CLIFFORD

CHANCE

ESAS JOINT ADVICE: A FALSE DAWN FOR THE EUROPEAN SECURITISATION PRUDENTIAL FRAMEWORK?

This is an update of an article originally published on 5 June 2023 as part of our publication "Securitisation markets and regulation: choosing different paths?", accessible here.

On 12 December 2022, the European Supervisory Authorities ("**ESAs**") provided a set of joint advice to the Commission about the prudential frameworks for securitisation applicable to banks and insurers. In their response, the ESAs recommended limited changes to the framework for banks and no changes to the framework for insurers. This article considers that advice, the direction of travel for those prudential frameworks and the potential impact on securitisation in Europe.

Key issues

- ESAs took the view that prudential requirements on banks and (re)insurers have limited impact on growth of EU securitisation markets.
- Proposals by ESAs for meaningful reform to bank prudential requirements are impractical because they require going to Basel, meaning they would be delayed several years at best.
- Industry stakeholders disappointed no change was proposed to prudential requirements for (re)insurers despite evidence supporting recalibration of these capital requirements.
- There is some scope for changes despite the ESAs' unambitious report, but this likely requires significant industry support.

Background

The ESAs' joint advice on the review of the securitisation prudential framework applicable to banks and insurance companies (the "**JA**") was provided in response to a European Commission Call for Advice dated October 2021. The Commission were aiming to identify possible ways of reviving the EU securitisation market on a prudent basis.

This desire to revive the securitisation market comes in the context of low participation relative to the levels prior to the global financial crisis of 2008, and also relative to current levels of activity in the US securitisation market. For instance, the ESAs (consisting of the European Securities & Markets Authority, the European Insurance & Occupational Pensions Authority ("**EIOPA**") and the European Banking Authority) noted that the gap between the EU market for public securitisations and its US counterpart has widened significantly in recent years - while the public EU market has experienced an 8% decline in terms of outstanding balances in the last five years, its US counterpart has grown by 11% within the same period. A lack of data means no equivalent comparison for private markets was possible.[1]

Among other things, the Commission asked the ESAs to consider:

(i) the application and impact of the key parameters for the calculation of risk-weighted exposure amounts for securitisation positions in relation to banks;

[1] https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_66_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_banking.pdf

(ii) the impact of the existing parameters for the calculation of capital requirements on the spread risk for securitisation positions on the behaviour of (re)insurers;

(iii) the impact of the securitisation capital framework on banks' origination and investment activity;

(iv) whether the Solvency II capital framework has been a significant driver for (re)insurance companies' investment activity in EU securitisation markets in recent years; and

(v) whether other factors, including regulatory rules other than capital requirements, should be regarded as having a major impact.

We consider the ESAs' response relating to banks and (re)insurers below.

The Banking Sector

Capital requirements

The ESAs considered the impact of existing prudential requirements on banks' securitisation activity and took the view that a recalibration of the securitisation prudential framework for banks, without more, would not be sufficient to revive the EU securitisation market. However, they acknowledged that some positive trends exist to show that the bank capital framework may play a more important role in the significant risk transfer ("SRT") market, as compared to the wider securitisation market.

In their view, the prevailing low growth in EU ABS markets is attributable to low interest by investors and originators, and not to regulatory capital requirements.

On the demand side, investors are discouraged from investing in ABS assets due to complex and extensive regulatory due diligence requirements. These impose an assessment premium in the form of high due diligence costs not imposed on comparable investments such as covered bonds. On the supply side, the limited investor base as well as access to alternative sources of funding from more familiar (and less complex) sources have also discouraged originators' participation.

The ESAs therefore made the following recommendations with respect to the prudential framework for banks:

- Technical fixes to improve the clarity and consistency of the existing prudential framework (without a significant deviation from the underlying logic of the Basel framework).
- Improving the risk sensitivity of the securitisation framework by recognising the reduced model and agency risk associated with originators retaining senior securitisation tranches (mainly relevant to synthetic SRT deals).
- Liaising with the Basel Committee on Banking Supervision on more substantial reforms on the securitisation risk weight formulas.

By way of background, in setting risk weights for bank securitisation exposures, the Basel Committee considered the agency risks (arising from the multiple relationships between the agents in a securitisation structure) and

model risks (arising from assumptions made on the underlying pool which is used to estimate loss distribution) associated with securitisations. This led to the adoption of a stricter prudential approach (compared to directly held exposures) to control for the agency and model risks via non- neutrality correction factors, i.e. the "p" factor and the risk weight floor. The "p" factor refers to a capital surcharge on securitisation tranches relative to the capital charge on the underlying pool.[2]

In adopting the non-neutrality correction factors, the Basel Committee however failed to make a distinction between circumstances where senior tranches of securitisations are retained and where they are not, even though the risks are clearly lower in securitisation transactions where senior tranches are retained by the originator such as SRT transactions.

Although the recommendation to reduce the risk weight floor applicable to senior tranches of securitisation retained by originators represents a departure from the Basel methodology, this recommendation appears to be a step in the right direction particularly as it seems economically inefficient to require originators who hold positions in the senior tranches of their own securitisations to maintain high capital buffers for agency and model risks. However, the ESAs acknowledged that implementing this recommendation should be accompanied by an appropriate set of safeguards.

On the other hand, it is not clear why the ESAs have not extended their recommendation to include a reduction of the "p" factor, as they have done for the risk weight floors. This is particularly noteworthy as industry participants have previously expressed the view that they consider the "p" factor to be punitive.

Indeed, there is a compelling argument to reduce this factor to reflect reduced agency and model risks associated with senior tranches of securitisations which are retained by originators – as is the case for most SRT transactions.

Criticisms of the calibration of the "p" factor are not limited to industry. A broad range of stakeholders in the EU's High-level Forum on the Capital Markets Union have called for a reduction of the "p" factor across securitisations on the basis that the introduction of the STS framework has addressed some of the agency risks which the "p" factor corrects for. In addition, a recalibration of the "p" factor would also serve to maximise the effect of the reduction in the risk weight floors on retained senior tranches, which is a recommendation of the JA.

It is noteworthy that although not proposed by the ESAs, temporary amendments to the "p" factor have been proposed by the European Parliament as part of its negotiating position going into trilogues on the amendments to the Capital Requirements Regulation. These amendments are proposed to be in place as a transitional arrangement pending the completion of the "securitisation comprehensive review", an essential element of the Capital Markets Union Action Plan. It is proposed that the "p" factor would be halved for the purpose of the calculation of the output floor, in order to mitigate the unintended impact of the output floor calculation which limits the amount of capital benefits a bank can obtain from using its internal risk models rather than the standardised risk models. The proposal for reform was justified on the

[2] https://www.eba.europa.eu/sites/default/documents/files/document_library/Opinion%20on%20the%20regulatory%20treatment%20of%20NPE%20securitisations.pdf

basis that the existing highly conservative calibration of the SEC-SA (securitisation standard approach) means the output floor would significantly reduce the efficiency of securitisation transactions.

More generally, even if the position of the ESAs that the prudential framework for banks is not responsible for the slow growth of the EU securitisation market is accepted (itself arguable), there was a missed opportunity for the ESAs to make wider recommendations targeted around addressing the unjustifiably punitive treatment of securitisations from a regulatory capital perspective.

Finally, the ESAs' recommendation to agree more substantial reforms on the securitisation risk weight formulas via the Basel process is an unsatisfactory and impractical solution because it would necessarily extend the current punitive treatment and uncertainty around reforms for several more years. It is clear that even if this process was followed and finalised quickly, the earliest such reforms could apply fully to EU banks is 2028.[3] If this route were to be followed it would need, at the very least, some wide-ranging transitional relief in order to be practical.

Liquidity framework

The ESAs also considered a recalibration of the Liquidity Coverage Ratio ("**LCR**") to permit certain securitisation positions to qualify as Level 2A High-Quality Liquid Assets ("**HQLA**"). Currently securitisations can only qualify under the securitisation- specific category of "Level 2B securitisations" that is slightly less favourably treated than other Level 2B assets. The ESAs noted that any such recalibration would have to be based on new observations under an LCR stress scenario. However, they acknowledged the challenge posed by the unavailability of sufficient data for measurement given that no LCR stress period had been observed in the banking system in the last few years.

The ESAs however noted that, in reality, only a negligible amount of securitisation positions, including STS securitisation positions, are taken into account in the LCR stress buffers and this has been the case from when the LCR was introduced in 2013 to date. They also held the view that "*there is a reasonable assumption that credit institutions have very small appetite to use securitisations as part of the LCR stress buffer or perceive a low marketability of security positions during LCR stress scenarios*"[4] given that the LCR levels of these institutions are very high, exceeding the minimum regulatory requirements. The ESAs considered upgrading securitisations from Level 2B to Level 2A HQLA which would mean an increase to the cap of the current 15% to 40% of the liquidity buffer, and concluded that there was no justification for this upgrade. On this basis, the ESAs considered that there was no change necessary to the liquidity framework.

From a practical perspective however, the position may not be quite as simple as banks preferring not to include securitisation positions in their LCR stress buffers for e.g. marketability reasons.

---

[3] https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_5386

[4] https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_66_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_banking.pdf

Although securitisation positions are considered Level 2B assets, they are in fact treated worse than other Level 2B assets e.g. corporate debt securities. Article 13(2)[5] of the LCR Delegated Regulation sets out a long list of requirements which must be met by an ABS to qualify for inclusion in the LCR stress buffers, including (i) being Simple Transparent and Standardised ("**STS**"); (ii) being the most senior tranche; (iii) meeting stringent credit quality requirements; and

(iv) being one of a limited list of asset classes (residential mortgages, auto loans/ leases, commercial loans, or consumer loans). Even where these requirements are all met, securitisations are subject to punitive maximum bucket sizes (15% of HQLA in total) and haircuts (25% for residential mortgage and auto securitisations and 35% for commercial and consumer loans). This reveals some circularity in the argument by the ESAs and throws up the question of whether securitisations are not liquid enough to be in the LCR because they are so poorly treated in the LCR, ensuring that they will never be liquid enough to be included in the LCR?

Notwithstanding the above, while it is acknowledged that credit institutions have historically not used a significant amount of ABS assets to make up their LCR buffers, it is disappointing that the ESAs have not taken advantage of the Call for Advice to recommend updates to the liquidity framework to at least reflect a consistent LCR calibration between securitisations and covered bonds, which in many ways should be regarded as a comparable asset class. At a minimum, this would have signalled a step towards improving the reputation of securitisation as a safe asset class (given empirical evidence since the financial crisis) and reduced the punitive regulatory treatment of ABS, particularly when compared to other asset classes. Commenting on the LCR calibration, the Association for Financial Markets in Europe ("**AFME**") argued that the LCR calibration which favours covered bonds over ABS should be revisited on the basis that while covered bonds were more liquid than ABS in the early 2010s, this position changed in 2016 and senior ABS have been consistently more liquid than covered bonds since then.[6]

The (Re)insurance Sector

The ESAs considered Solvency II and its effects on (re)insurers participation in the EU securitisation market. They noted that since it became effective in 2016, investments by (re)insurers in securitisations across Europe have been consistently low, amounting to approximately 12.5 billion or 0.33% of their total investment assets.[7] In addition, responses received on a survey conducted by EIOPA on (re)insurers indicated that for a vast majority of (re)insurers, the demand for securitisation products is low or non-existent while securitisation investments are relevant for only a small number of (re)insurers.[8]

The ESAs also noted that the introduction of the STS criteria to the securitisation regulatory regime does not appear to have improved this situation, notwithstanding that the STS label attracts beneficial capital

---

[5] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061

[6] https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_66_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_banking.pdf

[7] https://www.eiopa.europa.eu/publications/investment-insurers-and-reinsurers-securitisations_en

[8] https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_67_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_insurance.pdf

treatment. Although the ESAs acknowledged that the introduction of STS may have brought some changes in the volumes and categories of securitisation held by (re)insurers, they noted that no strong trends could be identified given the limited time series

(as the STS regime was only introduced in 2019).[9]

The ESAs reported that findings from their survey indicated that (re)insurers' appetite for securitisations varied greatly among different undertakings for different reasons. One reason is the different asset-liability management of individual insurance undertakings which drives their investment behaviour. In addition, while some (re)insurers indicated that they would rather invest in other assets with better risk-return profiles, a vast majority of respondents seem to have never invested in securitisations and do not see the need to change their investment behaviour. In this regard, it is noted that less than 20% of the respondents had been active securitisation investors.

However, a small group of (re)insurers did indicate that they have refrained from investing in securitisation assets due to the high capital charges associated with such investments.

It is therefore unclear why the ESAs took the view that the overall risk sensitivity of the Solvency II risk charges for STS securitisation was appropriate for the time being and that there was no need to change the securitisation prudential framework for (re)insurers. Although the ESAs noted that the limited time series posed a challenge to their observations, industry stakeholders considered the ESAs response to be a disappointing response to correct the situation.

Indeed, there is a basic logical flaw in the ESAs' argument that the limited time series has posed a challenge in relation to their observations around the impact of Solvency II on securitisation investments. In this regard, one would have expected the ESAs to consider a time series *before and after* the introduction of Solvency II if they wanted to understand the effect of the introduction of Solvency II. Thus, even if more time passes and the ESAs consider that the limited time series problem has been overcome, any data regarding the impact of Solvency II on securitisation investments which considers only the period after the introduction of Solvency II is not likely to be very helpful in providing a clear picture of the effect of Solvency II on securitisation investments.

In addition to the ESAs own report that some (re)insurers identified the punitive capital treatment as being responsible for their low level of investment in securitisations, Insurance Europe (the European re(insurance) federation comprised of 37 national insurance associations) have criticised the capital costs of investing in securitisations as being too high in contrast to corporate bonds, thus making corporate bonds a significantly more attractive asset class for European (re)insurers. The below words from Insurance Europe are instructive:

[9] https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_67_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_insurance.pdf

"*…the existing Solvency II capital requirements of securitised assets … do not reflect the risk and yield of this asset class. More specifically, the current capital charges for non- simple, transparent and standardised (STS) securitisation are unreasonably high and are not appropriately justified based on either past data or EIOPA's analysis. EIOPA's recent consultation paper does not provide any quantitative arguments that support the retention of the current factors for this category.*"[10]

Since its publication, the JA has received significant criticism from key industry players. AFME suggested that there is evidence to support a recalibration of the prudential framework for banks and insurers and that the ESAs "*postulating that it is probably not worth making calibrations more risk sensitive and proportionate because they cannot quantify the benefit [was] no justification for inaction*".[11]

It should also be noted that although the European Commission has proposed[12], and the Council of the EU has agreed[13], certain reforms to Solvency II none of these reforms appear to be targeted specifically at reviving (re)insurers' investments in securitisations.

Nonetheless, and despite the ESAs position in the JA, we understand the Commission to be sympathetic to the need for some adjustments to the Solvency II framework for securitisation. That said, the JA position against such adjustments make the Commission's job of recalibration more difficult, since Commission staff would need to take on the technical analysis work that would normally be carried out by the ESAs in order to do so. In this respect, market participants may wish to consider engaging with their trade associations in order to put together detailed technical analysis and evidence to assist the Commission with this work.

For more on the changes being considered in relation to Solvency II, see the article entitled *"Solvency II (EU and UK): encouraging insurers back to the securitisation markets?"* later in this volume.

---

[10] Via the July 2022 Response to EIOPA Consultation Paper on the Advice on the Review of the Securitisation Prudential Framework for Solvency II: https://www. insuranceeurope.eu/publications/2677/response-to-eiopa-consultation-paper-on-the-advice-on-the-review-of-the-securitisation-prudential-framework-in-solvency- ii/#:~:text=While%20insurers%20are%20willing%20to,the%20key%20obstacles%20to%20investing.

[11] https://www.afme.eu/news/press-releases/details/afme-disappointed-by-esas-inaction-on-securitisation--eu-legislators-should-provide-leadership-to-address-regulatory-imbalances

[12] https://data.consilium.europa.eu/doc/document/ST-11763-2021-INIT/en/pdf

[13] https://www.consilium.europa.eu/en/press/press-releases/2022/06/17/solvency-ii-council-agrees-its-position-on-updated-rules-for-insurance-companies/

CONTACTS

Andrew Bryan
Knowledge Director,
London

T +44 207006 2829
E andrew.bryan
@cliffordchance.com

Precious Ivongbe
Lawyer,
London

T +44 207006 3894
E precious.ivongbe
@cliffordchance.com

Kevin Ingram
Partner,
London

T +44 207006 2416
E kevin.ingram
@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2023

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Delhi • Dubai • Düsseldorf • Frankfurt • Hong Kong • Houston • Istanbul • London • Luxembourg • Madrid • Milan • Munich • Newcastle • New York • Paris • Perth • Prague • Riyadh • Rome • São Paulo • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

AS&H Clifford Chance, a joint venture entered into by Clifford Chance LLP.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.