EU-Regulation

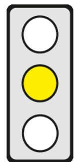
SECURITISATIONS AND COVID-19

cep**PolicyBrief** No. 2020-11

KEY ISSUES

Objective of the Regulation: Changes to the securitisation rules aim to support the lending capacity of banks in the COVID-19 crisis.

Affected parties: Banks, investors in securitisations.



Pro: (1) The proposed exceptions for NPE-securitisations reflect their specific nature. The proposed easing of prudential rules is acceptable because it is limited to senior tranches of already heavily discounted NPE-exposures.

(2) Even though experience with true-sale securitisations is very limited, preferential treatment for on-balance-sheet synthetic securitisations is acceptable. The minimum requirements regarding the credit protection agreement and the limitation to senior positions that meet additional risk concentration criteria are adequate conditions for such treatment as they significantly reduce risks to banks.

Contra: (1) As the entry into force of rules on the maximum leverage ratios of banks has been delayed because of the COVID-19 crisis, it will be important for supervisors to monitor the impact of the proposed prudential easing on bank leverage.

(2) The proposals risk intensifying the bank–state nexus which may increase systemic risks.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2020) 282 of 24 July 2020 for a **Regulation** of the European Parliament and of the Council amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for **simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic**;

Proposal COM(2020) 283 of 24 July 2020 for a **Regulation** of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards **adjustments to the securitisation framework** to support the economic recovery in response to the COVID-19 pandemic.

Brief Summary

Unless mentioned otherwise, articles refer to Articles of Regulation (EU) 2017/2402 as amended by COM(2020) 282.

- **Definitions and context**
  - Securitisation refers to the pooling and conversion of credit claims of banks into tradeable securities.
    - In the case of true-sale securitisations, the original creditor of credit claims ("originator") transfers the claims to a third party ("special purpose entity" or SPE) which issues the securities that may be bought by investors.
    - In the case of "synthetic securitisations", the credit claims remain with the originator and only the risks associated with them are transferred to investors.
  - Since 2019, an EU Regulation sets out general rules for securitisations and an EU-label for simple, transparent and standardised (STS) securitisations [Regulation (EU) 2017/2402, see cep**PolicyBrief**]. It covers true-sale securitisations only. Banks investing in STS-securitisations profit from preferential regulatory treatment.
  - Securitisations allow banks to remove credit risks from their balance sheets. This frees up bank capital and increases the lending capacity of banks.
  - The proposal is part of an EU Capital Markets Recovery Package. The package also includes amendments to
    - the Markets in Financial Instruments Directive [MiFID II, 2014/65/EU, see cep**PolicyBrief**] to alleviate information requirements for investment firms and help nascent energy derivative markets [see forthcoming cep**PolicyBrief**];
    - the Prospectus Regulation [(EU) 2017/1129, see cep**PolicyBrief**] creating a new short form „EU Recovery Prospectus" to facilitate the raising of capital in public markets [see forthcoming cep**PolicyBrief**];

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- **Aim and key elements of the proposal**
  - The Commission wants to support the lending capacity of banks and fund the economic recovery after the COVID-19 crisis by
    - adapting the general rules on securitisations to support the securitisation of non-performing exposures (NPEs),
    - extending the definition of STS securitisations to include on-balance-sheet synthetic securitisations,
    - setting minimum requirements for such securitisations regarding the transfer of risk to investors,
    - easing the prudential treatment of securitisations and on-balance-sheet synthetic securitisations.

- **NPE securitisations: exceptions to the general rules for securitisations**
  - Non-performing exposure securitisations – i.e. securitisations backed by a pool of assets of which at least 90% are non-performing [new Art. 2 (24)] – will profit from three exemptions to the general rules on securitisations:
    - Until now, the lender, the originator or the sponsor of the SPE had to retain a material economic interest in the securitised assets ("risk retention"). In future, for securitisations of non-performing exposures (NPE) only, the risk retention may also be fulfilled by the servicer, i.e. the entity managing NPEs on a daily basis. [new Art. 6(1)]
    - Until now, the risk retention was at least 5% of the notional value of the securitised assets. In future, for NPE securitisations only, the risk retention will be set at 5% of the outstanding value of the assets [new Art. 6(3a)].
    - Until now, originators had to ensure that securitised credits satisfied sound criteria for credit granting. In future, as an exemption, originators who buy and securitise credits from a third party that are already non-performing, need not ensure sound credit granting [new Art. 9(1)].
    - In order to lower the level of own funds that must be held by banks investing in NPE-securitisation, senior tranches of NPE-securitisations will be subject to a risk weight of 100% only for those NPE exposures that have been sold to the special purpose entity at a discount of at least 50% [new Art. 269a Regulation (EU) No 575/2013].

- **On-balance-sheet synthetic securitisations as STS-securitisations**
  - On-balance-sheet synthetic securitisations are securitisations where the originator transfers credit risks from its balance-sheet to investors. The originator does so by means of a credit protection agreement with the investor, which includes a premium paid by the originator to the investor and payments by the investor to the originator in case of pre-defined events. As opposed to true-sale securitisations, the exposures are not transferred to an SPE but remain on the balance-sheet of the originator. [new Art. 26b (6) a and b]
  - In future, the definition of STS securitisations will be extended to include certain on-balance-sheet synthetic securitisations. On-balance-sheet synthetic securitisations will qualify as STS securitisations when they fulfil the criteria of:
    - Simplicity: The pool of underlying exposures must be part of the core lending business of the originator which is an EU-regulated financial institution [new Art. 26b (2)]. It may not contain NPEs [new Art. 26b (11)] and must contain exposures of one type only, which must not be securitisations [new Art. 26b (8)]. The creditworthiness of debtors must have been adequately assessed and debtors must generally have made at least one payment before the exposures can be securitised [new Art. 26b (10) and (12)].
    - Transparency: The originator must publish default and loss performance data for similar exposures covering at least five years and an independent party must confirm – at least for a sample – that the underlying exposures are covered by the credit protection agreement [new Art. 26d].
    - Standardisation: The originator or original creditor must guarantee a 5% risk-retention. The originator must publish and keep up to date a register of the underlying exposures, including the outstanding notional amount of the exposures. [new Art. 26c]

- **Minimum requirements guaranteeing the transfer of risk for STS on-balance-sheet synthetic securitisations**
  - The credit protection agreement of STS on-balance-sheet synthetic securitisations must meet minimum standards regarding
    - guarantees or collateral transferred by the investor to the originator to back the obligation of the former to pay; such collateral must be cash or zero-risk weight debt securities issued by central banks, governments, public sector entities or international organisations; such zero-risk weight investors do not have to provide collateral [new Art. 26e (7)];
    - the number of credit events (e.g. default, bankruptcy) that trigger a payment by the investor to the originator [new Art. 26e (1)];
    - the risk premium paid by the originator, which must reflect the risk of the underlying exposures and may not be designed so as to reduce the loss allocation to the investor, e.g. by repayments to the investor [new Art. 26e (3) and (6)];
    - the timeliness of payments by the investor to the originator on occurrence of pre-defined events [new Art. 26e (2)].

- **The prudential treatment of securitisations and STS on-balance-sheet synthetic securitisations**
  - Until now, public guarantees for securitisations, i.e. guarantees by a public authority for parts of the securitisations, in which banks invest, allow those banks to maintain a lower level of own funds only when the credit rating of the guarantor is at least A– at the time of the first credit protection. In future, the rating requirement for public guarantee schemes will be dropped [modified Art. 249(3) Regulation (EU) No 575/2013].
  - As regards the senior positions of their on-balance-sheet synthetic securitisations that qualify as STS, banks profit from preferential prudential treatment and do not have to provide as much backing out of own funds as under existing rules. In future, this will apply only to securitisations that meet minimum criteria regarding risk concentration [modified Art. 270 Regulation (EU) No 575/2013].

Statement on Subsidiarity by the Commission

EU-Regulations cannot be amended by Member States.

Legislative Procedure

24 July 2020	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA)
Committees of the European Parliament:	Economic and Monetary Affairs (leading), Rapporteur: Paul Tang [COM (2020) 282], (S&D, NL) and Othmar Karas [COM (2020) 283], (EPP, AT)
Federal Germany Ministries:	Finance
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Competence:	Art. 114 TFEU (Internal Market)
Type of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic impact assessment

Securitisations are, in principle, an economically useful mechanism. They make it easier to spread the risk on the financial markets and increase the potential for banks to grant credit. Since 2019, the STS-label for true-sale securitisations has contributed to combatting the stigma of securitisations that has been linked to the financial crisis and to re-establishing confidence in the securitisation markets.

In past years, banks in many Member States have managed to considerably lower the amount of non-performing loans on their balance sheets. However, the COVID-19 crisis is likely to result once again in a spike in NPE-loans. Hence, the policy aim of making use of NPE-securitisations as a means to remove these NPE-loans from bank balance sheets is laudable, as it frees up banks' capital and thus increases banks' lending capacity. This lending capacity will be necessary to fund the COVID-19 recovery.

The proposed exceptions for NPE-securitisations – regarding the actor required to fulfil the risk retention, its calculation and the fulfilment of sound criteria for credit granting – all **reflect their specific nature**, as opposed to traditional securitisations. **The proposed easing of prudential rules is acceptable because it is limited to senior tranches of already heavily discounted NPE-exposures.** In order to free up capital and have a material effect on banks' lending capacity, it will be necessary for NPE-securitisations to find investors from the non-banking sector, i.e. financial actors such as hedge funds, which are not subject to capital requirements. Moving risks in this way from bank to non-bank balance sheets has a positive impact on lending capacity and may increase risk diversification. However, it does not make these risks disappear, particularly given that capital market investors are likely to invest in junior securitisation tranches, which are subject to higher risks. It will be important for supervisory authorities to closely monitor any risks to financial stability which this risk transfer may cause.

On-balance-sheet synthetic securitisations are comparable to insurances against credit risks. Similar to true-sale securitisations, they can contribute to better risk management. Their contribution to the COVID-19 recovery may be

significant for two reasons. First, given the absence of any transactions of claims, on-balance-sheet synthetic securitisations profit from lower transaction costs, especially in the context of a cross-border transfer of risks. Hence, investors throughout the EU may be interested in financing such securitisations. This may enhance the potential to free up bank capital. Secondly, on-balance-sheet synthetic securitisations are mainly used with regard to corporate and SME loans. Lowering borrowing costs for these entities will also contribute to the COVOD-19 recovery.

The inclusion of on-balance-sheet synthetic securitisations under the STS-label is likely to boost the use of this label by banks, as it is linked to limited preferential prudential treatment in the sense of lower capital requirements. These are necessary to compensate for the costs incurred by banks in complying with the STS-minimum requirements. Without this preferential treatment, STS on-balance-sheet synthetic securitisations would gain little in attractiveness and the label would not contribute to freeing up regulatory bank capital, which helps to increase lending capacities. **Even though experience with true-sale securitisations is very limited, preferential treatment for on-balance-sheet synthetic securitisations is acceptable. The minimum requirements regarding the credit protection agreement and the limitation to senior positions that meet additional risk concentration criteria are adequate conditions for such treatment as they significantly reduce risks to banks.**

However, three risks deserve special attention. First, if successful, the changes proposed by the Commission may lead to an intensive use by banks of synthetic securitisations and thus to less regulatory capital. **As the entry into force of rules on the maximum leverage ratios of banks** – the ratio of a bank's Tier 1 capital to its total non-risk-weighted assets and off-balance-sheet items – **has been delayed because of the COVID-19 crisis** (see **cepPolicyBrief**), **it will be important for supervisors to monitor the impact of the proposed prudential easing on bank leverage.**

Second, as all STS-securitisations work as self-certification systems, the originators of securitisations themselves are responsible for compliance with the STS-conditions (see cep**PolicyBrief**). Depending on the scale of use of on-balance-sheet synthetic securitisations, it may be very challenging for supervisors to safeguard correct application at all times. At the same time, the consequences of wrong-doing for financial stability may be very severe.

Third, **the proposals risk intensifying the bank–state nexus which may increase systemic risks.** Breaking up this nexus has been one of the lessons of the financial crisis. First of all, Member States may want to act as investors in on-balance-sheet synthetic securitisations. They do not have to provide collateral and banks profit from lower capital requirements. It will be important for the Commission to strictly apply state aid rules if this scenario materialises. Also, the link between banks and states is dangerously increased by the fact that a guarantee for securitisations from States with a credit rating below A– qualifies for lower regulatory capital. In practice, this means that banks will also profit from lower capital requirements for NPE-securitisations backed by a guarantee from, e.g., Greece or Italy.

Legal assessment

Legislative Competence of the EU

Unproblematic.

Subsidiarity

Unproblematic.

Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

Unproblematic.

Summary and assessment

The proposed exceptions for NPE-securitisations reflect their specific nature. The proposed easing of prudential rules is acceptable because it is limited to senior tranches of already heavily discounted NPE-exposures**.** Even though experience with true-sale securitisations is very limited, preferential treatment for on-balance-sheet synthetic securitisations is acceptable. The minimum requirements regarding the credit protection agreement and the limitation to senior positions that meet additional risk concentration criteria are adequate conditions for such treatment as they significantly reduce risks to banks. As the entry into force of rules on the maximum leverage ratios of banks has been delayed because of the COVID-19 crisis, it will be important for supervisors to monitor the impact of the proposed prudential easing on bank leverage. The proposals risk intensifying the bank–state nexus which may increase systemic risks.