ESMA Templates: not fit for risk sharing transactions

Applying true sale securitisation reporting standards to balance sheet synthetic trades might have unintended consequences for banks and investors.

Context

Joint European supervisory authorities have taken the universally welcomed decision to strengthen the securitisation market in Europe by introducing reporting templates for securitisation. The European Securities and Markets Authority (ESMA) has been tasked with drafting these templates for the different types of transactions in the securitisation market. While we strongly support standardisation and the creation of sound reporting standards, the templates as currently drafted will have unintended and undesirable consequences for risk sharing transactions, also known as balance sheet synthetic securitisations.

PGGM invests in risk sharing transactions since 2006 and over time we have built a € 6 billion portfolio on behalf of our client, the € 238 billion Dutch Pension Fund for the care sector, PFZW. Unlike in true sale securitisations, where a bank originates a certain portfolio of loans and subsequently sells it to investors, loans in risk sharing transactions remain on the bank's balance sheet. The expected losses on the loans plus an additional buffer are borne by the investor, with banks required to retain some net economic exposure to ensure "skin in the game".

In exchange for taking that credit risk, the investor in a risk sharing transaction is paid a premium by the bank. While true sale transactions are predominantly used for funding purposes, risk sharing transactions offer banks a tool to manage their capital. Not surprisingly, the popularity of risk sharing transactions within the banking community has grown noticeably in recent years, offering an attractive instrument for investors as well as a means to partially address increasingly stricter capital requirements for banks across the world.

Potential issues with proposed reporting standards

Standardised *minimum* reporting standards (the required information that banks provide to potential investors about the loans in the portfolio they would like to securitise) might increase transparency in the securitisation market, improve price discovery and ultimately help attract new investors and issuers. However, the set of reporting standards currently proposed seems to have been designed with true sale securitisation in mind and, most importantly from our point of view, contain elements that make best practices in investment analysis for risk sharing transactions more difficult to implement. Specifically, we see two major issues with the current standardised reporting templates.

The first relates to **client confidentiality:** many risk sharing transactions, and certainly the ones we invest in, are structured as blind pools, in which the names of the borrowers included in the portfolio are not disclosed. Crucially, all relevant risk-sensitive features of the borrower are disclosed in detail, such as the borrower's economic sector, country of operation, the maturity, currency and security level of the loan being securitized, and the bank's internal rating and estimated loss given default for that loan and borrower. The last two items in the list are key inputs in our pricing methodology. Together with extensive actual historical data of a representative loan book and credit events covered in the risk sharing transaction we come to our own prediction of expected losses under different economic scenarios. However, because of confidentiality restrictions, many banks would not be able to share internal rating data on individual obligors unless the data remains behind Chinese walls and the name of the obligor remains undisclosed. Therefore, it is crucial that the confidentiality of such data can be preserved which is not possible by requiring banks to provide detailed data on financials, region within a country and economic sector of the borrower. The level of required granularity in this data is so high that the investor can easily identify the actual borrower, especially in case of a large corporation. For example, one can easily guess the identity of a very large telecommunications company in Madrid, especially when financial statement data is also disclosed as this is also publicly available. The same would apply for a very large Chemicals company in South-Limburg.

Therefore, the templates create the risk that banks will not be able to share with investors the borrower internal rating and loss given default data. This data is so crucial to us, that not receiving it may lead to the conclusion that we are unable to do the necessary analysis to make investment decisions at all.

The addition of more data fields is not the solution, however, changing a number of data fields is. The solution we propose is to swap non-relevant data for essential data, and this will not result into real loss of information value. The reason for this is that the internal rating and loss given default metrics already incorporate a lot of different data. The bank's credit officers assess all information they have including a borrower's financial statement data, business viability and management quality and express their findings in an internal rating for probability of default and expected loss for a particular loan upon default.

The second issue we see relates to the **complexities** that the new standard reporting would create for **non-European banks** who wish to enter into a risk sharing transaction. The proposed regulation will be applicable in Europe only. While non-EU banks cannot be required by the regulation to fill in the templates, as they are not based in the EU, any EU-based investors must verify that they received information in the appropriate format – meaning in accordance with the templates. In short, transacting with any EU-based institutional investors would mean that non-EU banks will become obliged to complete the templates as well. Similar to EU banks it would impose a burden, and in addition for non-EU banks it would increase complexity as several fields must specifically be completed based on EU definitions. Two examples of this are the definitions of default and leveraged loans, which have been harmonized across the EU but are not required to be adopted by non-EU banks in the same way.
A non-EU issuer cannot reasonably be expected to track such definitions. This puts EU-based investors at a serious competitive disadvantage.

Proposed changes to mitigate unintended consequences

We believe that the following changes could help mitigate the unintended consequences we highlighted.

1) We propose to exempt the issuers of private securitisation transactions from the requirement to provide data in accordance with the ESMA templates and exempt investors from verifying that such data has been received.

   Alternatively, there could be increased flexibility in the manner of compliance with the regulation, particularly for private transactions. For example, rather than requiring strict compliance with the template, a "comply or explain" principle could be adopted, allowing the issuer and investor to jointly agree to deviate from the template as long as it can justify the deviation, for example for confidentiality reasons.

   Another possibility could be to use a template specifically designed for blind pool risk sharing transactions. We have drafted such a template based on the ESMA corporate template (Annex 4), by removing any troublesome or unnecessary data fields and adding the fields we absolutely require. We believe having such a template added to the set will be of great help and at the same time we realise there may still be data challenges for certain securitisation transactions.

2) We propose to clarify that a non-EU issuer is not required to disclose information on the basis of the templates even when the investor is an EU-based institution, and that any EU-based investor is not required to verify a non-EU entity's compliance with the disclosure templates. This would alleviate the competitive disadvantage that would otherwise occur for EU-based investors.

Concluding remarks

We realise that by now the window for getting a change implemented is small, given the proposal is already with European Parliament. At the same time, we feel we should seize any opportunity to try as we genuinely believe that this will possitively contribute to the development of the credit risk sharing market Therefore, earlier this year we shared our feedback with ESMA and the European Commission.

Together with the joint European supervisory authorities we welcome a sound and sustainable securitisation market in Europe, and we hope the unintended consequences will be recognized as truly undesired side effects and addressed by European Parliament.

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