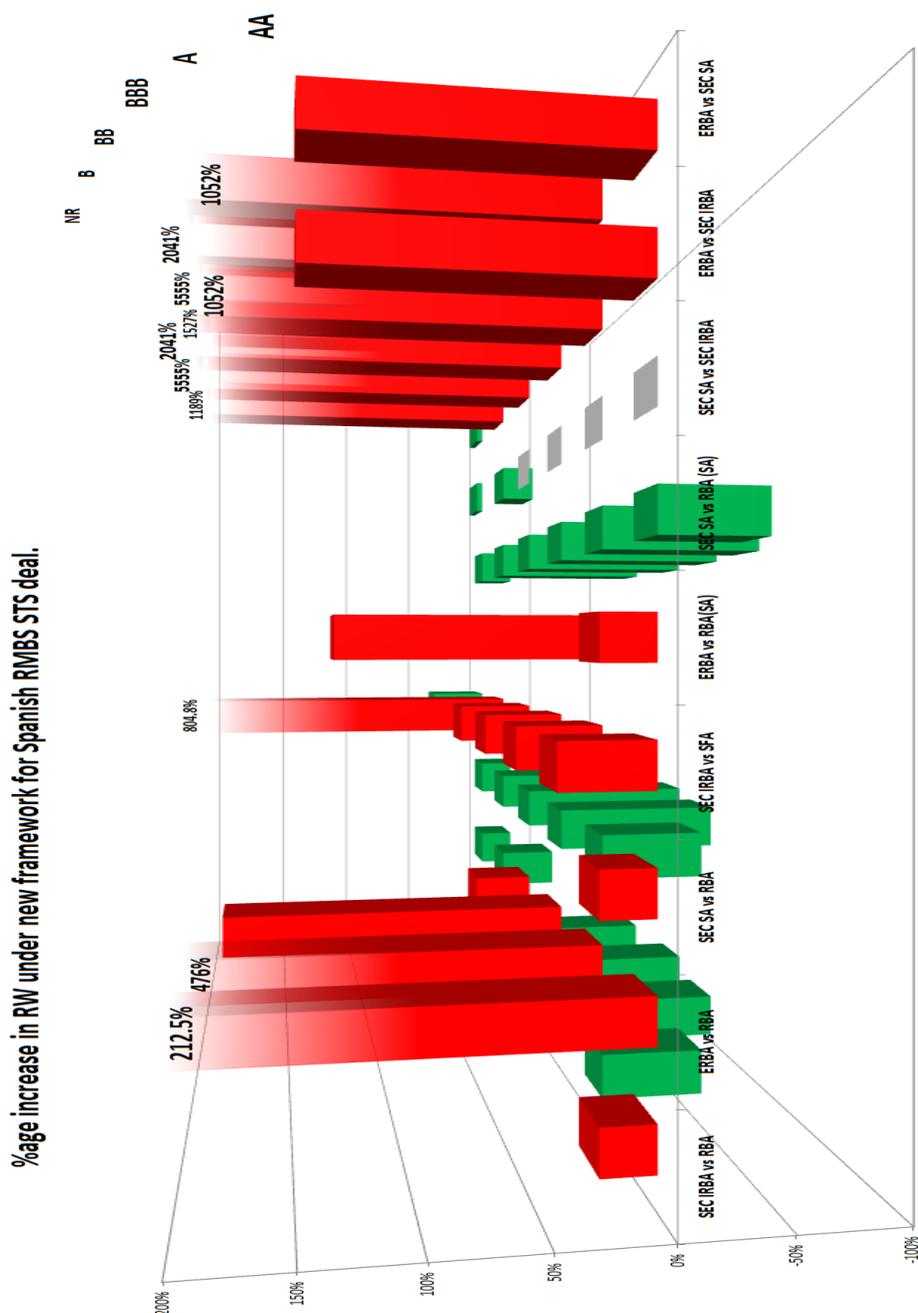
We understand that policymakers and regulators may be reluctant to depart from the Basel recommendations. However, we point out that this is not entirely without precedent; for example European regulators have departed from Basel recommendations in other areas of regulation, such as Liquidity Coverage Ratio, and continue to consider doing so if rules weigh unduly on the financing of the European economy. In this context, we strongly support the Commission's call for evidence process as well as the Financial Stability Board's initiative to assess the coherence and calibration of the international G20 mandated regulatory reform. In our view, careful assessment of the impacts on regional and global level should inform the authorities about areas where the post crisis reforms unduly penalise economic activity

without safety and soundness benefits. We recommend that that the EU and BCBS securitisation frameworks are carefully assessed against this principle.

Analysis

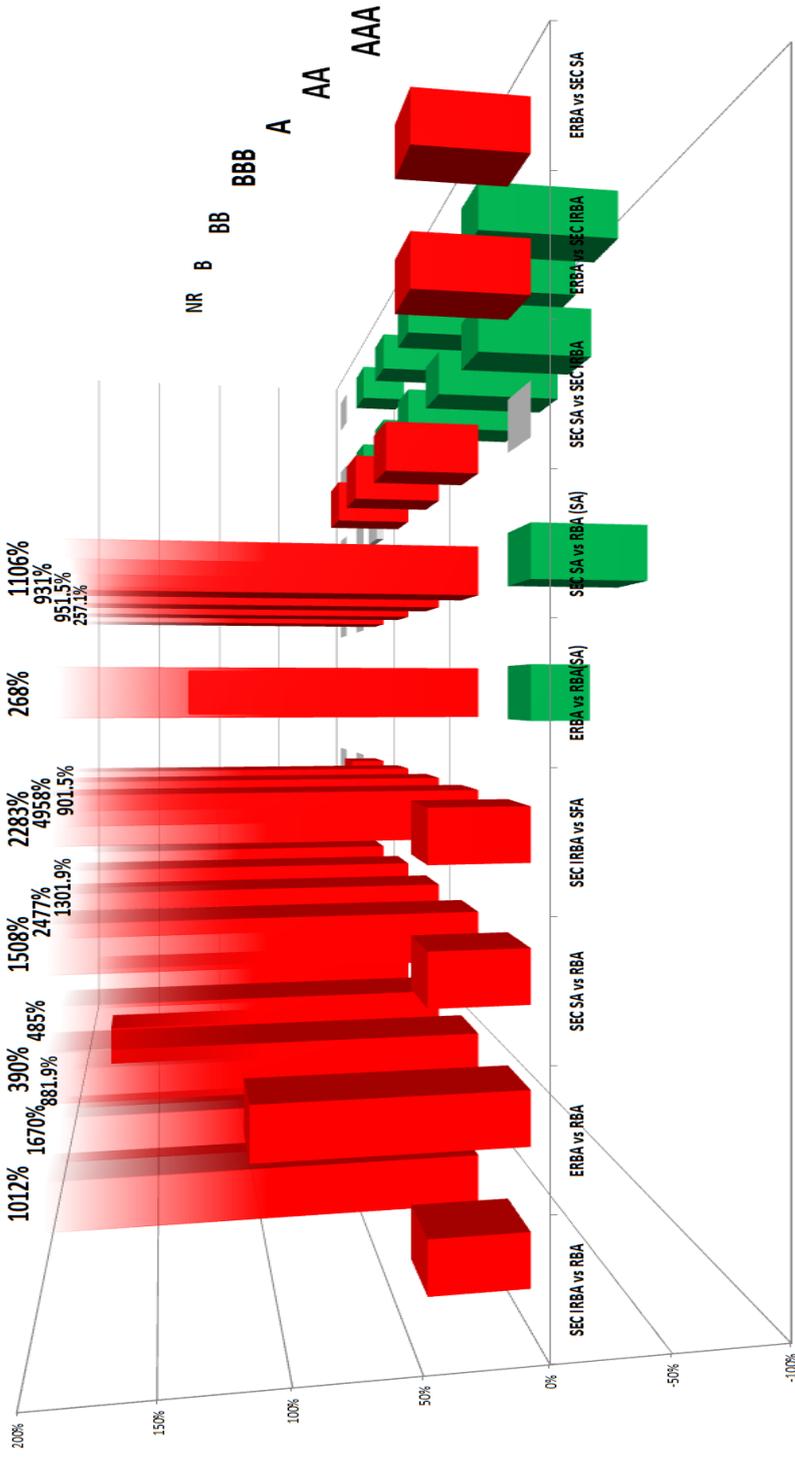
A. In the following charts we show the relative changes in regulatory capital required for a Spanish residential mortgage securitisation and a European auto loan securitisation, using sample transactions selected by the EBA for their Discussion Paper on simple standard and transparent securitisations of 14 October 2014 (EBA/DP/2014/02). The attached excel spreadsheet shows additional examples. The height of each bar represents how much more or less capital is required after the proposed change .

Some of the capital increases are so high, we have had to truncate many of the bars for reasons of scale and to fit on the page.



Source: EBF

%age increase in RW under new framework for European Auto STS deal.



Source: EBF

Observations:

The Basel framework contains significant distortions which will damage prospects for the recovery of securitisation in Europe.

As demonstrated by Perraudin and Duponchee, among others:

- The opaque Basle calibration “p” formula rewards poor asset performance: as KIRB increases, the capital surcharge counter-intuitively decreases.
- The least risky senior tranches will experience a 43% increase in capital charges (7% weighting under Basle 2.5 to 10% weighting for STS).
- Relative to other secured asset classes (covered bonds), the capital charges are disproportionately higher, given the similar risk profiles.

The SEC-SA is not calibrated to be proportionally aligned to the SEC-IRBA, with haphazard and major differences observed across most tranches of Auto ABS and, to a lesser extent, RMBS.

There are large and random discrepancies observed between the different approaches. EU Auto ABS are severely punished by the SEC-IRBA versus the SEC-ERBA, whereas EU RMBS sees the opposite effect. This anomaly reflects the failure of the Basel formulas to take into account the effect of excess spread in cash securitisations involving higher margin consumer assets. This anomaly is particularly prejudicial to publicly placed Auto ABS, one of the highest quality, liquid and stable asset classes in Europe, an asset class that directly funds the real economy.

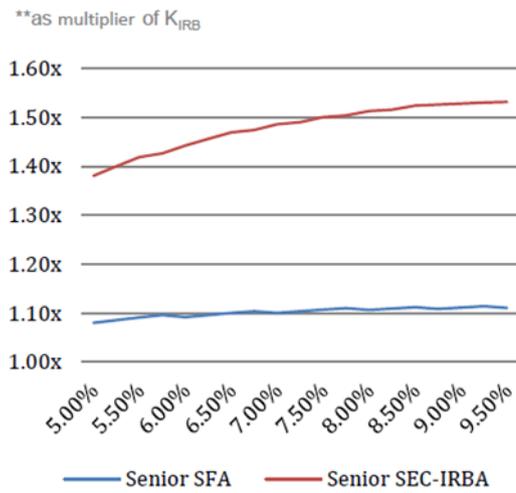
B. SEC-IRB vs SFM (Supervisory Formula Method)

Under the existing CRR rules, in order for securitisations to deliver reductions in the cost of capital (which is essential if securitisation is to regain its function as a risk transfer, not just a funding, tool), and to qualify for the RWA floor of 7%, the senior securitisation positions must attach at a point greater than the capital requirement of the reference portfolio (i.e. Kirb). The greater the difference between the senior attachment point and Kirb, the greater the impact is on the cost of capital for the originator. Take for example, a transaction on a portfolio with a Kirb of 7%, the originator would need to set the attachment point at 1.1x Kirb, a buffer of c.70bps.

Under the SEC-IRB, the proposals suggest a new formula for calculating the risk weights of securitisation positions to replace the existing Supervisory Formula Method. To qualify for the RWA floor of 10% or 15%, the SEC-IRB method significantly increases the required buffer above Kirb. In the example above, the originator would now need to set the attachment point at 1.45x Kirb, a buffer of 315bps. This requirement to have a significantly bigger protected securitisation position removes the economic benefit of doing the transaction.

For illustrative purposes, see below, a graph of “Kirb multiplier in order to qualify for the RWA floor” vs “Kirb” is shown.

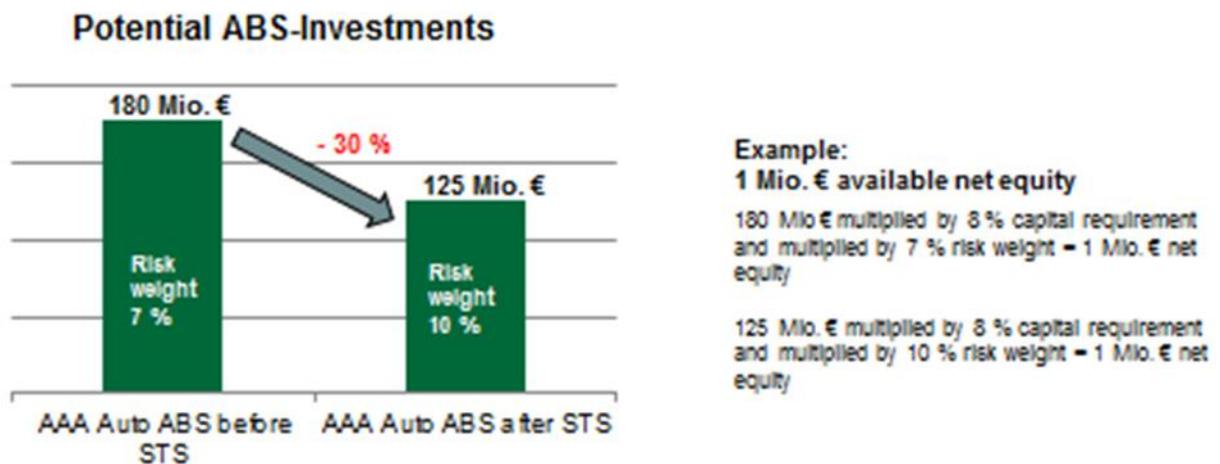
Senior attachment point required to reach RW floor**



Source: EBF

Impact on securitisation market investors:

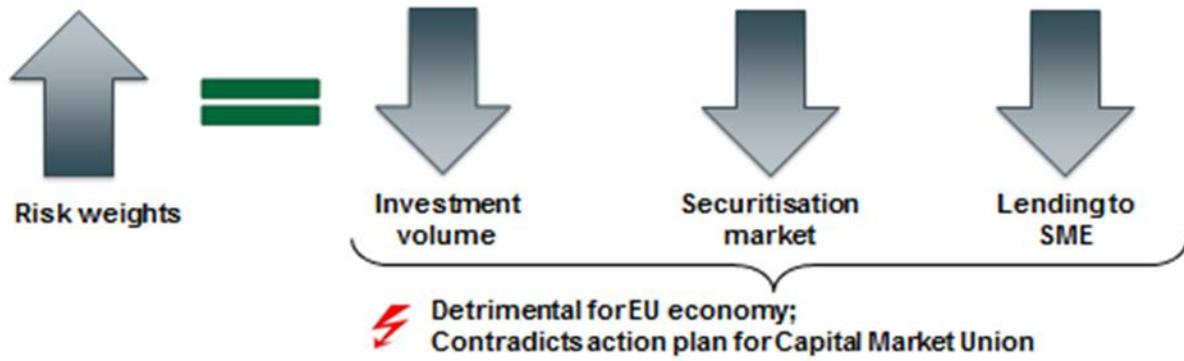
With a supposed net equity of 1 M. Euro, an investor will be able to buy 30% less ABS in the new STS regime due to the higher risk weights. As a consequence, the European securitisation market will suffer a decline:



Source: VDA/CCFA/BDA

Impact on EU economy:

The increase in the calibrations means a significant decrease of the investment volume. As a consequence, this leads to a general decline of the securitisation market and eventually to a decline of lending to the real economy:

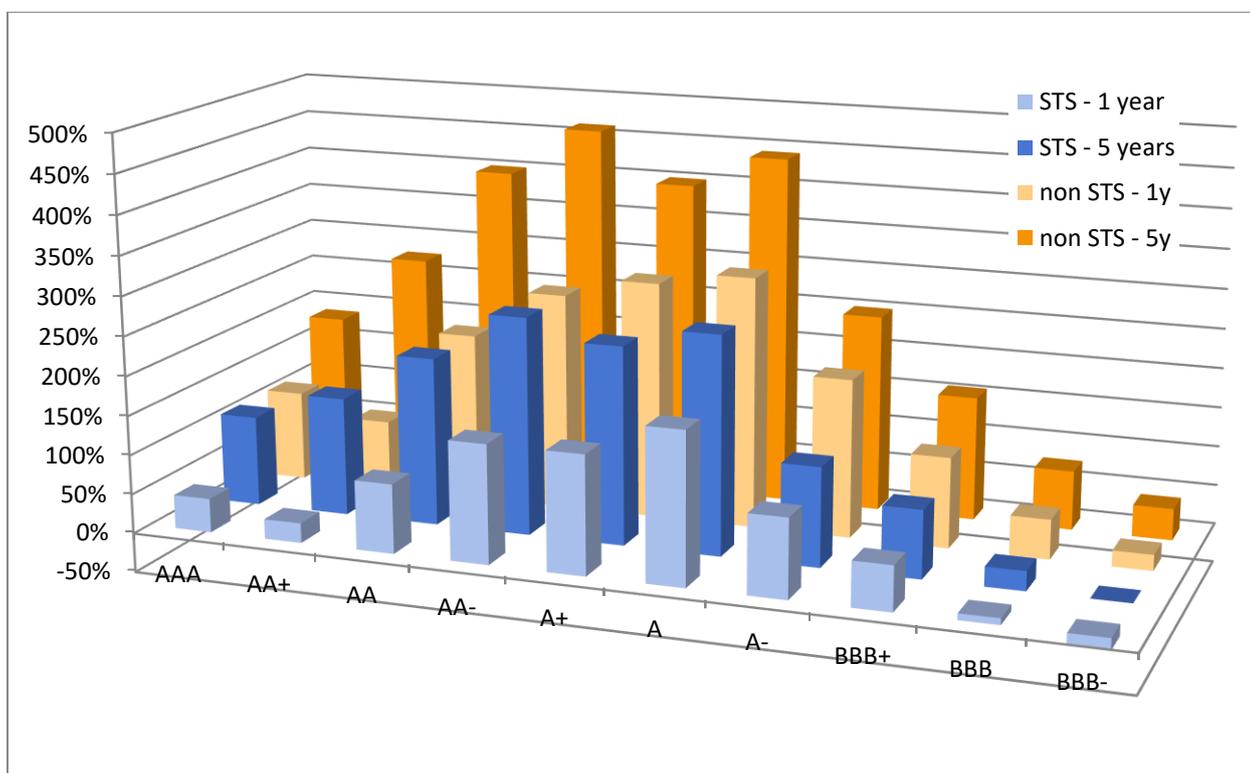


C. Capital increase for ABCP transactions increases the funding costs of real economy companies

ABCP programmes predominantly securitise and finance trade and lease receivables generated by the real economy. As of May 2016 more than 32 B. USD (equivalent) trade receivables have been financed by ABCP programs in Europe. In addition more than 12 B. USD (equivalent) auto loans and more than 9 B USD auto leases have been financed (numbers based on: “Moody’s EMEA ABCP Market Summary: H1 2016” as published on 4 November 2016). As most of the ABCP transactions are senior and of high quality, they are generally not rated sub-investment grade. The rating of European ABCP transactions is predominantly based on the internal assessment approach (IAA). European ABCP transactions rated on the basis of those models have been proven to provide secure financing even through the financial crisis.

Despite the importance of ABCP transactions for the real economy and its proven high quality, the proposed new risk weights result in a dramatic increase of required capital. This endangers an entire form of refinancing for corporates. The below tables show the dramatic increases even for future STS transactions. The fact that risk weights for lower quality ABCP transactions (rated below investment grade) would improve is not beneficial for banks as no reasonable bank aims to structure an ABCP transaction with such a weak rating level. Therefore we look only at the investment grade ratings.

Table 1



Source: Leaseurope/Eurofinas

We believe that in order not to hinder the ABCP market, risk weights for STS transactions should be maintained at the current level. The above table is especially dramatic as the majority of ABCP transactions are structured for a rating between A and AA.

We propose the following tables for transactions:

For senior STS tranches

Rating	Senior tranche	
	Tranche maturity (M_T)	
	1 year	5 years
AAA	7%	10%
AA+	8%	15%
AA	8%	15%
AA-	8%	15%
A+	10%	20%
A	12%	25%
A-	20%	30%
BBB+	35%	40%
BBB	60%	70%
BBB-	100%	120%

For senior non STS tranches

Rating	Senior tranche	
	Tranche maturity (M_T)	
	1 year	5 years
AAA	10%	15%
AA+	15%	20%
AA	15%	20%
AA-	15%	25%
A+	20%	30%
A	25%	35%
A-	30%	45%
BBB+	40%	55%
BBB	70%	85%
BBB-	100%	120%