
S&P Global Ratings

Response from S&P Global Ratings to the European Commission's Targeted Consultation on the Functioning of the EU Securitization Framework

S&P Global Ratings welcomes the opportunity to respond to the European Commission's consultation on the functioning of the EU securitization framework.

For any questions related to this response please contact Andrew South, Managing Director, Head of Structured Finance Research, EMEA (andrew.south@spglobal.com) and David Henry Doyle, Vice President, Head of Government Affairs & Public Policy, EMEA (davidhenry.doyle@spglobal.com).

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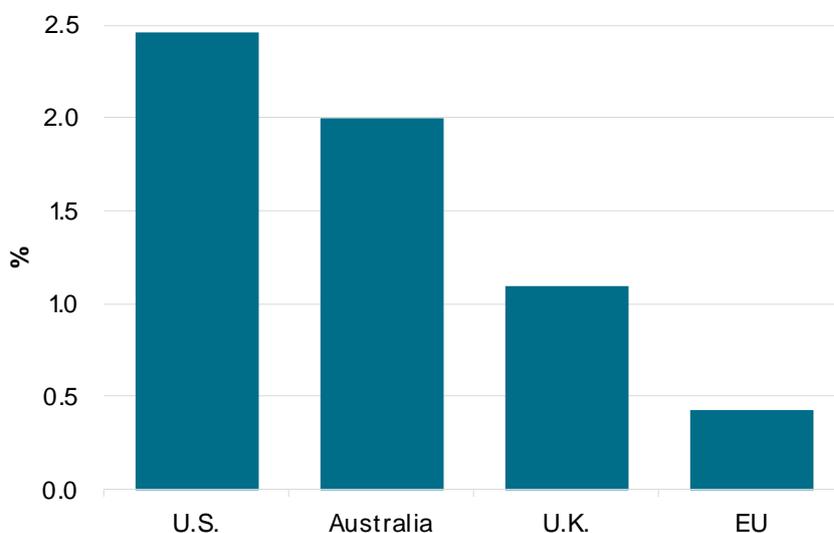
The Potential Role of Securitization in the Capital Markets Union

The development of a robust securitization market could play an important role in furthering the objectives of the EU's Capital Markets Union (CMU) project.

Securitization can act as an alternative funding source for banks and non-bank lenders, helping to reduce financing costs for end borrowers such as companies and households. When used as a risk transfer tool, securitization can free up capacity on the balance sheets of lenders, enabling the extension of new loans to finance various needs. This includes green and digital projects that align with Europe's long-term economic strategy and sustainability goals.

Despite this potential, the EU securitization market has stagnated since the Global Financial Crisis (GFC) and remains underdeveloped compared with other regions (see chart 1). In the EU, outstanding public investor-placed securitization amounts to less than €400 billion, according to our estimates. By comparison, the U.S. market stands at about €3500 billion (or well over €10 trillion when including the U.S. agency securitizations), according to data from the Association for Financial Markets in Europe (AFME Q2 2024 Securitisation Data Report, 22 October 2024).

Chart 1: Public Investor-placed Securitization Issuance Over GDP, 2018-2023



Source: National statistical offices, S&P Global Ratings.

Potential Benefits of a Targeted Review

In our opinion, a targeted review of the EU regulatory framework for securitization presents an opportunity to address existing barriers to the market's development. While the regulatory framework has brought some benefits, its investor due diligence requirements, for example, have likely suppressed buyside participation.

In addition, the unfavorable treatment that securitization exposures receive in regulatory capital and liquidity rules may also have deterred some investors and originators. The current regulatory requirements for both the supply and demand sides of the market may not take account of the robust performance track record of the prevailing types of securitization products in the current market.

A targeted review could allow the EU market to develop further and help unlock significant capital flows to support the EU's strategic objectives and economic resilience. In our view, reforms are likely necessary on multiple fronts, given the interconnected nature of the current barriers to an issuance revival.

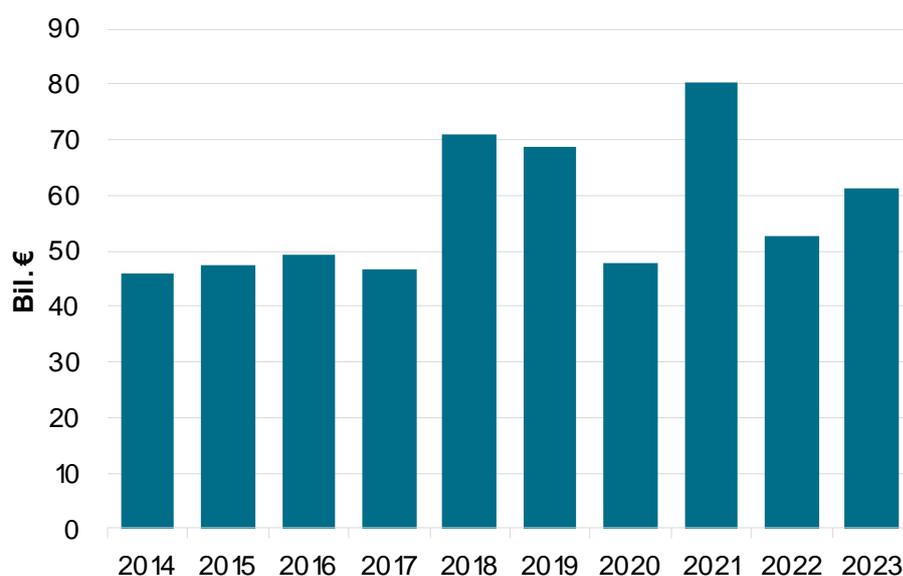
However, any proposal to streamline regulations, to encourage greater participation from institutional investors, and to enhance the overall scale and liquidity of the market should maintain necessary safeguards. In the following sections, we comment on some of the topic areas set out in the European Commission's consultation paper.

Effectiveness of the Securitization Framework

In our view, the current EU securitization framework has not achieved its core objective of reviving the market to help finance the economy. Public investor-placed securitization issuance in the EU has been largely range-bound between €40-€80 billion per year for the past decade.

Issuance levels are similar before and after the framework was implemented in 2019 (see chart 2). This would appear to indicate that the revised regulatory regime had minimal impact in stimulating securitization as a funding and risk transfer channel.

Chart 2: Public Investor-placed EU Securitization Issuance



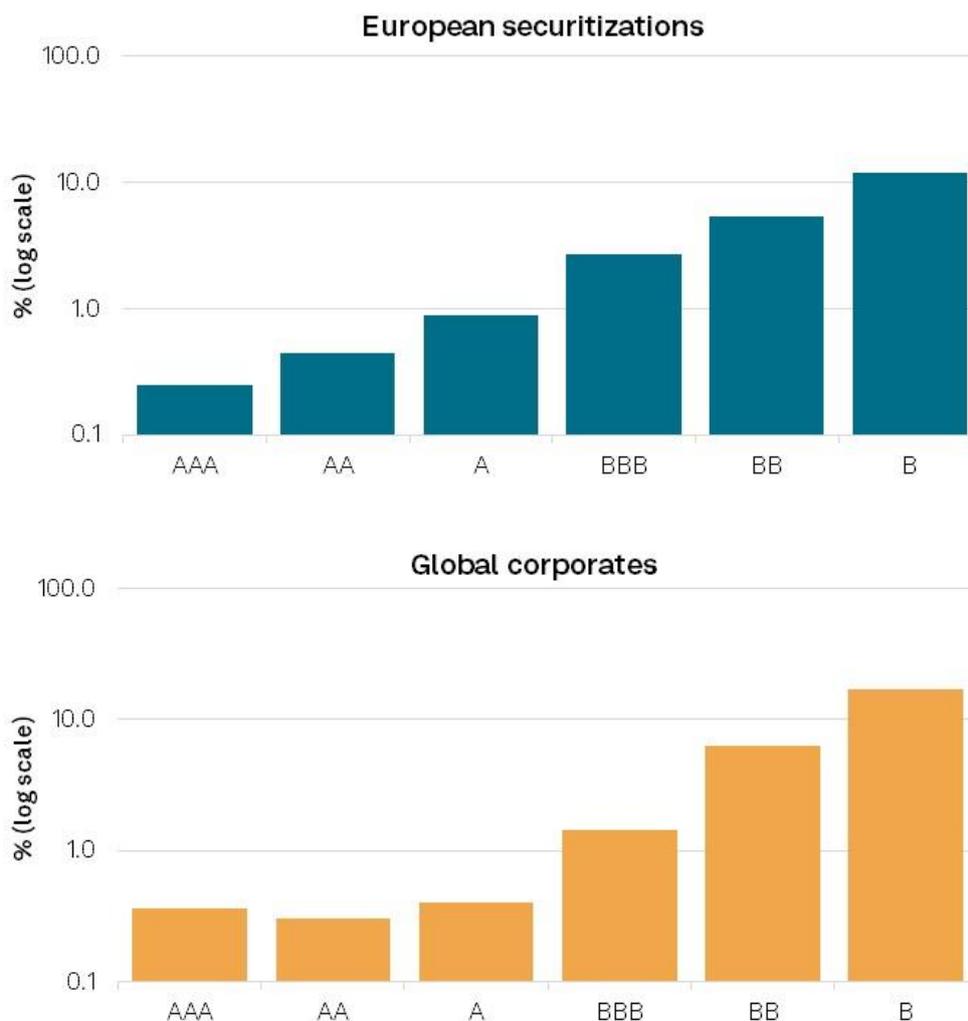
Source: S&P Global Ratings.

Since the GFC, the formalization of risk retention rules to reduce agency risk—and the effective removal of resecuritizations from the market—are both widely accepted as positive developments. The introduction of the "Simple, Transparent, and Standardized" (STS) label has likely been neutral for the market. However, certain aspects of the framework have introduced requirements that duplicate risk mitigants and may curtail issuance.

For example, the issue of perceived agency risk and information asymmetry between securitization originators and investors is mitigated by risk retention requirements and detailed transparency rules. The same risk factors are also reflected through high non-neutrality factors in banks' regulatory capital formulae. Unless calibrated to avoid duplication and to reflect historical performance, the combination of elements in the framework addressing the same risk factors may constrain interest in securitization.

In terms of observed credit performance, the types of transactions that make up the current European securitization market have performed similarly to mainstream corporate credit over their 40-year history (see chart 3). The market's resilience has now been tested through multiple economic cycles and periods of stress, including the GFC, the eurozone sovereign debt crisis, and the COVID-19 pandemic.

Chart 3: Five-year Cumulative Default Rates – European Securitizations vs. Global Corporates



Source: S&P Global Market Intelligence CreditPro. Based on 1983-2023 period for tranches rated by S&P Global Ratings. European securitizations data based on currently active sectors, i.e., ABS, RMBS, CMBS, and corporate-backed CLOs.

Due Diligence Requirements

A thorough due diligence process is important to ensure that investors understand what they are buying and can appropriately assess the risk and return characteristics of their investments. However, the due diligence requirements of the EU securitization framework are complex and could be simplified.

Simplification which aligns with practical investor needs may increase interest in the asset class among prospective market participants and reduce existing barriers that constrain market growth. Overly granular and prescriptive due diligence requirements may not anticipate or account for all the possible circumstances in which they will be applied.

For example, some references to the "original lender" in Article 5 may implicitly assume that this entity is involved in the securitization. Often this is not the case, making the rules difficult to interpret. There are also references that assume investors are purchasing securitization exposures in the primary market. For a secondary market trade, the way that due diligence requirements are expressed relative to milestones in the purchasing process may not be suitable.

Context can also be an important consideration in determining the details of an appropriate approach to due diligence. For example, context could include whether the investor has prior experience of—and interactions with—the originator, whether the transaction involves a debut originator, and whether the securitization exposure is more senior or more junior in the capital structure. Codifying such differences in an overly templated approach would be difficult and may generate additional administrative requirements which could result in reduced investor interest.

Overly prescriptive due diligence requirements can also quickly become outdated in a market known for its innovation. The types of underlying collateral backing securitizations, market practices, and transaction structures can and do evolve. For example, in the past 12 months S&P Global Ratings has published half a dozen commentaries in our "ABS Frontiers" series on prospective emerging securitization asset classes that have indications of originator interest.

The ability to adapt and evolve can be one of the potential benefits of the securitization market to the EU economy. However, investor due diligence rules which do not account for this aspect of the asset class may create unintended barriers. It may make sense, for example, to provide a more principles-based, proportionate, and less complex approach to due diligence which provides investors with the necessary flexibility to account for different situations when applying the requirements in practice.

Finally, a subset of the current due diligence rules require that investors verify the originator, sponsor, or original lender's compliance with some of their own rules which are already subject to supervision elsewhere. This includes risk retention and disclosure requirements. This additional application of supervision to other market participants may place duplicative burdens on investors.

Transparency Requirements

Disclosure and transparency requirements represent a core component of the securitization framework. This is the element of the framework that most directly mitigates information asymmetry between securitization originators and investors and ensures that investors have access to the fundamental information required for their decision-making.

As with the investor due diligence requirements, however, the current framework's transparency requirements may be overly detailed and prescriptive. This can lead to similar challenges regarding contextual flexibility and relevance, as described above with respect to due diligence.

For financial products that share similarities with securitizations, such as covered bonds, reporting on the underlying cover pool is less detailed and conducted at a higher level of aggregation. Some rationalization in transparency requirements could therefore make sense.

However, in our view, switching to a solely principles-based transparency approach would risk shrinking the existing investor base, whose processes may be based to some extent on current template-based reporting. For existing issuers, there would be little cost advantage as they have already established their reporting systems. While prospective new issuers may benefit, reporting norms and standards would likely diverge over time. This would effectively place a cost and resource burden onto investors as they develop the ability to handle multiple reporting formats.

It could be anticipated that originators are in a better position to comply with a standardized reporting format than investors are to deal with multiple reporting formats from different originators. Standardization of transparency requirements therefore reduces overall market frictions for all stakeholders.

Generally retaining the current philosophy for transparency requirements would therefore make sense. This could include basing the requirements on specified templates. However, the current templates could also benefit from some streamlining, as suggested in the Commission's consultation paper.

Prudential and Liquidity Treatment of Securitization for Banks and Insurers

Banks are core participants in the securitization market. As originators, they use securitization to diversify their funding sources. They also increasingly use securitization to manage their balance sheets and capital, through so-called "significant risk transfer" (SRT) transactions.

As investors, banks can typically buy between 25% and 75% of the debt placed with investors in a new securitization issuance. However, given the limited scale of the European securitization market, investments in this asset class only constitute a very small portion of banks' treasury assets. Some banks also have securitization exposures through their provision of ancillary services, such as transaction accounts or interest rate swaps.

The securitization process may involve agency and model risk, which should be accounted for in any regulatory framework. The EU securitization framework seeks to account for and mitigate agency risk in several ways. A key element is the inclusion of risk retention requirements by the originator. In addition, the seller's potential information advantage is reduced by the combination of transparency and due diligence requirements.

However, the prudential treatment for banks in the EU securitization framework may not adequately account for the credit performance of securitization products in the European market (see chart 3 above).

Under bank capital rules, the aggregate regulatory capital charge is increased relative to the charge for the underlying loan pool ("non-neutrality"). However, the same level of agency risk would apply in the sale (by an originator) and purchase (by a bank) of an unsecuritized loan pool. In this case, though,

none of the above requirements would apply. This raises a question over whether the combination of requirements in the securitization framework are proportionate.

The act of tranching in a securitization does not alter the credit loss characteristics of the underlying collateral pool. Tranching does introduce model risk because tranche-level losses can be more sensitive to the details of the assumed underlying loss distribution. However, this is a more significant consideration for thinner tranches towards the bottom of the capital structure, which is not where banks typically have securitization exposure. Rather, both banks that originate SRT securitizations and those that invest in tranches issued by other originators typically only have exposure to senior tranches.

Risk Weight Floors

Risk weight floors in the capital framework are important both for banks that originate SRT securitizations and banks that invest in senior tranches. For the former, the scale of the risk weight floor limits the amount of capital relief that they can achieve with an SRT securitization. For the latter, the floor constrains return on capital for the securitization investment.

When the securitization framework was introduced in 2019, the risk weight floor increased from 7% to 10% for STS securitizations and to 15% for non-STS transactions. This increase may not have adequately accounted for the other safeguards that the framework introduced and the track record of credit performance. For some securitization investors, this would have reduced their return on regulatory capital by more than half, i.e., if the investment's risk weight more than doubled from 7% to 15%.

Floors in the current framework may also not be risk-sensitive given that they are independent of the risk weight of the underlying collateral pool. For some types of assets—such as lower-risk residential mortgage loans—a senior securitization tranche (even if it has substantial credit enhancement) can have a higher risk weight than the unsecuritized, unenhanced asset pool, which is counter-intuitive. In practice, this means that it is not possible for an originating bank to achieve any capital relief on an SRT securitization backed by such assets, regardless of how much risk is transferred.

Model risk relates to uncertainty surrounding the way in which the credit risk of the underlying portfolio is apportioned across the capital structure, rather than uncertainty over the scale of that credit risk. To the extent that risk weight floors are intended to account for this model risk (at least on senior tranches), it may be more logical that the floors are themselves a function of the risk weight on the underlying pool, rather than a fixed level.

As a hypothetical example, if the risk weight floor were set at 10% of the pool risk weight, then this might equate to a 10% floor for a securitization backed by lending to corporates, but 2% for a transaction backed by low-risk residential mortgage loans.

A calibration in risk weight floors which aligns more directly to the underlying credit risk and performance history could stimulate demand for senior securitization tranches from bank investors, given the corresponding increase in their return on capital for such an investment. In addition, such calibration could increase the use of securitization by banks for risk transfer, as it would generate somewhat higher capital relief. As also described above, it could also broaden the range of underlying loan types for which SRT securitization makes economic sense.

The 'p' Factor

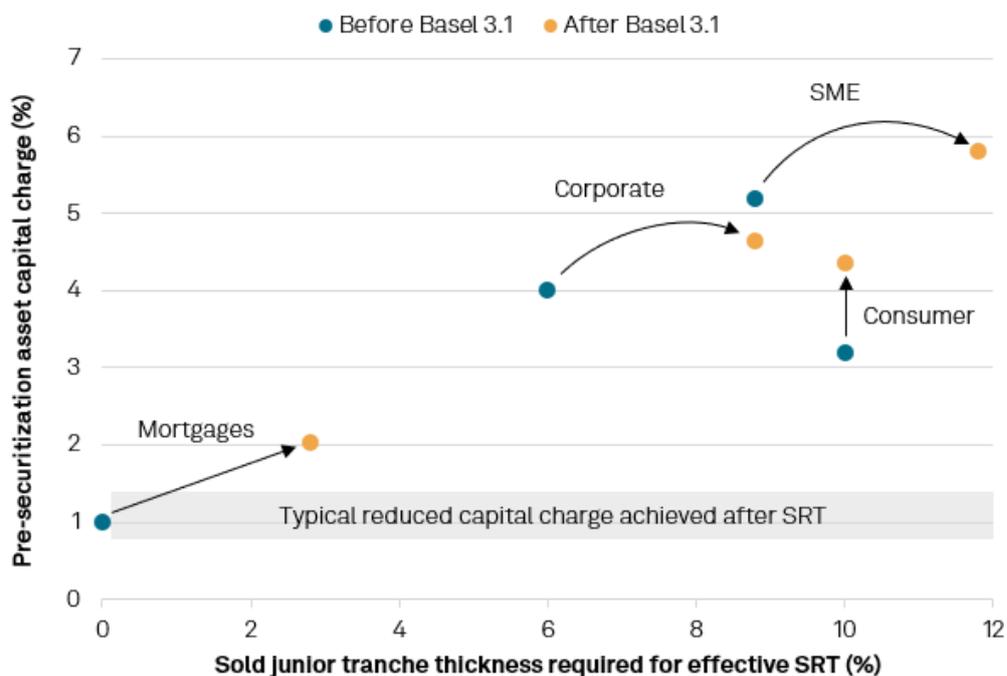
The non-neutrality factor (p factor) in the bank prudential framework is a major determinant of the economics of SRT securitizations for bank originators as it affects the conditions under which they can achieve targeted capital relief.

SRT securitizations are a key mechanism for consideration given the objectives of the CMU. While more traditional securitizations can provide an alternative funding channel for banks (and non-bank lenders), risk transfer securitizations reduce the economy's dependence on the banking system's capacity to extend credit, by enabling them to recycle capital and increase lending velocity to borrowers such as consumers or small and midsize enterprises (SMEs) (see also "[Banks Ramp Up Credit Risk Transfers To Optimize Regulatory Capital](#)", published 22 February 2024).

The upcoming implementation of Basel 3.1—including the introduction of an aggregate capital output floor for some banks—adds to the importance of appropriate p factor calibration. A likely consequence of the output floor could have been to make many SRT securitizations uneconomic.

The EU appears to have acknowledged this issue and made transitional arrangements that allow banks to halve the p factor applied in the output floor calculation. Even with this derogation, however, we calculate that SRT securitizations become more challenging under Basel 3.1 once the output floor is fully implemented (see chart 4).

Chart 4: Incentive vs. Challenge for EU SRT Securitization



Source: S&P Global Ratings. SME—Small and midsize enterprises. SRT—Significant Risk Transfer.

The current p factor calibrations may continue to result in challenging outcomes for banks. In some scenarios, for example, the p factor is one, meaning that overall capital requirements for the securitized capital structure are double those of the unsecuritized underlying pool. Such a result may be difficult to justify on the grounds of securitization agency and model risk, especially given other mitigants contained in the securitization framework.

In general, it is also not clear why non-STS exposures should attract a higher p factor than STS exposures, given that the STS framework does not appear to differentiate the types of risks that the p factor is intended to address.

Targeted recalibration of the p factor may therefore be a relevant consideration in any review of the EU framework. The most important impact of an appropriate p factor recalibration would likely be to reduce the size of junior/mezzanine tranches that an originating bank would have to sell to achieve significant risk transfer and corresponding capital relief, thereby potentially stimulating more SRT securitization activity.

Liquidity Coverage Ratio and Solvency II

Bank investors typically take a reasonable share of primary securitization issuances, but this is only in the context of the small scale of the market. In the context of the overall balance sheets of banks, their holdings of securitization tranches are dwarfed by other asset classes, such as sovereign bonds. While some insurers historically invested in mortgage risk through securitizations, the Solvency II treatment of these exposures mean that they are now more likely to do so via mortgage funds.

As noted in the Commission's consultation paper, securitizations account for less than 1% of EU banks' liquid asset portfolios, likely due to the high haircuts applied on securitization assets in banks' liquidity coverage ratio (LCR) calculations. Similarly, EU insurers generally allocate less than 1% of their investment assets to securitization positions.

We note that some securitization industry studies have examined liquidity measures for senior securitization tranches in vanilla asset classes—such as those that are eligible as high-quality liquid assets (HQLA) in the LCR calculations (see, for example, "ABS and Covered Bond Risk and Solvency II Capital Charges", Perraudin & Qiu, Risk Control, February 2022).

These studies suggest that such tranches have not exhibited systemically greater market value volatility than similar asset classes—such as covered bonds—or at least not to the extent implied in the Solvency II and LCR rules. Although not directly related to liquidity, such asset classes have also seen stable credit performance over long timeframes, as witnessed by limited ratings transitions, for example.

These findings are promising, especially since they have been made in a context where other elements of the securitization framework are arguably hampering liquidity. For example, due diligence rules constrain secondary market trading, which negatively impacts liquidity and further limits the investor base. It is therefore hard to assess how dynamic the secondary market might be if multiple elements of the framework were to be reformed.

Greater diversity in banks' and insurers' asset portfolios could also be a positive development. When there have been fixed income market value and liquidity shocks over the years, they have tended to be specific to certain credits and/or market structures. Diversification of high credit quality asset holdings among banks and insurers could therefore help mitigate the effect of future shocks.

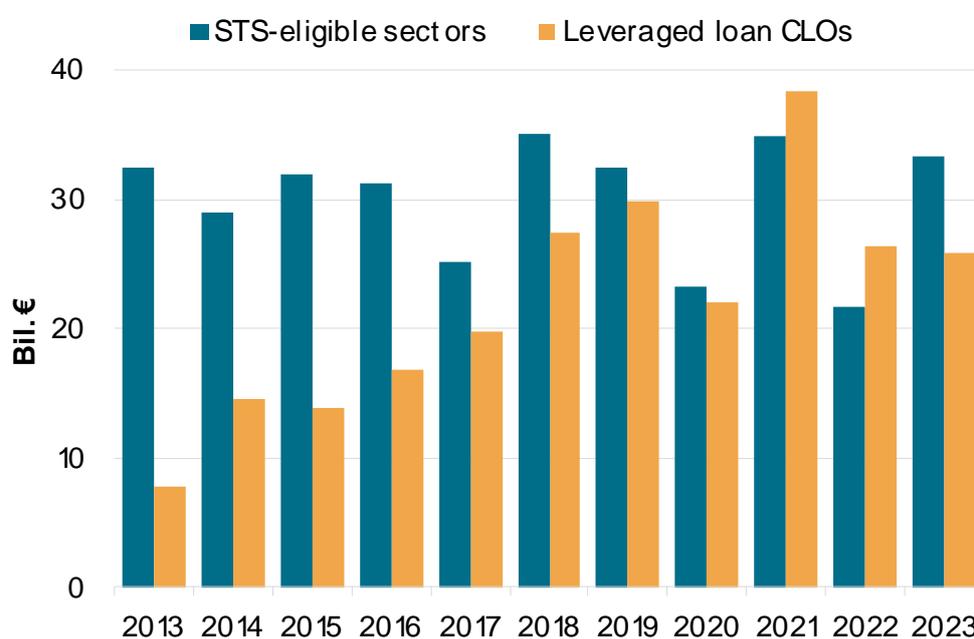
STS Standard

The introduction of the STS standard has had limited impact in terms of reviving the European securitization market. The label's existence provides another way to segment the market into two categories but has likely not fundamentally affected the course of development for either.

Originators consistently use the STS label in those asset classes where typical transaction characteristics already lend themselves to achieving eligibility. Since 2019, nearly all EU ABS and prime owner-occupier RMBS transactions have carried the STS label. By contrast, the vast majority of CMBS, leveraged loan CLO, buy-to-let, nonconforming, and reperforming RMBS transactions have not used the label.

However, there is little evidence that the type of transactions which could typically qualify for the STS label have seen greater issuance growth due to the label's existence, or relative to non-STS products. Conversely, the largest European securitization sector in which transactions systematically do not qualify for the STS label—the leveraged loan CLO sector—saw compound annual issuance growth of nearly 13% from 2013-2023, while issuance in potentially STS-eligible sectors remained broadly flat over the same period (see chart 5).

Chart 5: Public Investor-placed EU Securitization Issuance, STS-eligible vs. CLO



Source: S&P Global Ratings. Proxy for STS-eligible sectors includes all EU ABS and RMBS except Irish RMBS, due to the prevalence of nonperforming and reperforming collateral not eligible for the STS label.

Overall, the introduction of the STS label has likely been neutral for the EU securitization market. Although it has had limited impact on the growth of the market for STS securitizations, there does not appear to be any negative impact on non-STS products. The label is consistently used for certain asset classes, which may be due to the economic incentives for some regulated investors, including lower capital charges and (limited) LCR eligibility for banks, for example.