Memo

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| To: | European Commission, Directorate-General for Financial Services |
| Date: | 4 December 2024 |
| From: | Aloïs Thiant, Director of Government Relations for Europe |
| Subject: | Targeted consultation on the functioning of the EU securitisation framework |
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**About Marsh McLennan**

Marsh McLennan is the world’s leading professional services firm in the areas of risk, strategy and people. The Company’s more than 85,000 colleagues advise clients in 130 countries. We help clients navigate an increasingly dynamic and complex environment through four market-leading businesses:

* Marsh provides data-driven risk advisory services and insurance solutions to commercial and consumer clients.
* Guy Carpenter develops advanced risk, reinsurance and capital strategies that help clients grow profitably and pursue emerging opportunities.
* Mercer delivers advice and technology-driven solutions that help organizations redefine the world of work, reshape retirement and investment outcomes, and unlock health and wellbeing for a changing workforce.
* Oliver Wyman serves as a critical strategic, economic and brand advisor to private sector and governmental clients.

**About our response**

This response is limited to on-balance-sheet synthetic securitisations as per definition set out in Article 2 of Regulation (EU) 2017/2402. We provide responses only to selected questions listed below.

## Section 7. STS standard

### Questions to stakeholders:

**7.1. Do you think that the STS label in its current form has the potential to significantly scale up the EU securitisation market?**

**Response:**

In its current form, no. With regards to on-balance sheet synthetic securitisations / SRT, this is for two primary reasons:

1. Unlevel playing field for issuing banks across the EU – the STS framework favours regional banks and the largest domestic banks under the IRB approach who will have sufficiently large loan portfolios to select efficient portfolios that satisfy the current homogeneity requirements, or can issue sufficiently large SRT transactions to absorb the cost of compliance / verification of compliance of the STS criteria. Banks that are less frequent issuers (including a number of the larger domestically focused IRB banks under JST supervision), banks under the Standardised Approach (in general domestic banks, challenger banks, etc.) are disadvantaged relative to their regional peers as meeting STS criteria can be both costly and inefficient; and
2. Unlevel playing field for private investors – a crucial source of capital from well capitalised and prudentially regulated (re)insurance undertakings is currently not allowed for unfunded STS transactions, whereas 0% risk weighted entities (being public and quasi-public sector entities) are able to participate in such transactions. This can lead to increased reliance on such public sector entities where private market solutions, at efficient pricing, exist. Furthermore, this limits the extent to which (re)insurance companies can diversify their exposure to SRT risks and may have the unintended consequence of impacting further growth and participation from the (re)insurance sector.

We note that (re)insurance companies bring a diversifying source of capital to the SRT market which is much needed for certain asset classes (e.g. residential mortgages) and certain tranches (e.g. senior mezzanine) to make transactions more efficient, and in some cases economically viable.

We expand on the above and our thoughts regarding changes to the STS framework to promote healthy market development.

**7.2. Which of the below factors, if any, do you consider as holding back the expansion of the STS standard in the EU?**

**• Overly restrictive and costly STS criteria**

• **High capital charges**

**Response:**

The expansion of the STS securitisation framework in the EU is constrained by several key factors that impact its economic viability and practical accessibility for both originators, in particular domestic banking groups, and investors, in particular prudentially regulated (re)insurance undertakings.

One significant barrier is the exclusion of private unfunded credit protection providers, such as (re)insurers regulated under Solvency II, or equivalent, frameworks. These well capitalised and highly regulated companies are critical for broadening the STS SRT investor base and ensuring cost-effective protection, where in addition to increasing competition to regular capital market investors, they can offer capacity for senior mezzanine tranches and lower-risk portfolios that are crucial to the real economy (e.g. residential mortgage portfolios). Their inclusion would foster competition and innovation, especially for portfolios that are not economically viable in a fully funded format.

Additionally, the current capital requirements under the STS framework are insufficiently risk-sensitive. The high RW floors and the overly conservative calibration of the (p) factor in the SEC-SA methodology impose disproportionately high capital charges. This particularly disincentivizes domestic banks from engaging in securitization, as the transactions become too costly to justify from a capital efficiency perspective.

The stringent homogeneity requirements further restrict participation. While intended to simplify securitisation structures, these requirements are overly rigid, excluding portfolios that share consistent risk profiles but do not fit narrow asset-type definitions. This disproportionately affects smaller institutions, limiting their ability to participate in the STS market.

Finally, the fragmented regulatory approach across jurisdictions and the lack of standardization in demonstrating compliance with STS and Significant Risk Transfer (SRT) criteria with respect to non-JST supervised banks result in high structuring and operational costs. These costs are particularly prohibitive for smaller banks in addition to costs associated with verification check in relation to STS label, which lack the scale to justify such expenses.

Addressing these challenges through the inclusion of unfunded credit protection providers, recalibration of capital requirements, greater flexibility in homogeneity criteria, and harmonization of regulatory assessment would enhance the attractiveness of STS securitisations for issuers, fostering broader market participation on both the originator and investor side.

**7.3. How can the attractiveness of the EU STS standard be increased, for EU and non-EU investors?**

**Response:**

To enhance the attractiveness of the EU STS standard for investors, we propose the addition of (re)insurance companies as eligible unfunded credit protection providers (rated CQS2 or better at transaction inception and CQS3 or better thereafter) under the on-balance sheet STS framework. This would increase issuance volumes by broadening the investor base, increasing competitive pricing, reducing execution risk and reducing the risk of cliff effects.

In addition, we encourage the following further changes, which will prudently enable a broader set of banks to issue on-balance sheet securitisations under the STS framework, helping to level the playing field for EU banks as well as for private unfunded investors (as only quasi public entities can currently participate in STS transactions on an unfunded basis) who will then be able to better diversify their SRT underwriting:

1. decreasing the RW floors for senior tranches without introducing further eligibility criteria (which may have the unwanted consequence of introducing more complexity);
2. scaling down the (p) factor, particularly for banks using the standardised approach, would allow for increased issuance volume, improving domestic banks’ ability to structure securitisations more cost effectively,
3. reviewing and relaxing homogeneity requirements, to level the playing field for domestic banks who would otherwise struggle to identify sufficiently efficient portfolios under the current homogeneity rules; and
4. proposing a unified standardised approach from a regulatory perspective across jurisdictions as well as originators (not differentiating between G-SIB and domestic banks not supervised by JST), when assessing new issuances.

### STS criteria

**7.4. In the case of an unfunded credit protection agreement where the protection provider provides no collateral to cover his potential future liabilities, should such an agreement be eligible for the STS label, to facilitate on‑balance‑sheet STS securitisations?**

**Response:**

Yes

**7.5. If you answered yes to question 7.4., what safeguards should be put in place to prevent the build-up of financial stability risks arising from the provision of unfunded credit protection?**

**Response:**

Unfunded credit protection providers play a crucial role in the synthetic securitisation markets, with (re)insurance companies emerging as pivotal players in diversifying the investor base over the past 6 years. In particular, (re)insurance companies have provided banks with a valuable source of capital to address the thicker tranching requirements to achieve SRT resulting from Regulation (EU) 2017/2401, as they are able to price the tranches according to the risk of the tranche rather than being subject to the same minimum absolute return hurdles that credit opportunity funds can be subject to.

By excluding (re)insurers from participating in STS synthetic securitisation transactions, the regulatory framework inadvertently limits the development of the EU securitisation market, contradicting its goal of fostering market growth. Moreover, (re)insurance companies are now a well-established investor base in non-STS synthetic securitisations without any indication of increasing financial stability risks.

Allowing (re)insurance companies to participate as unfunded credit protection providers in synthetic STS transactions builds on their established capabilities and further diversifies their portfolio of risks. (Re)insurance companies who participate in the credit market are regulated under the robust Solvency II framework (and equivalent in third jurisdictions), which equips them with sophisticated risk management practices, including comprehensive credit risk assessment models, underwriting frameworks, and stringent capital requirements. As such they are well-suited to participate in both synthetic STS and non-STS transactions.

It is worth emphasizing that the STS label is fundamentally about creating a high quality standard of securitisation transactions to attract more investor appetite. By excluding (re)insurance companies from participating in synthetic STS, the market loses much needed access to a critical investor base that has steadily developed over recent years. (Re)insurers introduces competition among different groups of protection providers (approximately 15 insurance companies actively participate in SRT transactions and around 30 frequent capital market investors) resulting in more efficient pricing and risk distribution.

Moreover, (re)insurance companies have shown strong appetite for mezzanine tranches, which are generally less attractive to the funded SRT investors. This is particularly beneficial for banks operating under the Standardised Approach, as they often need to place thicker tranches for corporate and SME portfolios. Retail mortgage portfolios, with their relatively low-risk weights, also benefit significantly from the participation of (re)insurers, who have a long track record in the asset class, as funded protection may not always be cost-effective for these portfolios.

We also note that (re)insurance companies routinely reinsure their exposures, thereby syndicating risks across a broad base of reinsurance companies with highly diversified balance sheets (where credit risk typically represents <10% of their liabilities). This natural risk-sharing mechanism adds another layer of diversification, reducing systemic risks in the process.

For these above reasons, we argue that allowing (re)insurance companies to participate in STS transactions on an unfunded basis will lead to more efficient pricing, greater liquidity, diversification of capital, broader distribution of risks and therefore reduced financial stability system risk

With regards to safeguards, we strongly argue that any additional requirements be principles based rather than prescriptive. Under the CRR, banks already manage counterparty risk with respect to protection received from insurance companies. These existing rules, which specify eligibility criteria and prescribe capital treatment for insurance counterparties, should logically extend to STS securitisations without additional restrictions.

The existing safeguards, particularly the minimum credit rating requirements, sufficiently mitigate financial stability risks. Under the CRR, unfunded credit protection providers are required to hold at least a credit quality step of CQS2 (equivalent to an A- rating) at transaction inception and at least CQS3 (equivalent to BBB-) thereafter. Unfunded credit insurance has been used by banks for decades, and the claims paying track record of insurers, and their financial / ratings stability (see responses to questions 7.6), demonstrates that the existing credit rating thresholds are sufficient. The capital requirements imposed on (re)insurance companies under Solvency II further bolster their resilience, as they ensure that (re)insurers maintain sufficient capital buffers to honor their obligations and maintain diversification of risks on their balance sheet.

Introducing additional restrictions, such as limits on the amount of securitisation activity a (re)insurer can undertake, or limits on the amount of unfunded STS an originator can execute with a (re)insurance company, is unnecessary. The existing requirements ensure that only financially stable and well-capitalised institutions can participate in unfunded STS transactions. It is worth noting that rating agencies, assigning rating to (re)insurance companies, already incorporate consideration of product and geographical concentration in their assessments, providing another layer of protection against systemic risks. Furthermore, banks who issue SRT transactions will already prudently assess and manage their counterparty risk. If any additional safeguard is sought, then at most it should be principles based and for the SRT issuing bank to set out in its SRT self-assessment how it has adequately considered, and will manage, the incremental counterparty risk it would be taking.

To summarise, (re)insurance companies, are well-equipped to participate in unfunded STS synthetic securitisation transactions without posing undue risks to financial stability. The existing safeguards, particularly minimum credit rating requirements, are sufficient to mitigate potential risks to well rated and highly regulated (re)insurance undertakings. Additional restrictions would hinder market development, limit competition and increasing costs for banks. To foster the growth of the EU securitisation market and align with its objectives, regulators should permit (re)inurers to participate as unfunded credit protection within the STS framework.

**7.6. What would be the implications for EU financial stability of allowing unfunded credit protection to be eligible for the STS label and the associated preferential capital treatment?**

**Response:**

Allowing unfunded credit protection from (re)insurance companies to be eligible for the STS label and the associated preferential capital treatment will have several positive implications for EU financial stability, supporting the broader objectives of enhancing the securitisation market. By allowing (re)insurance companies to participate in unfunded STS transactions, the market is able to access a broader base of counterparties rather than relying solely on capital market investors, or certain 0% risk weighted entities. This reduces systemic risk by dispersing credit exposures across a more varied set of entities with differing risk profiles.

(Re)insurance companies are inherently set up to underwrite and manage risks, including credit risk. Their participation complements the funded market by addressing gaps in demand, particularly for mortgage portfolios, and mezzanine tranches, and provides a broader base of banks, including those under the Standardised Approach, with more tools to achieve effective risk transfer at efficient pricing.

The vast majority of claims submitted to insurance companies are covered and settled in a timely manner, reflecting efficient processes and adherence to policy terms. Only a small fraction, approximately 2.5%, remain uncovered due to the insured party not fulfilling specific terms or obligations outlined in their insurance policy. Please, refer below to the statistics in relation to Financial Institution claims data collected jointly by a number of insurance brokers:

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Furthermore, from the global average transition rates extracted from publicly available credit research by S&P[[1]](#footnote-1) with respect to insurance companies, we observe that during the period 1981 – 2023, out of 565 credit ratings issued to insurance companies rated A- and above, only 1 was downgraded to BB+ or worse, and only 10 ratings observed migration to BBB+ or BBB. Note, that while defaulting entities that were not rated (NR) are not always captured in the default rate calculations for the year of default, S&P captures them in the longer-term cumulative default rate statistics, which are tied back to the year in which defaulted entities were last rated.

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*Source: S&P*

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*Source: S&P*

A graph showing the number of insurance sector

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*Source: S&P*

**7.7. How would allowing unfunded credit protection to be eligible for the STS label and the associated preferential capital treatment impact EU insurers’ business model of providing credit protection via synthetic securitisation (for example, would EU insurers account such transactions as assets or as liabilities)?**

**Response**

The business model of (re)insurance companies is to write insurance policies on the liability side of their balance sheet in favour of their clients. (Re)insurers have been active in providing credit insurance for decades and have been active in the bank unfunded SRT market since 2018. Allowing (re)insurers to participate in unfunded SRT with the STS label will not alter this fundamental aspect of their business model and so they will continue to use the liability side of their balance sheet for this business.

It is worth noting that enabling (re)insurers to participate in unfunded SRT with the STS label will lead to greater diversification within their credit portfolio. It will also increase pricing consistency between STS and Non-STS transaction and reduce the cliff effects between structures.

Please note, that the credit insurance policies written by specialist (re)insurers as part of their standard business on the liability side is very different from investments that they make on the asset side, which are used as a reserve against insurance liabilities and must have a sufficient liquidity profile in order to pay claims in a timely fashion.

**7.12. Do the homogeneity requirements for STS transactions represent an undue burden for the securitisation of corporate loans, including SMEs? Please explain your answer.**

**Response:**

The current homogeneity requirements under the STS framework present substantial challenges for small to medium sized regional banks, and even for some large domestic EU banks, due to the fragmented nature of their loan books. These banks often lack sufficiently large loan books of corporate, SME, commercial real estate (CRE), and project finance exposures to select an efficient and homogenous portfolio for structuring synthetic on-balance sheet securitisations. The strict segmentation required to meet homogeneity criteria, such as asset class, obligor type, or jurisdiction, forces smaller institutions into inefficiencies that make achieving the STS label particularly burdensome.

Domestic banks typically lack the extensive and diverse portfolios of larger institutions. To meet homogeneity requirements, these banks would need to segment their already limited loan book into narrowly defined asset pools. This results in either:

1. Multiple issuances: smaller banks would need to issue several securitisations, each tailored to meet homogeneity criteria, to cover the spectrum of their portfolios. This approach significantly increases costs related to structuring, legal, and compliance efforts; or
2. Non-granular pools: such banks may not be able to put together a sufficiently granular / diversified portfolio for securitisation, which may not satisfy regulatory standards for risk diversification or investor preferences, and thus not being able to originate STS securitisation.

Both outcomes reduce the cost-efficiency and practicality of achieving STS compliance for these institutions and places them at a competitive disadvantage to their larger regional peers.

While alternative asset classes, like retail mortgages or consumer loans, could technically meet homogeneity requirements, they often do not align with the structuring objectives:

1. Retail mortgages carry low risk weight densities, providing limited capital relief, which diminishes the value of securitisation as a capital optimisation tool;
2. Consumer loans typically exhibit higher credit risk (higher PD and LGD), while SEC-IRBA formula for retail exposures is calibrated in a more conservative way, making these exposures less attractive for securitisation due to increased transaction costs.

To enable domestic and regional banks to more readily benefit from STS synthetic securitisations without undue burden, we would propose to relax the homogeneity requirements to ensure that they can originate STS securitisations at reasonable costs, for example by allowing portfolios blended across different but similar credit asset classes (e.g., combining SME and corporate loans). It is worth noting that issuers and investors in SRT are broadly aligned on this point.

## Section 9. Prudential and liquidity risk treatment of securitisation for banks

**9.11. Do you agree that securitisation entails a higher structural model risk compared to other financial assets (loans, leases, mortgages) due to, for example, the inherent tranching? Please explain your answer.**

**Response:**

No.

Securitisation adds a structural layer to a direct investment. However, this is true for other asset backed transactions like covered bonds or infrastructure debt (e.g. project financing) as well. The senior tranche of a securitisation is not dissimilar to a covered bond - while the securitisation benefits from credit enhancement in the form of contractually subordinated capital at risk, for covered bonds the reduction in risk relative to a direct investment in the underlying assets flows from overcollateralization and recourse to the issuer. For project finance, the reduction in risk relative to a direct investment is achieved a cashflow waterfall (as with securitisations) and robust debt service coverage.

In securitisation and project financing, the impact of the waterfall used to allocate asset cashflows to investors needs to be analysed by investors.

In a covered bond, both the double default risk, including potential correlation between covered bond issuer and collateral assets, and the over-collateralization need to be assessed in order to understand the risk. While covered bonds as an asset have regulatory disclosure requirements, there are proportional and are not further specified in the context of due diligence.

In general, the structural layer rather protects investors due to structural enhancement, eligibility criteria and further covenants regarding the underlying asset class. In addition, exposure to systemic risk present for mezz tranches in securitisation is also present for certain corporate loans depending on the corporate, refinancing structure and mezz tranches for, e.g. project financings.

**9.20. Do you consider that the current levels of the (p) factor adequately address structural risks embedded in securitisation, such as model risk, agency risk and to some extent correlation, as well as the cliff effects?**

**Response:**

No

**9.21. If you answered no to question 9.20., please provide the justification, and provide quantitative and qualitative data, for whether and how the (p) factor overestimates the risks and inappropriately mitigates the cliff-effects, for specific types of securitisation exposures**

**Response:**

At Marsh McLennan, we recognize that under the SEC-SA and SEC-IRBA frameworks, the p-factor plays a crucial role in determining the level of non-neutrality. This non-neutrality reflects the extent to which the total capital requirements for securitisation tranches surpass those for the underlying assets. Such a discrepancy has significant economic implications, as it results in capital requirements that are not directly tied to the risk profile of the underlying assets, thereby increasing their cost of holding. Consequently, all else being equal, this capital non-neutrality can lead to a decline in securitisation issuance.

We believe that the p-factors utilized in the SEC-IRBA and SEC-SA risk weighting formulas, particularly the p-factor in the SEC-SA, significantly overestimates the risks associated with securitisation positions, leading to capital requirements that are disproportionate to the actual risks involved. This concern also extends to the non-neutrality present in the SEC-ERBA, which, while lacking explicit p-factors, still exhibits similar issues. The p-factor should ideally address the adequate allocation of capital between the tranches, capital neutrality and steepness of the cliff effect which is driven by systemic risk.

Furthermore, we note that the UK’s Prudential Regulation Authority (PRA) is proposing an alternative calculation for the SEC-SA p-factor, which would introduce floors of 0.5 for non-STS transactions and 0.3 for STS transactions. This calculation is based on a formula akin to that used in the SEC-IRBA. The PRA suggests that this alternative SEC-SA p-factor would significantly alter the incentives for synthetic SRT of standardised approach exposures compared to the current fixed p-factor of 1.

As a consequence, this approach will represent, if no adjustment will be implemented in the EU, a competitive advantage for SA banks and portfolios in the UK relative to EU peers.

**9.22. Do you consider that potential targeted and limited reductions to the (p) factor may increase securitisation issuance and investment in the EU, while at the same time keeping the capitalisation of the securitisation tranches at a sufficiently prudent level?**

**Response:**

Yes

Overcoming excessive capital non-neutrality would lead to a level playing field against other Asset-based financing markets. Our preferred proposal to overcome in particular, excessive capitalization for some mezzanine securitisation positions, is not to amend the p-factor directly (other than capping the SEC-IRBA p), but to reduce the steepness of the curve in capital requirements generated by p by applying a scaling factor to the underlying asset capital requirement (tranches detaching up to which are subject to 1,250% risk weighting or deduction) before its insertion into the SEC-SA formula. With the scaling factor set at 0.5, one gets capital neutrality, removing the capital surcharge but leading to slight undercapitalization for some mezz position. An adequate level would be 0.65 (with ‘p factors’ remaining at current levels/set to 1.0). A similar approach could helpfully be adopted in relation to the SEC-IRBA. This proposal would remove a significant source of non-neutrality in the framework and mitigate excess non-neutrality while guarding against potential cliff effects flowing from a simple reduction in p.

If no such scaling factor is implemented, similar to others in the industry, we would support, in the CRR, on a permanent basis whenever applying the SEC-SA module (i.e. a change benefitting SA banks/portfolios, and not merely IRB banks for purposes of calculating the output floor) that the p-factor is adjusted from 1 to 0.5, for non-STS transactions, and from 0.5 to 0.25, for STS transactions. Given the underlying principle of the output floor, there is no reason why SA banks should be discriminated against vs IRB banks given the capitalization differentiation is already covered in the application of the output floor itself.

**9.26 Do you consider that the current approach to non-neutrality of capital requirements as one of core elements of the securitisation prudential framework, leads to undue overcapitalisation (or undercapitalisation) of the securitisation exposures, in particular when compared to the realised losses and distribution of the losses across the capital structure (different tranches of securitisation) over a full economic cycle? Please explain your answer.**

**Response:**

Yes

We refer to IACPM and other exhaustive analyses on default and loss statistics of securitizations in Europe and US (e.g. “*S&P Default, Transition, and Recovery: 2023 Annual Global Structured Finance Default And Rating Transition Study*”) demonstrating lower default and loss rates compared to most underlying markets:

**Historical Cumulative Default Rates of European SF vs. Corporate for 1, 5 and 10 yrs**

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**9.27 If you answered yes to question 9.26, please justify your reasoning and provide quantitative and qualitative data to show the extent of the undue non-neutrality (overcapitalisation or undercapitalisation), in particular when compared to the realised losses and distribution of the losses across the capital structure, taking into consideration the need to cover a full economic cycle.**

**Response:**

The current design of the securitisation risk weighting formulae (SEC-SA and SEC-ERBA) embeds known weaknesses. For example, in SEC-SA, with p set at 1.0: p overcapitalises tranches in particular from 0.0x to 2.5x KA. In the range 1.0x - 2.0x KA, the capital burden for what is considered a fairly safe tranche in investment terms has a higher level of capital requirement than a delinquent asset that is implicitly risk weighted at 625%. There are no ranges of undercapitalisation. Under this calibration there is 100% more capital. The SEC-SA fails at each tranche and capital neutrality overall.

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1. Default, Transition, and Recovery: 2023 Annual Global Financial Services Default And Rating Transition Study; S&P; https://www.spglobal.com/ratings/en/research/articles/240624-default-transition-and-recovery-2023-annual-global-financial-services-default-and-rating-transition-study-13137806 [↑](#footnote-ref-1)