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IPD Response, Targeted Consultation on the EU Securitisation framework

Insurance & Pension Denmark is the business association representing Danish insurers, including life insurers and multi-employer pension companies. Our members manage pension savings on behalf of around 90 pct. of all Danish wage earners. Total savings comprise some 4,000 bn. DKK, equivalent to around 150 pct. of Danish GDP.

Members of Insurance & Pension Denmark would be natural investors in securitizations. But for reasons elaborated on below, hardly any Danish life insurers and pension companies invest in this type of asset.

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The EU Securitisation Regulation, which came into effect in 2019, was designed to overhaul and standardize the securitisation market within the European Union. Its goals were to promote a more transparent, efficient, and resilient securitisation market by providing a regulatory framework that would help banks and other financial institutions free up capital while ensuring greater investor protection and financial stability.

While the regulation has had both positive and some challenging effects, we would like to take the opportunity and point out that the regulation bears evidence of a political ambition to never again allow a financial crisis as the one we saw in 2008. This has been accomplished as far as the EU market goes. The securitization market is all but dead and gone and, in our view, a revival of the market is not possible without significant scaling back of the regulatory requirements.

Insurance & Pension Denmark believes the regulatory requirements towardssecuritizations can be scaled back without compromising safety and financial stability. Please see further below for some suggestions on how to approach this.

The Danish pension business generally holds a positive view of securitisations. The products can be a way for pension companies to invest customers’ savings in asset classes that are otherwise difficult for pension companies to tap into. Further, pension companies have the opportunity to invest in the tranches of a securitization that best fit their desired risk/reward. So, theoretically, the EU securities regulation, had it been designed appropriately, should have made securitisations a massive hit, at least for Danish pension companies.

The reason why this has not been the case is two-fold:

Firstly, as seen from the perspective of the Danish pension business, the very extensive due diligence and ongoing monitoring obligations laid down in article 5 of the regulation.

Danish pension companies are regulated under Solvency II. Therefore, the prudent person principle, ref. the Solvency II Directive art. 132, is the governing principle for these companies’ investments. It states that companies may only invest in assets where the company can identify, measure, monitor, manage, control and report on the risks of the asset. And further, that companies are obliged to invest in a way that ensures the quality and profitability of the portfolio in relation to ensuring that customers get the benefits they expect.

Thus, pension companies must carefully consider whether securitizations align with their broader risk management framework and whether they can meet the Solvency II regulatory expectations for risk identification, diversification, and solvency management. While securitizations may offer attractive returns, the regulatory requirements under Solvency II impose a significant burden on insurers to ensure that such investments are managed in a way that protects policyholders and ensures long-term solvency.

Adhering to the Solvency II prudent person principle, although a complex and burdensome task, is, obviously, something Danish pension companies take very seriously.

However, against the background of the Solvency II requirements the additional requirements laid down in article 5 of the securitization regulation become a significant hindrance for companies’ investing in securitisations.

Specifically, Article 5 addresses the due diligence requirements for institutional investors participating in securitisations.

In order to comply with article 5, pension companies must

* ensure – and document - that they carry out adequate due diligence when investing in securitisations, They need to assess and understand the risks associated with the securitisation, including the structure, the underlying assets, and the potential impacts on their portfolios.
* have a thorough understanding of the risk involved in the transaction, including the risks related to the underlying assets and the overall structure of the securitisation. This also includes understanding the credit quality and the expected performance of the underlying securitised assets.
* ensure they have access to sufficient and relevant information, including information about the securitisation itself, as well as the underlying assets, before investing and on an ongoing basis.
* ensure that originators, sponsors, and original lenders in a securitisation retain a meaningful portion of the risk associated with the securitised assets.
* Pension companies must verify that the risk retention rules are being complied with as part of their due diligence process and ongoing.

These requirements, while fundamentally sound, adds a significant extra layer to the requirements found in the prudent person principle. This is not conducive for pension companies to invest in securitisations.

Further, where the prudent person principle requires pension companies to ensure the quality and profitability of the entire portfolio, and thus allows companies to exercise proportionality where investments are of a magnitude that allows for this, the securitization regulation article 5 calls for due diligence and ongoing monitoring and verification regardless of the size of the investment, and there seems to be no leeway for carrying out more limited due diligence, monitoring etc. if the investment is in the senior tranche of a securitisation. This is clearly a hindrance for investing. Also, if a pension company would invest in a portfolio of securitisations eg. through an external manager, the obligation to carry out due diligence, monitor and verify on an ongoing basis remains with the pension company, as there seems to be no allowance for outsourcing these tasks. It would, no doubt, promote securitisations if pension companies were able to give a securitization investment mandate to an external manager who could build up sufficient expertise in performing the requirements under article 5 on behalf of one or more pension companies.

Secondly, for reasons that are not entirely clear, the issuance of securitizations – particularly in Denmark – seems very limited. In fact, we’re not aware of any securitisations having been issued in Denmark since the introduction of the securitization regulation. Representing the investor side, we do not have deep insight into the reasons behind this lack of issuance. It is our impression, however, that potential issuers have been experiencing difficulties with regard to competent authorities acknowledging that planned securitisations would in fact be in compliance with regulations regardless of the quality of procedures and documentation put forward.

For the reasons stated above, if pension companies are to invest in securitisations to any significant extent and thereby help free up bank capital, provide capital for SMVs etc., we urge the EU-Commission to align securitization rules with sound company and customer protection rules that are already laid down in sectorial regulation, here the Solvency II-regulatory complex.

We would like to reiterate that a prerequisite for establishing a more well functioning securitization market is that regulators and national competent authorities begin to view securitizations as relevant financial instruments. They can help banks free up capital, and manage risks on their loan portfolio, and they can provide a good investment opportunity for pension companies providing diversification into asset types that are otherwise difficult to tap into. But, if they are to have a place in the market they can’t be regulated to death as is currently the case. Thus, we also urge that the Commission, in conjunction with EBA, EIOPA and ESMA ensure that national competent authorities adopt a more constructive approach towards securitisations.

We would like to close this note with some suggestions regarding approaches the EU Commission could take in order to make the securitization regulation more manageable without compromising investor protection and financial stability:

* Due diligence requirements for (some) institutional investors are excessive and redundant, as the requirements towards these investors are already laid out in sector specific regulation. Thus, removing altogether or, at least, narrowing down due diligence requirements to the absolute necessities would be helpful without compromising safety.
* Simplifying or tiering disclosure requirements based on the size and complexity of the securitization and tailored to individual tranches could help reduce costs and administrative burden without significantly undermining transparency. Complex securitisations, entailing more risky underlying assets could still face more robust requirements.
* We believe that pension companies are both able to and have a keen interest in assessing thoroughly the risks of their investments. Thus, enhancing transparency and the availability of data on underlying assets, credit ratings, and other key features can support investors in making good investment decisions and reduce the need for overregulation. Further, allowing for external asset managers to manage securitization investments on behalf of institutional investors would allow for highly specified knowledge build up with such managers. We believe this would be akin to the way many pension companies invest in unlisted assets via fund managers. External securitization managers could be required to have some extent of skin-in-the-game.
* Regulators could assess whether the frequency and level of reporting are necessary for all securitizations. For less risky, simpler deals, reporting could be less frequent, thereby reducing the regulatory burden while still ensuring adequate oversight.
* Regulation could focus on more risky areas within the securitization market while thoose involving more stable, traditional assets could have lighter regulation.
* Moving from a very prescriptive regulation to more principles-based oversight could be a way to scale back regulation without compromising financial stability. Competent authorities could monitor the behavior of market participants, the quality of underwriting, and the overall health of the securitization market through ongoing surveillance rather than excessive prescriptive requirements.
* Regulators could also provide clearer guidance on acceptable practices, fostering a better understanding of the limits of risk-taking, while reducing the volume of rules and paperwork required.