FSB FINANCIAL STABILITY BOARD

Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation: Consultation report

Response to Consultation

Alternative Credit Council (ACC) and the Alternative Investment Management Association (AIMA)

1. **Preliminary findings: Does the report draw the appropriate inferences about the extent to which the securitisation reforms have achieved their objectives? Is there other evidence on the effects of the reforms to complement the preliminary findings of the report?**

2. **Analytical approach: Are the descriptive analyses used to evaluate the effects of the securitisation reforms appropriate? Are there other such analyses to consider? What types of empirical analysis based on available data could inform the evaluation?**

3. **Trends: Are the securitisation market trends presented in this report adequate given the scope of the evaluation? Are there other important trends that should be included and, if so, what additional data sources could be used for this purpose?**

   The market trends presented in the consultation report are comprehensive and generally accurately portray the evolution of the market over the past decade, particularly the trend of banking retrenchment in securitisation markets. They include a fair assessment of the securitisation technology and the benefits that it brings to the market.

   However, a key trend that the report fails to present adequately is the growth of the SRT market. The description of the market for synthetic securitisations used for capital relief purposes accurately notes the growth of the market in the USA, but fails to properly account the regulatory factors that have driven and continue to drive this market. The SRT market has existed since the late 1990s but has grown significantly following the implementation of the Basel III and IV frameworks. In the EU, the extension of the STS framework to synthetic securitisations provided a considerable boost to the SRT market, as it made it easier for standardised banks to achieve an attractive cost of capital relief.

   Despite the growth of the market being driven by regulatory forces, SRTs would likely continue to be attractive even if the regulatory environment changed. Importantly, SRTs are a non-dilutive, non-permanent capital solution that enables banks to strategically and tactically manage capital both at the overall firm level and for specific businesses. Moreover, it benefits from other factors like:

   - Raising bank capital is expensive.

- SRTs are generally economic for the issuer when the cost of the regulatory capital saving is below its cost of capital.

- After the write-down of Credit Suisse's AT1 bonds, investor demand for other types of capital instruments has fallen.

- Earnings do not have an immediate effect and generally build over years.

The demand side might also continue to drive growth, as investors – usually credit funds – are attracted to the premium income from SRTs and exposure to a range of assets that they would not be able to access in other markets. Pemberton research compared the performance of SRTs to CLOs, high yield bonds and bank AT1 sub-debt since January 2014, showing that the SRT asset class has enjoyed an attractive performance over the past decade both in absolute terms and relative to other asset classes. While the annual return for SRTs since 2014 has been 10%, the annual returns of the other instruments over the same period have been 3% for AT1s, 7% for BB CLOs and 4% for HY bonds. Pemberton research also concluded that SRTs display high resilience to credit stress, finding that a typical SRT transaction delivered positive returns even in scenarios involving multiple times the worst year over the 1981-2021 period.

4. **Relevant reforms: Does the report appropriately describe the key aspects of the design and jurisdictional implementation of the BCBS and IOSCO reforms for analysing their impact on securitisation markets? Are there other important aspects of these reforms that should be considered for inclusion?**

The consultation report claims that:

"Under the Basel II approach, the capital requirement for securitisation exposures was capped at the level that would apply to the underlying assets if they were not securitised and were held directly by the bank. The GFC revealed various shortcomings in the Basel II approach that were subsequently addressed by a series of reforms."

The consultation report also claims that the risk sensitivity of the prudential framework is well adjusted. We fundamentally dispute with this assessment and, while in agreement with the approach outlined below, we do not believe that this approach has been followed in frameworks like the European Solvency II.

"The risk sensitivity of the prudential framework is one of the drivers of a sustainable securitisation market that can support financing to the economy. Such a framework, by ensuring that capital charges are commensurate with the risks, enables banks to contribute to a proper functioning of the market and to channel lending to the real economy. As noted in section 3.1, the Basel III reforms increased overall capital charges for securitisation exposures and generally made them more risk sensitive."

Moreover, the consultation notes that the Joint Committee of the European Supervisory Authorities concluded in 2022 that re-calibrating the securitisation prudential framework would not be a solution that would ensure the revival of the securitisation market.

By contrast, in the European context, the recent political agreement on Solvency II, as well as the Noyer Report , have recognised the inadequacy of the prudential framework and the

need to ensure that the prudential treatment and capital requirements of investments in securitisation, including STS, appropriately reflects the actual risks of the assets. We believe that post-GFC reforms have failed to follow a risk-based approach to both the non-STS and the STS prudential treatments. In the European context particularly there is a need for a revision of the framework in order to introduce the principles of capital neutrality and pari passu treatment for similarly rated assets.

We believe that the US example is valid for many global regulators, including those in Europe. In the USA, for example, under the current National Association of Insurance Commissioners ("NAIC") regime CLOs are regarded as pari passu with corporate debt. This means that, for example, AAA CLO tranches get the same capital treatment as a AAA rated bond, which reflects the similar risk profile of these assets. In recognition that CLO investment grade tranches have a better historical default rate than similarly rated corporate bonds, the NAIC is updating the capital charges for CLOs to better reflect their actual risk.

By contrast, in the EU a corporate bond might get a 7% capital charge while an equivalent CLO can get up to 100%, which does not reflect the reality of the assets and disincentivises investment in the European market. This mismatch puts EU investors at a disadvantage and makes the European market less competitive. In particular, BBB CLO tranches should be targeted for a pari passu treatment with corporate debt based on their lower historical default rate. Securitisation markets generally cannot function without robust demand for BBB tranches, for which insurers are the logical participant.

As seen in Figure 1 on our response paper, the comparison between the cumulative defaults for CLOs compared to corporate debt puts CLOs at a clear advantage. This market reality, however, is not taken into account in European capital requirements, which instead seems to be reversed and penalises assets that are safer and have lower defaults. The justification for this non neutrality and the disproportionate and unrealistic capital treatment is based on the supposed existence of model risk. These model risks, however, do not seem to be manifesting, which should make regulators and policymakers question the non-neutral approach followed in the European market.

Importantly, we believe that Solvency II capital charges for prudentially regulated investors investing in real assets such as equity, company debt and property do not correctly reflect the real economic risks faced by insurers and banks, which also suffer from a myriad of unduly restrictive features when it comes to securitisation. Even accounting for any potential increase in complexity arising from the securitisation instrument, the current treatment is entirely disproportionate to the real risk of a securitised asset compared to an equally rated covered bond or a corporate loan. This can be observed in Figure 2 below, as well as by comparing the treatment received by securitisations in the EU with other equivalent jurisdictions like the USA (Figure 3).

A further example is that, in the USA, the NAIC has increased on an interim basis the risk-based capital charges for ABS residual tranches. Even if the most penalising scenario materialises and the proposed 45% residual capital charge is maintained, this would remain significantly better than the EU equivalent. In fact, the treatment afforded to the riskiest

portion of securitisations under the proposed US insurance rules would still be better than the treatment of the highest quality/lowest risk non-STS securitisation under EU rules

5. **Other reforms: Does the report accurately identify other G20 and domestic financial reforms that are most relevant for securitisation markets? Are there other reforms that should be considered in terms of their impact on market participants?**

Due diligence and disclosure reforms

We believe that the regulatory response aimed at strengthening requirements for investors to conduct adequate due diligence has been a failure. Overall, the detailed due diligence obligations for institutional investors add little value, yet the associated compliance risks are a significant barrier to their investment in securitisation products.

Regional regulatory frameworks like the EU and UK Securitisation Regulations prescribe extremely detailed investor due diligence requirements which are disproportionate compared to other comparable financial products and do not account for other rules, such as the AIFMD, which already address similar matters. This creates an administrative burden on investors to demonstrate compliance and creates bottlenecks in the investment process. Requirements should be reassessed to take into account the type of investor (retail or professional) and existing investor protection mechanisms to remove duplicative layers of due diligence. Reducing the burden placed on investors would boost the competitiveness of European markets.

We believe that a better approach to due diligence requirements at the global level and in regional contexts like the EU should be to relax certain requirements for the most sophisticated investor groups, such as AIFMs. Non-prudential but regulated investors should benefit from a lower level of due diligence obligations commensurate with the non-prudential impact of their securitisation investments, particularly if they are already covered by an overarching regulatory regime that includes extensive due diligence requirements. For example, the requirement to conduct due diligence on the originator/original lender itself, in addition to the underlying exposures, should be reconsidered. We also believe that there should also be more proportionate transparency and disclosure rules for issuers and managers of securitisations.

Additionally, the securitisation regulatory framework should, where appropriate, defer to sectoral legislation when it comes to due diligence requirements. For example, AIFMD already has detailed and strict due diligence requirements that apply to any investment managers can make. Additionally, there are operational and organisational requirements that managers need to tailor to the assets and strategies they focus on. The EU SR requirements therefore appear as largely redundant for market participants already subject to the AIFMD.

A key problem with the existing European framework is that the current wording of the EU SR requires any disclosure to comply with specific EU requirements. In many cases, non-EU regulatory regimes are substantially similar to EU requirements in terms of enabling investors to evaluate risk and perform due diligence and, in many circumstances, identical information is reported, albeit in a different format to the prescribed Article 7 templates. However, the current wording of Article 7 serves to:

a) Create significant administrative overheads such as performing a gap-analysis exercise between the disclosure requirements of the third-country securitisation regulations and those of Article 7 for each new prospective investment opportunity.

b) Prevent EU institutional investors from investing in third-country securitisations where sufficient information to allow investors to evaluate risk and perform due diligence is disclosed (or made available on request), but the level of detail or exact format of disclosures does not match that prescribed by Article 7.

This is a problem that encompasses all third-country securitisations, but its most significant impact is to investors that are locked out of investing in substantial portions of US securitisation markets, which are some of the most liquid and dynamic securitisation markets in the world. An illustrative example is an investor interested in an Auto ABS originated in the US. SEC regulations require the disclosure of:

a) Asset-level information covering 70+ fields. We believe this information is fully sufficient to allow investors and investment managers to evaluate risk and perform due diligence. Furthermore, it has substantial overlap with the 84 fields required by the EU SR Annex 5, even though it does not perfectly match all fields.

b) Distribution and pool performance information. This information is substantially similar, but not identical to, the 64 fields mandated by Annex 12 and is more than sufficient to allow investors to evaluate risk, monitor performance and perform due diligence.

Importantly, recently approved UK reforms have been achieved a more principles-based and proportionate due diligence approach to verifying disclosure by overseas sell-side parties with EU rules. The UK approach has produced a single approach that requires institutional investors to verify:

- the sufficiency of the information a sell-side party has made available to institutional investors to enable them to independently assess the risk of holding the securitisation position;

- that they have received at least the information listed in the rules; and

- there is a commitment from the sell-side parties to make further information continually available, as appropriate.

Beyond allowing investors in foreign securitisations to rely on substantially similar information, an alternative beneficial solution would be establishing a wider recognition of foreign regimes. If a securitisation is originated in a third country but complies with national rules, investors should be free to conduct their due diligence based on the information available even if the information is not “substantially the same”.

Particular focus should also be given to reducing the reporting burden and improving the disclosure requirements for issuers and managers of private securitisations and CLO transactions. ESMA’s recent engagement with the industry has been a welcome development in order to analyse how the current securitisation disclosure framework can be amended to support burden reduction

6. **Conceptual framework: Does the report adequately explain the objectives, transmission channels and expected outcomes of the securitisation reforms? What other metrics to assess the impact of the reforms should be considered?**

For detailed comments on the relevance of risk retention reforms and the effectiveness of risk retention achieving the policy objective of interest alignment, please see section 8.

7. **Resilience metrics for the CLO market: Does the report accurately describe the evolution of resilience indicators for the CLO market? To what extent can the evolution of these indicators be attributed to the reforms?**

The evolution of the CLO market

We do not believe that the consultation report accurately approaches the CLO market and its evolution since the GFC. A key error in its approach is including CLOs and CDOs in the same category, which demonstrates a fundamental misunderstanding of the characteristics of each securitised asset class. This association inevitably makes CLOs seem riskier than their real performance and risk profile and leads the FSB to disregard the actual data and the evolution of the market. For example, it attributes the low default rate of CLO tranches post-GFC to the overall macroeconomic trends, the extended interest rate period and fiscal support in periods like the COVID-19 pandemic. This analysis overlooks that CLO tranches have continued to perform well over the past two years of high rates and that during the pandemic they proved resilient in markets like the USA, where there was no fiscal support for indebted companies. While it is true that the market stress of the past few years has not reached the levels seen during the GFC or in previous crises, the performance during this time indicates that the CLO market would prove resilient even in the face of a more acute credit cycle. The consultation report also states that the CLO market is reliant on sufficient liquidity to function, which is a generic comment without any specific relevance to the CLO market and which can be applied to any financial market.

The CLO asset class has “historically shown strong credit performance with few defaults”, according to S&P, which has rated nearly 21,000 CLOs. The first defaults of CLOs originated after 2008-2009 only occurred in 2021. The overall global CLO default rate rose to 0.08% in 2021 from 0.02% in 2020, returning to the 2019 level and near its 0.09% long-term average. By comparison, the speculative grade corporate default rate has always been above the default rates of CLOs – 5.5% in 2020, 1.68% in 2021. No US or European leveraged loan CLO tranche originally rated 'AAA' has ever defaulted (see Figure 5 on our response paper).

We believe that CLOs are a positive market force enhancing financial stability and increasing the provision of financing to the real economy. A key feature of securitisation is that by pooling assets, the securitisation lowers the overall risk exposure to the investor compared to a single investment. CLOs are a prime example of how securitisation structures reduce risk for investors and provide stability to the market, and they include structural features and protections that differ from other securitisation products. Given that market stress and recessions are inevitable, we believe that CLO structures mitigate such stress, are designed to be resilient and avoid spreading the risk through the wider financial system.

Moreover, CLOs are a key economic actor that, as with other securitisation structures, decreases the dependence of European borrowers on banks as their lifeline to funding. By increasing the availability of finance and liquidity for EU businesses, CLOs also help increase market resilience. CLOs behave like a closed-end fund in many respects, meaning they are unlikely to be forced sellers during times of stress. Instead, they typically step up as buyers helping to reduce volatility. An example of the important backstop provided by CLOs is that the leveraged loan market index only takes a large dip when CLO issuance is on pause. A key driver in the strong activity of the US and European leveraged loans markets in Q1 2024 has been the surge in issuance volumes of CLOs, which "have long been the lifeblood of the US loan market".

CLOs are also increasingly participating in restructurings and becoming an integral provider of capital and liquidity in that market. New mechanisms have been introduced to allow CLOs to participate in a broader range of restructuring and distressed situations, such as the introduction of debtor-in-possession loans in Europe to allow CLOs to invest at any time in super senior debt issued as part of a distressed situation.

Given the relevance of CLOs to global credit markets, we welcome the recognition in the FSB's consultation paper, for example in Graph 14, of the resilience of CLOs compared to other asset classes such as leveraged loans. See also Figure 6 on our response paper.

The consultation report does successfully identify the market changes that have taken place since 2010, which have led to an entirely new generation of CLOs 2.0, but does not integrate this into its analysis of the resilience and value of the CLO market.

CLOs' unique features like active management, diversification and investor constraints have all been enhanced since the GFC, establishing a clear distinction between the pre- and post-GFC generations of CLOs. Key differences between the first-generation CLO 1.0 transactions and the post-GFC CLO 2.0 transactions include:

- More credit enhancement for the rated CLO notes, especially at the top of the CLO capital structure;

- Collateral pools that excluded investments in assets other than corporate loans and some small portion of corporate bonds;

- Transaction documents that incorporated lessons learned from the GFC, including provisions that prevented or mitigated CLO note cancellation and limited the manager's ability to extend the life of the CLO transaction via trades done after the end of the reinvestment period.

- The investor base for the 2.0 transactions was (and is) less levered and less sensitive to changes in market value of the tranches than the CLO 1.0 universe had been.

We welcome the FSB's reference to Bank of England analysis showing that even after applying stress that resembles the GFC, holders of investment-grade tranches (i.e., rated BBB or above) would not incur losses due to defaults and "that it would take a loss rate more than twice as severe as that of the financial crisis for AAA-rated tranches to incur losses." While model risk always has to be taken into consideration, this Bank of England's report

also accounts for a potential deterioration in lending standards on top of stress resembling that of the GFC, showing that CLO structures are reliable absorbing and mitigating stress and preserving investor value even if collateral quality potentially decreases.

8. **Risk retention in CLOs: Does the report accurately describe risk retention practices in the CLO market before and after the reforms? What additional analysis could be included to assess the effectiveness of risk retention in CLOs across FSB jurisdictions, including on how financing of risk retention deals by third party investors impacts effectiveness?**

While we agree with the consultation paper's analysis and its literature review on the reduction of risk and misaligned incentives that is achieved by risk retention practices, we also believe that these are not the only mechanisms through which skin-in-the-game and a better alignment of interest and incentives can be achieved. It may be true, as outlined by the consultation, that "underlying loans of securitisation deals with risk retention have: a lower probability of becoming non-performing, lower loan-to-value (LTV) ratios, higher income to debt service ratios, a lower delinquency amount, and a shorter time in arrears." However, we believe that it is important for regulators to recognise that other market best practices and forms of 'skin-in-the-game' such as fee structures can provide for greater alignment of interest. We also believe that risk retention can unintentionally give investors a false sense of security about the credit quality of the assets, as risk retention practices are not a guarantee of proper underwriting and interest alignment.

Impact of risk retention requirements on the EU and UK markets

This is particularly relevant in the context of US open-market CLOs, which thanks to the 2018 court decision in LSTA vs. SEC are not obliged to comply with the risk retention provisions of Section 941 of the Dodd-Frank Act. While this decision has not impacted the alignment of interests in the US CLO market, it had consequences in the EU and UK markets, where their respective Securitisation Regulations require EU and UK AIFMs, their subsidiaries and affiliates to evidence that any securitisations they invest in comply with risk retention requirements (i.e., the securitisation sponsor or issuer must retain 5% of the securitisation as a 'skin-in-the-game' alignment of interest).

This means that many US open-market CLOs do not meet the EU risk retention requirement and are considered non-compliant investments under the EU SR. Under the Regulation, EU AIFMs and their international subsidiaries are required to evidence that the securitisations they invest in are compliant with the risk retention requirement, which means that EU AIFMs and their international subsidiaries cannot invest in these US CLOs. While some US open-market CLOs are structured to comply with EU risk retention requirements and appeal to European investors, the great majority of the market is not structured in that way, as the US investor base is generally sufficient. This excludes EU-based AIFMs from a significant investment market worth around USD 1tn.

As well as preventing EU investors from being able to access this market, the SR also diminishes the competitiveness of the EU asset management industry as EU AIFMs are unable to offer a full product set to their investors. This places them at a competitive disadvantage, for example when raising new funds. In order to build a globally competitive

European securitisation market, AIFMs should be able to access the full range of securitisation products.

This prohibition also undermines the returns achieved by European institutional investors, as US CLOs are the deepest market and have a strong performance record. We also believe that such a prohibition creates concentration risks among European investors, who are forced either to over allocate to European assets, increasing their risk profile, or to under allocate in order to maintain their desired risk levels. Expanding the available investment universe would improve diversification and, ultimately, allow investors to allocate more to European assets by reducing their concentration risk.

Other mechanisms that can substitute risk retention

These impacts are particularly disproportionate considering that there are other mechanisms in the CLO market that can achieve the same level of 'skin-in-the-game' and interest alignment, while also avoiding the increased due diligence burden and cost of capital for originators and investors. As recognised by the consultation paper, "[these costs decrease] the relative attractiveness of securitisation as a financing tool (i.e., increasing prices and lower volumes)."

We recognise that risk retention can play an important role in securitisation structures, yet also believe that there are many characteristics of CLOs that make risk retention less relevant than for other forms of securitisation. This is particularly relevant considering that the consultation paper recognises that risk retention does not always achieve the intended risk reduction in the CLO market:

"The financing in certain cases of CLO managers' retained risk by third-party investors raises questions about the extent to which the objective of risk alignment is fulfilled. CLO managers may operate with light balance sheets, so any retained risk would force them to fund these assets with additional debt or equity. This has contributed to the establishment of risk retention vehicles to attract third-party investors such as pension funds or family offices, which appear to be used widely in both the US (where there are no risk retention requirements applicable to open-market CLOs) and Europe. This practice might not be fully aligned with the goals of risk retention regulation because in many cases the vehicle does not belong to the same corporate group as the CLO manager, thereby moving risk to parties not originally envisioned by the IOSCO recommendations. Such a practice may also complicate authorities' efforts to determine who is ultimately exposed to risk retention-related losses. Moreover, risk retention vehicles might themselves be levered and the financing arrangements may lead to margin calls, especially in cases where the retained risk consists of first loss exposures and hence subject to substantial asset value volatility."

It is important to note that the comparison of the CLO default data for Europe and the USA does not show any meaningful difference in risk achieved by risk retention requirements. As evidenced by S&P data, risk retention in CLOs does not lead to a reduction in the default rate of European CLOs. Another valid comparison that leads to the same conclusion is between CLO 1.0 and CLO 2.0 (see Figure 5). Furthermore, the USA serves almost as a laboratory case study: there has not been risk retention in US open-market CLOs for the past decade and the number of defaults is still very low and similar to Europe, even though the quality of collateral might have deteriorated in recent years following the increase of

interest rates. Even the European model of risk retention can be questioned in its effectiveness, as in many cases the risk retention is financed by external investors, not by managers' 'skin-in-the-game'.

This does not mean that risk retention does not achieve a risk reduction in other securitised asset classes, but it shows that it is not the only way to align interests and include managers' 'skin-in-the-game'. In the case of CLOs, risk retention requirements add a cost and operational burden to managers but do not change the risk profile meaningfully. Instead, the key to the CLOs' risk profile is the origination of collateral and the additional structural protections that are present in the market.

Importantly, the CLO market includes structural features and protections that differ from other securitisation products. Firstly, CLOs are unique in that a CLO manager can actively manage, within a set of well-defined constraints, the pool of underlying loans to optimise returns for their investors. In practice this means that the CLO manager seeks to identify better performing borrowers and loans rather than simply 'buying the market'. This is an important distinction between CLOs and other securitised products, where there may be little or no ability to actively manage the investors' exposure to the underlying pool of assets. Figure 7 below shows the impact of this active management on CLO performance.

It is also important to bear in mind that CLOs benefit from extensive levels of diversification, as they typically have several hundred borrowers in their portfolio. This reduces investor exposure to individual defaults. Additionally, CLOs operate within 'constraints', which limit the discretion of the CLO manager when managing the underlying pool of loans. These are generally designed to align the interests of the CLO manager with the investor. For example:

- CLO managers can only turn over a limited portion of the collateral, generally between 20-30%, each year.

- CLO managers can only replace the loans in the portfolio with loans that meet the eligibility criteria of the CLO structure used to determine the initial asset pool.

- The eligibility criteria used to determine the initial asset pool are typically set by external ratings agencies rather than the asset manager.

- CLO managers typically report details of trading of underlying exposures in the context of the CLO manager's management responsibilities, providing investors with transparency.

- A proportion of the CLO manager's fees are subordinated, which means that this proportion only gets paid when the CLO's debt tranches have paid interest. This incentivises strong performance of the CLO transaction and aligns the CLO manager's interest with their investors.

- The Volcker Rule restricts CLOs from investing more than 5% of their value in debt securities (such as high-yield bonds).

Lastly, CLO offering documents require managers to comply with various performance tests and criteria prescribing how the CLO should be managed rather than on a solely discretionary basis. These tests and criteria are outlined in the table on our response paper.

We believe that these practices ensure that investors' interests are being protected, promote consistency across the market and support the efficient allocation of capital across the economy. The strong performance of CLOs during the past decade demonstrates the effectiveness of these protections and the resilience of the CLO structures. We believe that regulators and policymakers should consider other structures beyond risk retention to achieve the policy objectives of interest alignment and risk reduction. Equivalence with third party regimes that achieve the desired risk alignment is also desirable and would free the market from a number of strict and unnecessary requirements.

Finally, we would also note that in jurisdictions like the UK and the EU, AIFMs are also subject to multiple risk management disciplines and requirements under the AIFMD that apply to all its activity – including any potential investments in CLOs – which sit atop the product level requirements imposed by the UK and EU Securitisation Regulations.

9. **Resilience metrics for the non-agency RMBS market: Does the report accurately describe the evolution of resilience indicators for the RMBS market? To what extent can the evolution of these indicators be attributed to the reforms?**

   We welcome the acknowledgement that key issues, such as the collateral quality in the RMBS class, have considerably improved over the past decade with the consequent decline in defaults. The consultation report notes that collateral quality does not seem to have improved in CLOs relative to the pre-GFC environment and compared to RMBS. However, as shown by S&P data, CLO defaults have not been comparable to RMBS defaults historically, which indicates that the quality of collateral in CLOs was of superior quality.

10. **Risk retention in RMBS: Does the report accurately describe risk retention practices in the RMBS market before and after the reforms? What additional analyses could be included to assess the effectiveness of risk retention in RMBS across FSB jurisdictions?**

11. **Effectiveness of BCBS securitisation reforms: Does the report accurately describe the changes in bank behaviour following the implementation of the BCBS securitisation framework reforms? To what extent can the effects of these reforms be disentangled from the broader Basel III framework, other reforms and confounding factors?**

12. **Simple, transparent and comparable (STC) securitisations: Does the report accurately describe the impact of the introduction of the STC framework on the securitisation market? To what extent has the reform met its objectives?**

    We agree with the introduction of STC labels like the EU's Simple, Transparent and Standardised framework, and we believe that it has alleviated, to an extent, the capital charge burden for STS securitisations. We agree with the consultation paper that the growth of STC/STS securitisations is a possible factor in creating more transparent structures and reducing risk in some asset classes. However, STS securitisations continue to make up only a small fraction of the market and it is likely, as noted by the FSB, that the STC/STS

label might have led to the relabelling of some transactions rather than stimulate new activity.

Overall, we believe that the evidence of the European market is that the STS framework is not currently fit for purpose and has failed to achieve its key objectives, including reviving insurers' interest in securitisation markets. For example, European insurers still find more value in the non-STS category, which, despite the unfavourable capital treatment, represents more than 70% of insurers' investments in securitisation between 2019 and 2020.

While the STS regime was introduced to reinvigorate the securitisation market, the framework has failed to achieve that goal due to the constrained scope of assets that are eligible for STS certification. STS securitisation as a percentage of total issuance in Europe has oscillated between 39% and 27% since 2020, which shows the limited impact that the framework has had. The focus of STS reform should therefore be on expanding the scope of assets that are STS eligible. This reform has previously been undertaken, albeit on a very small scale, with the expansion of the framework to synthetic securitisations, which has successfully supported the competitive European SRT market.

A proper risk-based calibration of the capital treatment is also needed in line with a revision of non-STS capital treatments, along with an expansion of the scope as argued further below. If these problems are addressed, the STS framework will become a useful label to designate simple, vanilla securitisation products. Ultimately, the STS label should be a way for less sophisticated investors, including mid-tier insurers, to access the securitisation market. In this function, the STS framework is key to expanding the investor universe and invested capital of the EU securitisation market.

Expanding the scope of eligible assets

The most important challenge faced by the STS framework in Europe and by the STC system in general, and where reform would generate the widest improvement, is that the scope of eligible assets is particularly constrained by the rejection of 'actively managed' structures. This outright exclusion of active management from the STS regime does not correspond with the realities of the market, as is most evidently seen in the case of CLOs. Under the EU and UK SR, CLOs are considered to be 'actively managed', which disqualifies CLOs from STS certification. The exclusion of CLOs from the STS framework acts as a brake on the provision of finance to European borrowers, while also limiting the ability of banks to de-leverage their balance sheets. Active management, as recognised in the FSB's consultation paper can mitigate credit deterioration and avoid collateral defaults by trading distressed loans.

We believe that the perimeter of what is STC/STS-eligible should be broadened significantly. Requirements around active portfolio management should be clarified and modified to explicitly include transactions where active management occurs within the clear criteria, as is the case with the criteria established by the CLO manager and their investors. The requirements on homogeneity should also be made more flexible to allow CLOs to qualify for STS treatment if they invest both in bonds and loans, which is sometimes the case in the market. These CLOs would not qualify for STS treatment even if the active management hurdle is fixed.

Reducing the operational burdens on investors by automating the process by which preferential capital treatment under the STS framework is granted

A key limitation of the existing European STS framework is that it does not directly guarantee preferential capital treatment for qualifying transactions and excludes certain types of investors from preferential treatment. If a securitisation transaction obtains the STS label, investors are not guaranteed to receive preferential capital treatment. Qualifying investors must undertake a multi-step process and tests under the Securitisation Prudential Regulation (2017/2401) which adds costs and hurdles. The application process for preferential capital treatment under the STS certification must be streamlined and improved.

We believe that authorised third-party certification of the STS designation for a securitisation transaction, followed by notification to the relevant regulators, should automatically grant a preferential capital treatment under the STS framework, thus reducing the operational burden imposed on investors.

13. Effects on financing the economy: Does the report accurately describe the main effects of the reforms on financing the economy? Is there additional analysis that could be undertaken to estimate the benefits and costs of these reforms and to assess their impact on securitisation as a financing tool?

The FSB's consultation claims that there is no evidence that post-GFC reforms impaired the aggregate supply of credit to the economy. While there is no data to quantify this claim, a useful proxy is to analyse the size of the European securitisation market since the GFC, particularly compared to other markets like the USA where the post-GFC reforms were applied differently and where securitisation is a key driver in the robust performance of its economy.

Overall, the size of the European securitisation market has decreased significantly since the Global Financial Crisis, and arguably since the introduction of the EU Securitisation Regulation. The trend before the GFC had been of considerable growth in the market, peaking at more than EUR 2tn in Europe in 2008-2009. Issuance then halted and the market size dropped significantly to EUR 1.5tn in 2013. In Q4 2022, the EU securitisation market was around 540bn EUR. By contrast, in the US, the total amount of securitisation reached USD 13.7tn in 2021, well above its 2008 levels (USD 11.3tn).

This difference between the US and the EU can partly be explained by structural differences between the two markets, with more widespread use of securitisation for market-based finance in the US and a large share of some of these products (in particular RMBS) guaranteed by state agencies such as Fannie Mae and Freddie Mac. However, the comparison with the US clearly shows that the EU market is small in relative terms and the European market is thus missing on the economic benefits of a well-functioning securitisation market, including additional finance to the real economy. Looking at securitisation issuance as a proportion of GDP is one way to illustrate this point, with the EU lagging behind other markets in terms of the amount that domestic securitisation markets contribute to the financing of the economy. This comparison illustrates that the EU Securitisation market remains small in relative terms and that the benefits of a well-functioning securitisation to the capital markets union remain below par. The fact that the

UK also lags below its peers reinforces the view that the Securitisation Regulation plays some part in this.

The issuance CLO structures in Europe since the GFC confirms the underperformance of the European securitisation market relative to its relevant peers. The failure of the European CLO market to achieve its potential is particularly grave considering the role that these structures could play in the European economy, as well as their strong performance over the past decade.

The FSB's consultation report claims that other factors such as the accommodative financial conditions of the past decade, the use of other financial market instruments and central bank refinancing operations, such as those spearheaded by the ECB, might mean that the overall financing to the economy has not been negatively affected by the post-GFC reforms. We would add that the global rise of private credit, with particular focus on the USA, UK and EU, has also contributed to mitigating the impact of the post-GFC reforms. In fact, the rise of private credit has in part been a consequence of the more restrictive regulatory environment and increased capital requirements for banks in the post-GFC context. Nevertheless, we believe that in jurisdictions like the EU and UK, the severe underperformance of the securitisation market over the past decade has meant that the net impact of the post-GFC reforms has been negative and that more capital would have reached the real economy if securitisation markets had been more vibrant.

14. **Effects on financial system structure and resilience: Does the report accurately describe the extent to which there has been a redistribution of risk from the banking to the non-bank financial intermediation sector? What role did the reforms play in this process and what are the main benefits and risks from a system-wide perspective? How have the reforms impacted the demand and supply of liquidity in securitisation markets?**

The FSB report echoes the concerns expressed in recent times by other global and national regulators around the redistribution of risk across the financial system, particularly from banks to the non-bank financial intermediation sector ("NBFI") and with a special focus on the private credit market.

We believe that the NBFI concept is not only unhelpful but also misleading in understanding potential financial system risks. The acronym NBFI, formerly known as shadow banking, unwisely groups diverse business models, such as money market funds, insurers, hedge funds, private credit, and private equity funds under one umbrella. This oversimplifies complex financial ecosystems while assuming banking regulation is the pinnacle of financial stability management.

The FSB and other regulators generally repeat popular misperceptions about the sector's opacity and lack of regulation and assess the risks of the NBFI sector by comparing it to the banking regulatory and supervisory framework. Today, all financial market entities are regulated and supervised with extensive reporting requirements to their respective sectoral regulators.

Applying bank-centric regulations to non-bank entities is problematic. Banking rules address risks associated with a business model that combines retail deposit-taking, liquidity

and maturity transformation, and high leverage. This means that the funding provided does not suffer from liquidity mismatches seen in traditional banking or market volatility associated with bond markets. Loans are generally held to maturity in vehicles that do not provide redemption or withdrawal rights with capital returned to investors only when loans are repaid. Leverage used in funds is generally low and matched with the underlying asset maturity.

Private credit firms, regulated under the EU asset management framework, exemplify this point. They maintain lower leverage and better align assets and liabilities, eliminating the banklike “run” risks witnessed in recent banking crises. In addition, as our research and the recent IMF report show, private credit market activity is less susceptible to a sudden credit shock than the high-yield bond and bank loan markets.

Global regulators dismiss the benefit of moving assets from precarious bank balance sheets funded by flight-prone depositors to those funded by stable, long-term, risk-bearing professional investors. It is difficult to understand how the rise of models that demonstrably generate less financial stability risk per dollar invested should be seen as anything but a positive step in delivering a more stable and faster-growing economy.

We welcome the FSB’s recognition that the transfer of risks outside of the banking sector can lead to a more diverse and robust financing ecosystem. We believe that non-bank investors like private credit managers are well placed in their funding structure and ability to with stand losses. This should allow private credit investors and their managers – AIFMs in the EU – to assume more securitisation risks, such as sponsoring securitisation structures and retaining the 5% risk exposure.

15. Other issues: Are there any other issues or relevant factors that should be considered as part of the evaluation?

We have submitted a more complete response paper in PDF format to fsb@fsb.org, which includes additional information, data and graphs.

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ACC and AIMA Comments on FSB's Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation

The Alternative Credit Council ("ACC")[1] and the Alternative Investment Management Association ("AIMA")[2] welcome the opportunity to comment on the Financial Stability Board's ("FSB") Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation[3] ("the consultation report/the report").

Securitisation is a core feature of capital markets and it provides a mechanism by which loans originated by banks and finance companies are transferred to capital market investors. Securitisation therefore allows investors to access asset classes such as real estate mortgages, auto loans and corporate loans (including those of SMEs) that would not be otherwise investible on an individual basis, providing much needed liquidity and investment. Additionally, securitisation also frees up the balance sheets of banks, allowing them to originate new loans and continue providing finance to the real economy.

Securitisation is undoubtedly the key instrument to channel investments into the real economy, including mobilising capital to invest in the growth of SMEs and key strategic areas like infrastructure, energy, defence and climate transition. Policymakers across the globe have recognised this, including former Italian Prime Minister Enrico Letta and Banque de France

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1 The ACC is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over $1 trillion of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

2 AIMA is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $3 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

3 https://www.fsb.org/wp-content/uploads/P020724.pdf

Governor François Villeroy de Galhau[4], as well as World Bank President Ajay Banga, who has highlighted that securitisation structures can be very attractive to put billions of capital to work and achieve scale in climate finance.[5]

Economies across the globe, most prominently in the USA, benefit greatly from the boost that robust and dynamic securitisation markets provide to domestic capital markets and to the real economy. We believe that the strong performance of the US economy over the past decade is due, partly, to being extremely well funded thanks to the availability of strong and wealthy capital markets driven by a well-functioning securitisation market.

By contrast, in the European Union, where most of the post-Great Financial Crisis ("GFC") G20 securitisation reforms have been implemented, capital markets continue to be fragmented and the economy continues to suffer from an overreliance on the banking system. While this is not all due to the G20 reforms, we believe that the poor performance of the European securitisation market over the past decade has been caused by the adverse, disproportionate and punitive regulatory environment that was imposed on the market in the aftermath of the GFC. If European policymakers wish to reduce the overreliance on the banking system and increase funding for the real economy, they should find ways to revive the European securitisation market, as we have argued in a recent position paper.[6]

As with all financial products, there are inherent risks to securitisation structures and markets. The key goal for policymakers must therefore be to identify appropriate and proportional disciplines around risk management that are consistent with other financial markets, products and jurisdictions, as well as with wider regulatory frameworks like AIFMD.

Nevertheless, it is important to note that in some asset classes, such as Collateralised Loan Obligations ("CLOs"), securitisation structures can actually enhance the risk profile of the securitised product compared to the underlying collateral. This is done via characteristics such as active management of the pool of underlying loans. In the case of CLOs, this takes place under well-defined constraints to optimise returns for their investors. Securitisation products include other features that improve their risk profile, including:

- Extensive levels of diversification, as they typically have several hundred borrowers in their portfolio. This reduces investor exposure to individual defaults.
- Operating within 'constraints' that limit the discretion to manage the underlying pool of loans.
- Compliance with various performance tests and criteria prescribing how the securitisation should be managed rather than on a solely discretionary basis.

[4] https://www.banque-france.fr/en/governors-interventions/capital-markets-union-genuine-financing-union-transition
[5] https://www.bloomberg.com/news/articles/2023-12-03/world-bank-wants-to-lower-risk-for-clean-energy-projects
[6] See the ACC's 'Reviving the EU securitisation market'

Specific securitisation asset classes, such as CLOs, also help increase the resilience of the broader market. For example, CLOs behave like a closed-end fund in many respects, meaning they are unlikely to be forced sellers during times of stress. Instead, they typically step up as buyers helping to reduce volatility. This is one of the key reasons why we reject any comparisons between CLOs and Collateralised Debt Obligations ("CDOs"), which the FSB tends to group together. Beyond some similarity in the name, the CLO and CDO asset classes share no commonality in terms of their collateral and management, their historical performance and risk profile, the levels of diversification and the constraints included in the documentation for each structure.

Where appropriate, we have provided comments below on the questions where the FSB is seeking specific feedback, but in broad terms we believe that:

- The FSB does not take into account the way that post-GFC reforms around capital requirements and the prudential framework have actually been implemented in jurisdictions like the European Union and the United Kingdom. We agree with the FSB's comments around the importance that capital requirements for securitisations are consistent with the underlying collateral and on the importance of having a risk-based prudential regulatory framework. However, we believe that the European implementation of securitisation reforms clearly evidences how those principles have not been followed.

- The consultation report fails to properly consider the evolution of the Significant Risk Transfer ("SRT") market and its growth in Europe and, recently, in the USA. It also fails to account for the mechanisms of SRT transactions, as well as the benefits offered to banks and investors.

- The regulatory response aimed at strengthening requirements for investors to conduct adequate due diligence has been a failure. Overall, the detailed due diligence obligations for institutional investors add little value, yet the associated compliance risks are a significant barrier to their investment in securitisation products. Particular problems exist in the EU and UK regulatory frameworks, for example around reporting requirements which dismiss identical information from third countries because it is reported in a different format to the prescribed Article 7 templates. A more flexible approach and more flexible higher guiding principles are needed when it comes to due diligence.

- The FSB does not fully integrate the good performance of the CLO market into its analysis and fails to account for all the structural features of the new generation of post-GFC CLO 2.0. The FSB report does evidence that the CLO asset class is extremely robust and has demonstrated strong resilience over the past decade, but fails to make this explicit or analyse this evidence in the broader context of securitisation reforms. Regarding risk retention in particular, the consultation report fails to consider other 'skin-in-the-game'

mechanisms and how the performance of the CLO market, especially the comparison between the USA and Europe, affects the analysis of the relevance of risk retention as a policy tool.

- It is important for regulators to recognise that other market best practices and forms of 'skin-in-the-game' such as fee structures can provide for greater alignment of interest than risk retention. It is important to note that the comparison of the CLO default data for Europe and the USA does not show any meaningful difference in risk achieved by risk retention requirements. Furthermore, risk retention requirements have a particular impact on European investors, as they are prohibited from investing in US open-market CLOs due to EU and UK regulatory barriers.

- The most prominent Simple, Transparent and Comparable ("STC") label that has been created, namely the European Simple, Transparent and Standardised ("STS") framework, has failed to achieve its objective of creating an attractive vanilla and simple securitisation asset class for less sophisticated investors like prudentially regulated firms. The inclusion of synthetic securitisations in the EU framework was a welcome course correction, but the label will not be successful as long as the scope of eligible assets continues to be very restrictive and the capital treatment for STS securitisation assets continues to be disproportionate.

We would be happy to elaborate further on any of the points raised in this letter or annex below. For further information please contact Nicholas Smith, Managing Director, Private Credit (nsmith@aima.org).

Yours sincerely,

Jiří Król

Deputy CEO, Global Head of Government Affairs, AIMA

Global Head of the ACC

AIMA/ACC Comments on the FSB's Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation

We welcome the inclusion in Box 8 of the consultation report of common industry feedback and concerns surrounding the post-GFC reforms of the securitisation regulatory framework, though these are presented in a very limited way. We would encourage regulators and policymakers to read the ACC's Position Paper on securitisation reform ('Reviving the EU securitisation market'), which develops these common points into more detail and includes additional challenges created by the regulations, as well as straightforward solutions to address all of these.

We have included detailed responses to the questions posed by the FSB in its consultation that are most relevant to private credit investors.

Overview of securitisation markets

3. *Trends: Are the securitisation market trends presented in this report adequate given the scope of the evaluation? Are there other important trends that should be included and, if so, what additional data sources could be used for this purpose?*

The market trends presented in the consultation report are comprehensive and generally accurately portray the evolution of the market over the past decade, particularly the trend of banking retrenchment in securitisation markets. They include a fair assessment of the securitisation technology and the benefits that it brings to the market.

However, a key trend that the report fails to present adequately is the growth of the SRT market. The description of the market for synthetic securitisations used for capital relief purposes accurately notes the growth of the market in the USA, but fails to properly account the regulatory factors that have driven and continue to drive this market. The SRT market has existed since the late 1990s but has grown significantly following the implementation of the Basel III and IV frameworks. In the EU, the extension of the STS framework to synthetic securitisations provided a considerable boost to the SRT market, as it made it easier for standardised banks to achieve an attractive cost of capital relief.

Despite the growth of the market being driven by regulatory forces, SRTs would likely continue to be attractive even if the regulatory environment changed. Importantly, SRTs are a non-dilutive, non-permanent capital solution that enables banks to strategically and tactically manage capital both at the overall firm level and for specific businesses. Moreover, it benefits from other factors like:

- Raising bank capital is expensive.
- SRTs are generally economic for the issuer when the cost of the regulatory capital saving is below its cost of capital.
- After the write-down of Credit Suisse's AT1 bonds, investor demand for other types of capital instruments has fallen.
- Earnings do not have an immediate effect and generally build over years.

The demand side might also continue to drive growth, as investors – usually credit funds – are attracted to the premium income from SRTs and exposure to a range of assets that they would not be able to access in other markets. Pemberton research[7] compared the performance of SRTs to CLOs, high yield bonds and bank AT1 sub-debt since January 2014, showing that the SRT asset class has enjoyed an attractive performance over the past decade both in absolute terms and relative to other asset classes. While the annual return for SRTs since 2014 has been 10%, the annual returns of the other instruments over the same period have been 3% for AT1s, 7% for BB CLOs and 4% for HY bonds. Pemberton research also concluded that SRTs display high resilience to credit stress, finding that a typical SRT transaction delivered positive returns even in scenarios involving multiple times the worst year over the 1981-2021 period.

Securitisation reforms

While the consultation report accurately describes the role that some securitisation sub-classes played during the GFC, it is important to emphasise the resilience and good performance of European securitisations during those years. The global post-GFC reforms of the securitisation regulatory framework were, in reality, a response to a grave but specific failure of the US RMBS market. This is clearly seen in Graph 13 (page 39) of the consultation report, which also evidences that the European and UK markets showed strong resilience during the GFC. We believe that the globally driven post-GFC reforms of the securitisation regulatory framework in the EU did not correspond to the real performance and the real risks of the European market. For example, a five-year AA securitisation in the EU and UK still has a capital default charge of over 15% even though their total accumulative default rate during the GFC (2007 to 2013) was only 0.14%.[8]

[7] https://pembertonam.com/wp-content/uploads/2023/11/RSS-Growth-Outlook-Oct2023.pdf?track=pmbrtn-rsrch-079
[8] https://www.theia.org/sites/default/files/2019-05/20150513-ecsecuritisationframeworkresponse.pdf

4. *Relevant reforms: Does the report appropriately describe the key aspects of the design and jurisdictional implementation of the BCBS and IOSCO reforms for analysing their impact on securitisation markets? Are there other important aspects of these reforms that should be considered for inclusion?*

The consultation report claims that:

> *"Under the Basel II approach, the capital requirement for securitisation exposures was capped at the level that would apply to the underlying assets if they were not securitised and were held directly by the bank. The GFC revealed various shortcomings in the Basel II approach that were subsequently addressed by a series of reforms."*

The consultation report also claims that the risk sensitivity of the prudential framework is well adjusted. We fundamentally dispute with this assessment and, while in agreement with the approach outlined below, we do not believe that this approach has been followed in frameworks like the European Solvency II.

> *"The risk sensitivity of the prudential framework is one of the drivers of a sustainable securitisation market that can support financing to the economy. Such a framework, by ensuring that capital charges are commensurate with the risks, enables banks to contribute to a proper functioning of the market and to channel lending to the real economy. As noted in section 3.1, the Basel III reforms increased overall capital charges for securitisation exposures and generally made them more risk sensitive."*

Moreover, the consultation notes that the Joint Committee of the European Supervisory Authorities concluded in 2022 that re-calibrating the securitisation prudential framework would not be a solution that would ensure the revival of the securitisation market.

By contrast, in the European context, the recent political agreement[9] on Solvency II, as well as the Noyer Report[10], have recognised the inadequacy of the prudential framework and the need to ensure that the prudential treatment and capital requirements of investments in securitisation, including STS, appropriately reflects the actual risks of the assets.[11] We believe that post-GFC reforms have failed to follow a risk-based approach to both the non-STS and the STS prudential treatments. In the European context particularly there is a need for a revision of the framework

[9] https://www.consilium.europa.eu/en/press/press-releases/2023/12/14/solvency-ii-and-irrd-council-and-parliament-agree-on-new-rules-for-the-insurance-sector/
[10] https://www.tresor.economie.gouv.fr/Articles/e3283a8f-69de-46c2-9b8a-4b8836394798/files/6b8593b5-ca31-45a3-b61c-11c95cf0fc4b
[11] Recital 83b. https://data.consilium.europa.eu/doc/document/ST-5481-2024-INIT/en/pdf

in order to introduce the principles of capital neutrality and pari passu treatment for similarly rated assets.

We believe that the US example is valid for many global regulators, including those in Europe. In the USA, for example, under the current National Association of Insurance Commissioners ("NAIC") regime CLOs are regarded as pari passu with corporate debt. This means that, for example, AAA CLO tranches get the same capital treatment as a AAA rated bond, which reflects the similar risk profile of these assets. In recognition that CLO investment grade tranches have a better historical default rate than similarly rated corporate bonds, the NAIC is updating the capital charges for CLOs to better reflect their actual risk.

By contrast, in the EU a corporate bond might get a 7% capital charge while an equivalent CLO can get up to 100%, which does not reflect the reality of the assets and disincentivises investment in the European market. This mismatch puts EU investors at a disadvantage and makes the European market less competitive. In particular, BBB CLO tranches should be targeted for a pari passu treatment with corporate debt based on their lower historical default rate. Securitisation markets generally cannot function without robust demand for BBB tranches, for which insurers are the logical participant.

As seen in Figure 1 below, the comparison between the cumulative defaults for CLOs compared to corporate debt puts CLOs at a clear advantage. This market reality, however, is not taken into account in European capital requirements, which instead seems to be reversed and penalises assets that are safer and have lower defaults. The justification for this non neutrality and the disproportionate and unrealistic capital treatment is based on the supposed existence of model risk. These model risks, however, do not seem to be manifesting, which should make regulators and policymakers question the non-neutral approach followed in the European market.

Figure 1: CLO and Corporate Bond Cumulative Defaults[12]

CLO and Corporate Bond Cumulative Defaults

CLOs' historically low default rate across the ratings spectrum compares favorably to corporate debt.

	CLO 1.0 + 2.0	Corporate	
Original Rating Category		5 Year	10 Year
AAA	0.00%	0.42%	0.83%
AA	0.03%	0.41%	0.96%
A	0.15%	0.64%	1.65%
BBB	0.30%	1.79%	3.93%
BB	1.26%	7.26%	13.35%
B	3.36%	17.48%	24.79%

Importantly, we believe that Solvency II capital charges for prudentially regulated investors investing in real assets such as equity, company debt and property do not correctly reflect the real economic risks faced by insurers and banks, which also suffer from a myriad of unduly restrictive features when it comes to securitisation. Even accounting for any potential increase in complexity arising from the securitisation instrument, the current treatment is entirely disproportionate to the real risk of a securitised asset compared to an equally rated covered bond or a corporate loan. This can be observed in Figure 2 below, as well as by comparing the treatment received by securitisations in the EU with other equivalent jurisdictions like the USA (Figure 3).

A further example is that, in the USA, the NAIC has increased on an interim basis the risk-based capital charges for ABS residual tranches.[13] Even if the most penalising scenario materialises and the proposed 45% residual capital charge is maintained, this would remain significantly better than the EU equivalent. In fact, the treatment afforded to the riskiest portion of securitisations under the proposed US insurance rules would still be better than the treatment of the highest quality/lowest risk non-STS securitisation under EU rules.

[12] https://www.guggenheiminvestments.com/perspectives/portfolio-strategy/understanding-collateralized-loan-obligations-clo

[13] https://content.naic.org/sites/default/files/inline-files/Oliver%20Wyman%20Residual%20Tranche%20Report.pdf

Figure 2: Capital charges for assets with 5/10/15 year durations for three indicative credit quality steps[14]

Table 1 – Capital charges for duration of 5 years for three indicative credit quality steps

	CQS 1	CQS 3	CQS 5
Covered bonds	4.5%	-	-
Bonds/loans	5.5%	12.5%	37.5%
STS senior	6.0%	14.0%	47.0%
STS non senior	17.0%	39.5%	100.0%
non STS (other)	67.0%	98.5%	100.0%

Table 2 – Capital charges for duration of 10 years for three indicative credit quality steps

	CQS 1	CQS 3	CQS 5
Covered bonds	7.0%	-	-
Bonds/loans	8.5%	20.0%	58.5%
STS senior	9.5%	22.5%	73.5%
STS non senior	26.5%	63.0%	100.0%
non STS (other)	100.0%	100.0%	100.0%

Table 3 – Capital charges for duration of 15 years for three indicative credit quality steps

	CQS 1	CQS 3	CQS 5
Covered bonds	9.5%	-	-
Bonds/loans	11.0%	25.0%	61.0%
STS senior	12.0%	28.0%	76.5%
STS non senior	34.0%	79.0%	100.0%
non STS (other)	100.0%	100.0%	100.0%

[14] https://www.eiopa.europa.eu/system/files/2022-06/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf.
"Bonds/loans" category includes corporate bonds.

Figure 3: Comparison of the securitisation regulatory and prudential framework in the EU and the USA (based on Table 1 in page 49 of the Noyer Report)[15]

		European Union	United States
Prudential treatment for banks	Solvency (p-factor)	Standard approach: - Non-Simple, Transparent and Standardised (STS): 1 - STS: 0.5 Internal model: minimum of 0.3	Standard approach: 0.5 Internal model Implicitly close to zero
	Liquidity (liquidity coverage ratio (LCR) eligibility)	Senior STS: HQLA level 2b (25-35% discount) Non-STS: non-eligible	Agency MBS: HQLA 2a (15% discount)
Prudential treatment for insurers		High capital requirements: higher charge for a senior tranche than for a direct exposure to the same pool Poor risk differentiation (no distinction between non-STS tranches)	Moderate charges Granular risk differentiation: 21-category scale according to tranche rating
Structuring rules	Risk retention	Required	Required (optional for open-market CLOs)
	Re-securitisation	Prohibited	Allowed
	Reporting and due diligence	Specific obligations	General obligations under securities law

[15] https://www.tresor.economie.gouv.fr/Articles/2024/04/25/developing-european-capital-markets-to-finance-the-future

5. *Other reforms: Does the report accurately identify other G20 and domestic financial reforms that are most relevant for securitisation markets? Are there other reforms that should be considered in terms of their impact on market participants?*

Due diligence and disclosure reforms

We believe that the regulatory response aimed at strengthening requirements for investors to conduct adequate due diligence has been a failure. Overall, the detailed due diligence obligations for institutional investors add little value, yet the associated compliance risks are a significant barrier to their investment in securitisation products.

Regional regulatory frameworks like the EU and UK Securitisation Regulations prescribe extremely detailed investor due diligence requirements which are disproportionate compared to other comparable financial products and do not account for other rules, such as the AIFMD, which already address similar matters. This creates an administrative burden on investors to demonstrate compliance and creates bottlenecks in the investment process. Requirements should be reassessed to take into account the type of investor (retail or professional) and existing investor protection mechanisms to remove duplicative layers of due diligence. Reducing the burden placed on investors would boost the competitiveness of European markets.

We believe that a better approach to due diligence requirements at the global level and in regional contexts like the EU should be to relax certain requirements for the most sophisticated investor groups, such as AIFMs. Non-prudential but regulated investors should benefit from a lower level of due diligence obligations commensurate with the non-prudential impact of their securitisation investments, particularly if they are already covered by an overarching regulatory regime that includes extensive due diligence requirements. For example, the requirement to conduct due diligence on the originator/original lender itself, in addition to the underlying exposures, should be reconsidered. We also believe that there should also be more proportionate transparency and disclosure rules for issuers and managers of securitisations.

Additionally, the securitisation regulatory framework should, where appropriate, defer to sectoral legislation when it comes to due diligence requirements. For example, AIFMD already has detailed and strict due diligence requirements that apply to any investment managers can make. Additionally, there are operational and organisational requirements that managers need to tailor to the assets and strategies they focus on. The EU SR requirements therefore appear as largely redundant for market participants already subject to the AIFMD.

A key problem with the existing European framework is that the current wording of the EU SR requires any disclosure to comply with specific EU requirements. In many cases, non-EU regulatory regimes are substantially similar to EU requirements in terms of enabling investors to evaluate risk and perform due diligence and, in many circumstances, identical information is

reported, albeit in a different format to the prescribed Article 7 templates. However, the current wording of Article 7 serves to:

a) Create significant administrative overheads such as performing a gap-analysis exercise between the disclosure requirements of the third-country securitisation regulations and those of Article 7 for each new prospective investment opportunity.

b) Prevent EU institutional investors from investing in third-country securitisations where sufficient information to allow investors to evaluate risk and perform due diligence is disclosed (or made available on request), but the level of detail or exact format of disclosures does not match that prescribed by Article 7.

This is a problem that encompasses all third-country securitisations, but its most significant impact is to investors that are locked out of investing in substantial portions of US securitisation markets, which are some of the most liquid and dynamic securitisation markets in the world. An illustrative example is an investor interested in an Auto ABS originated in the US. SEC regulations require the disclosure of:

a) Asset-level information covering 70+ fields.[16] We believe this information is fully sufficient to allow investors and investment managers to evaluate risk and perform due diligence. Furthermore, it has substantial overlap with the 84 fields required by the EU SR Annex 5, even though it does not perfectly match all fields.

b) Distribution and pool performance information.[17] This information is substantially similar, but not identical to, the 64 fields mandated by Annex 12 and is more than sufficient to allow investors to evaluate risk, monitor performance and perform due diligence.

Importantly, recently approved UK reforms[18] have been achieved a more principles-based and proportionate due diligence approach to verifying disclosure by overseas sell-side parties with EU rules. The UK approach has produced a single approach that requires institutional investors to verify:

- the sufficiency of the information a sell-side party has made available to institutional investors to enable them to independently assess the risk of holding the securitisation position;
- that they have received at least the information listed in the rules; and

[16] *US CFR 17 Part 229.1125 Schedule AL - Asset-Level Information - Item 3 - Automobile Loans*, https://www.ecfr.gov/current/title-17/chapter-II/part-229/subpart-229.1100/section-229.1125

[17] *US CFR 17 Part 229.1121 – Distribution and pool performance information,* https://www.ecfr.gov/current/title-17/chapter-II/part-229/subpart-229.1100/section-229.1121

[18] https://www.fca.org.uk/publication/consultation/cp23-17.pdfhttps://www.fca.org.uk/publication/policy/ps24-4.pdf-

- there is a commitment from the sell-side parties to make further information continually available, as appropriate.

Beyond allowing investors in foreign securitisations to rely on substantially similar information, an alternative beneficial solution would be establishing a wider recognition of foreign regimes. If a securitisation is originated in a third country but complies with national rules, investors should be free to conduct their due diligence based on the information available even if the information is not "substantially the same".

Particular focus should also be given to reducing the reporting burden and improving the disclosure requirements for issuers and managers of private securitisations and CLO transactions. ESMA's recent engagement with the industry has been a welcome development in order to analyse how the current securitisation disclosure framework can be amended to support burden reduction.

6. *Conceptual framework: Does the report adequately explain the objectives, transmission channels and expected outcomes of the securitisation reforms? What other metrics to assess the impact of the reforms should be considered?*

For detailed comments on the relevance of risk retention reforms and the effectiveness of risk retention achieving the policy objective of interest alignment, please see section 8.

Effectiveness of the securitisation reforms

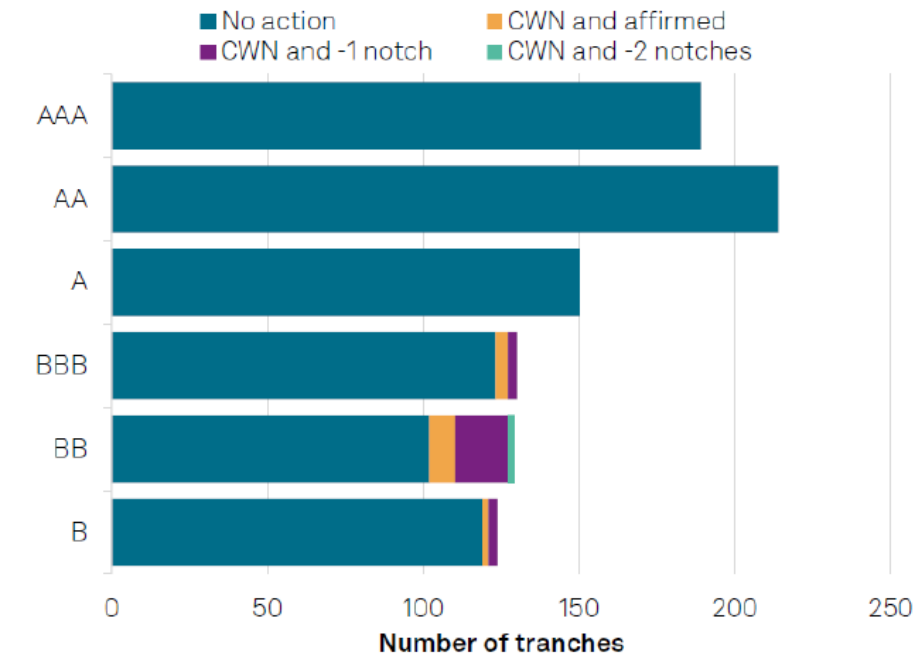
7. *Resilience metrics for the CLO market: Does the report accurately describe the evolution of resilience indicators for the CLO market? To what extent can the evolution of these indicators be attributed to the reforms?*

The evolution of the CLO market

We do not believe that the consultation report accurately approaches the CLO market and its evolution since the GFC. A key error in its approach is including CLOs and CDOs in the same category, which demonstrates a fundamental misunderstanding of the characteristics of each securitised asset class. This association inevitably makes CLOs seem riskier than their real performance and risk profile and leads the FSB to disregard the actual data and the evolution of the market. For example, it attributes the low default rate of CLO tranches post-GFC to the overall macroeconomic trends, the extended interest rate period and fiscal support in periods like the COVID-19 pandemic. This analysis overlooks that CLO tranches have continued to perform well over the past two years of high rates and that during the pandemic they proved resilient in markets

like the USA, where there was no fiscal support for indebted companies. While it is true that the market stress of the past few years has not reached the levels seen during the GFC or in previous crises, the performance during this time indicates that the CLO market would prove resilient even in the face of a more acute credit cycle. The consultation report also states that the CLO market is reliant on sufficient liquidity to function, which is a generic comment without any specific relevance to the CLO market and which can be applied to any financial market.

Figure 4: European CLO rating transitions during COVID-10, March-December 2020[19]



Source: S&P Global Ratings.

The CLO asset class has "historically shown strong credit performance with few defaults", according to S&P, which has rated nearly 21,000 CLOs. The first defaults of CLOs originated after 2008-2009 only occurred in 2021. The overall global CLO default rate rose to 0.08% in 2021 from 0.02% in 2020, returning to the 2019 level and near its 0.09% long-term average. By comparison, the speculative grade corporate default rate has always been above the default rates of CLOs – 5.5% in 2020, 1.68% in 2021. No US or European leveraged loan CLO tranche originally rated 'AAA' has ever defaulted (see Figure 5 below).[20]

[19] Source: S&P Global Ratings - Investor Outreach: European CLOs Market Insights, Performance Trends & Developments
[20] https://www.spglobal.com/ratings/en/research/articles/221031-default-transition-and-recovery-2021-annual-global-leveraged-loan-clo-default-and-rating-transition-study-12535652

Figure 5: CLO default summary by original S&P rating[21]

	--CLO 1.0--			--CLO 2.0--		
	Count of original ratings	Count of defaults	Currently rated	Count of original ratings	Count of defaults	Currently rated
Global						
AAA	2,021	0	0	3,982	0	1,894
AA	843	1	0	3,359	0	1,686
A	1,039	5	0	2,673	0	1,363
BBB	1,079	13	0	2,423	0	1,324
BB	776	39	1	2,045	2	1,154
B	39	4	0	718	3	447
Total	5,797	62	1	15,200	5	7,868

We believe that CLOs are a positive market force enhancing financial stability and increasing the provision of financing to the real economy. A key feature of securitisation is that by pooling assets, the securitisation lowers the overall risk exposure to the investor compared to a single investment. CLOs are a prime example of how securitisation structures reduce risk for investors and provide stability to the market, and they include structural features and protections that differ from other securitisation products. Given that market stress and recessions are inevitable, we believe that CLO structures mitigate such stress, are designed to be resilient and avoid spreading the risk through the wider financial system.

Moreover, CLOs are a key economic actor that, as with other securitisation structures, decreases the dependence of European borrowers on banks as their lifeline to funding. By increasing the availability of finance and liquidity for EU businesses, CLOs also help increase market resilience. CLOs behave like a closed-end fund in many respects, meaning they are unlikely to be forced sellers during times of stress. Instead, they typically step up as buyers helping to reduce volatility. An example of the important backstop provided by CLOs is that the leveraged loan market index only takes a large dip when CLO issuance is on pause. A key driver in the strong activity of the US and European leveraged loans markets in Q1 2024 has been the surge in issuance volumes of CLOs, which "have long been the lifeblood of the US loan market".[22]

CLOs are also increasingly participating in restructurings and becoming an integral provider of capital and liquidity in that market. New mechanisms have been introduced to allow CLOs to participate in a broader range of restructuring and distressed situations, such as the introduction

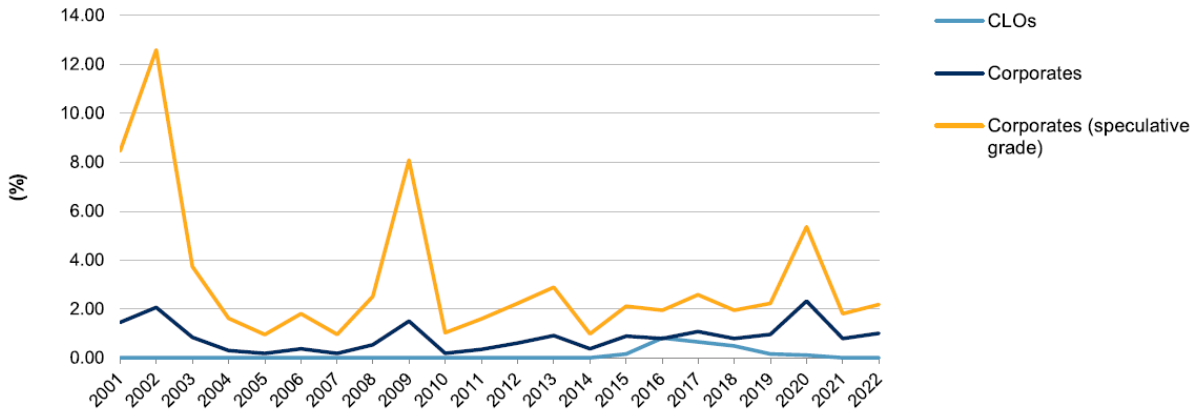
[21] https://www.spglobal.com/ratings/en/research/articles/221031-default-transition-and-recovery-2021-annual-global-leveraged-loan-clo-default-and-rating-transition-study-12535652

[22] https://www.partnersgroup.com/~/media/Files/P/Partnersgroup/Universal/perspectives-document/20240425-partnersgroup-qlmc-q1-2024.pdf

of debtor-in-possession loans in Europe to allow CLOs to invest at any time in super senior debt issued as part of a distressed situation.[23]

Given the relevance of CLOs to global credit markets, we welcome the recognition in the FSB's consultation paper, for example in Graph 14, of the resilience of CLOs compared to other asset classes such as leveraged loans. See also Figure 6 below:

Figure 6: Annual European default rates[24]



Default rates for CLOs and corporates include all European rated entities. Speculative-grade corporates include only companies rated 'BB+' or below. CLO--Collateralized loan obligation. Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro.

The consultation report does successfully identify the market changes that have taken place since 2010, which have led to an entirely new generation of CLOs 2.0, but does not integrate this into its analysis of the resilience and value of the CLO market.

CLOs' unique features like active management, diversification and investor constraints have all been enhanced since the GFC, establishing a clear distinction between the pre- and post-GFC generations of CLOs. Key differences between the first-generation CLO 1.0 transactions and the post-GFC CLO 2.0 transactions include:

- More credit enhancement for the rated CLO notes, especially at the top of the CLO capital structure;
- Collateral pools that excluded investments in assets other than corporate loans and some small portion of corporate bonds;

[23] https://www.allenovery.com/en-gb/global/news-and-insights/publications/the-growing-role-for-clos-in-restructurings
[24] Source: S&P Global Ratings - 2022 Annual Global Levergaed Loan CLO Default and Rating Transition Study

- Transaction documents that incorporated lessons learned from the GFC, including provisions that prevented or mitigated CLO note cancellation and limited the manager's ability to extend the life of the CLO transaction via trades done after the end of the reinvestment period.

- The investor base for the 2.0 transactions was (and is) less levered and less sensitive to changes in market value of the tranches than the CLO 1.0 universe had been.

We welcome the FSB's reference to Bank of England analysis showing that even after applying stress that resembles the GFC, holders of investment-grade tranches (i.e., rated BBB or above) would not incur losses due to defaults and "that it would take a loss rate more than twice as severe as that of the financial crisis for AAA-rated tranches to incur losses." While model risk always has to be taken into consideration, this Bank of England's report also accounts for a potential deterioration in lending standards on top of stress resembling that of the GFC, showing that CLO structures are reliable absorbing and mitigating stress and preserving investor value even if collateral quality potentially decreases.[25]

8. *Risk retention in CLOs: Does the report accurately describe risk retention practices in the CLO market before and after the reforms? What additional analysis could be included to assess the effectiveness of risk retention in CLOs across FSB jurisdictions, including on how financing of risk retention deals by third party investors impacts effectiveness?*

While we agree with the consultation paper's analysis and its literature review on the reduction of risk and misaligned incentives that is achieved by risk retention practices, we also believe that these are not the only mechanisms through which skin-in-the-game and a better alignment of interest and incentives can be achieved. It may be true, as outlined by the consultation, that "*underlying loans of securitisation deals with risk retention have: a lower probability of becoming non-performing, lower loan-to-value (LTV) ratios, higher income to debt service ratios, a lower delinquency amount, and a shorter time in arrears*." However, we believe that it is important for regulators to recognise that other market best practices and forms of 'skin-in-the-game' such as fee structures can provide for greater alignment of interest. We also believe that risk retention can unintentionally give investors a false sense of security about the credit quality of the assets, as risk retention practices are not a guarantee of proper underwriting and interest alignment.

[25] https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/july-2019.pdf

Impact of risk retention requirements on the EU and UK markets

This is particularly relevant in the context of US open-market CLOs, which thanks to the 2018 court decision in *LSTA vs. SEC*[26] are not obliged to comply with the risk retention provisions of Section 941 of the Dodd-Frank Act. While this decision has not impacted the alignment of interests in the US CLO market, it had consequences in the EU and UK markets, where their respective Securitisation Regulations require EU and UK AIFMs, their subsidiaries and affiliates to evidence that any securitisations they invest in comply with risk retention requirements (i.e., the securitisation sponsor or issuer must retain 5% of the securitisation as a 'skin-in-the-game' alignment of interest).

This means that many US open-market CLOs do not meet the EU risk retention requirement and are considered non-compliant investments under the EU SR. Under the Regulation, EU AIFMs and their international subsidiaries are required to evidence that the securitisations they invest in are compliant with the risk retention requirement, which means that EU AIFMs and their international subsidiaries cannot invest in these US CLOs. While some US open-market CLOs are structured to comply with EU risk retention requirements and appeal to European investors, the great majority of the market is not structured in that way, as the US investor base is generally sufficient. This excludes EU-based AIFMs from a significant investment market worth around USD 1tn.[27]

As well as preventing EU investors from being able to access this market, the SR also diminishes the competitiveness of the EU asset management industry as EU AIFMs are unable to offer a full product set to their investors. This places them at a competitive disadvantage, for example when raising new funds. In order to build a globally competitive European securitisation market, AIFMs should be able to access the full range of securitisation products.

This prohibition also undermines the returns achieved by European institutional investors, as US CLOs are the deepest market and have a strong performance record. We also believe that such a prohibition creates concentration risks among European investors, who are forced either to over allocate to European assets, increasing their risk profile, or to under allocate in order to maintain their desired risk levels. Expanding the available investment universe would improve diversification and, ultimately, allow investors to allocate more to European assets by reducing their concentration risk.

Other mechanisms that can substitute risk retention

These impacts are particularly disproportionate considering that there are other mechanisms in the CLO market that can achieve the same level of 'skin-in-the-game' and interest alignment, while also avoiding the increased due diligence burden and cost of capital for originators and investors.

[26] https://www.cadwalader.com/resources/clients-friends-memos/court-of-appeals-decision--managers-of-open-market-clos-not-subject-to-dodd-frank-risk-retention

[27] Based upon broker research we have been provided, as of March 2023 the total USD value of CLOs outstanding in the market was USD 963bn for US CLOs and USD 248bn for European CLOs.

As recognised by the consultation paper, *"[these costs decrease] the relative attractiveness of securitisation as a financing tool (i.e., increasing prices and lower volumes)."*

We recognise that risk retention can play an important role in securitisation structures, yet also believe that there are many characteristics of CLOs that make risk retention less relevant than for other forms of securitisation. This is particularly relevant considering that the consultation paper recognises that risk retention does not always achieve the intended risk reduction in the CLO market:

> *"The financing in certain cases of CLO managers' retained risk by third-party investors raises questions about the extent to which the objective of risk alignment is fulfilled. CLO managers may operate with light balance sheets, so any retained risk would force them to fund these assets with additional debt or equity.[28] This has contributed to the establishment of risk retention vehicles to attract third-party investors such as pension funds or family offices,[29] which appear to be used widely in both the US (where there are no risk retention requirements applicable to open-market CLOs) and Europe. This practice might not be fully aligned with the goals of risk retention regulation[30] because in many cases the vehicle does not belong to the same corporate group as the CLO manager, thereby moving risk to parties not originally envisioned by the IOSCO recommendations.[31] Such a practice may also complicate authorities' efforts to determine who is ultimately exposed to risk retention-related losses. Moreover, risk retention vehicles might themselves be levered and the financing arrangements may lead to margin calls, especially in cases where the retained risk consists of first loss exposures and hence subject to substantial asset value volatility."*

It is important to note that the comparison of the CLO default data for Europe and the USA does not show any meaningful difference in risk achieved by risk retention requirements. As evidenced by S&P data, risk retention in CLOs does not lead to a reduction in the default rate of European

[28] In this context, it has been argued that the need to finance risk retention requirements may have driven the sale of some smaller, independent CLO managers to larger groups such as private equity firms.

[29] During the period when risk retention was mandatory for open-market CLOs in the US, some CLO managers started financing the horizontal risk retention slice through a separate SPV commonly referred to as the risk retention vehicle. Third-party investors are given incentives to participate, such as discounted management fees. See Risk.net (2014), Lawyers tout fixes for CLO riskretention woes, 25 November; and Risk.net (2023), CLO managers tap captive capital for 'uneconomical' deals, 30 August

[30] It may also destabilise CLO managers financially. For example, it has been argued that the need to finance risk retention requirements may have driven the sale of some traditional independent CLO managers to larger groups with balance sheet such as private equity firms

[31] To address this issue, the EU has recently introduced regulatory changes clarifying that an entity created solely for the purpose of holding the risk retention slice should not be considered as a legal option. See EU (2023), Commission delegated regulation (EU) 2023/2175, Article 2 (7.a and 7.b).

CLOs.[32] Another valid comparison that leads to the same conclusion is between CLO 1.0 and CLO 2.0 (see Figure 5). Furthermore, the USA serves almost as a laboratory case study: there has not been risk retention in US open-market CLOs for the past decade and the number of defaults is still very low and similar to Europe, even though the quality of collateral might have deteriorated in recent years following the increase of interest rates. Even the European model of risk retention can be questioned in its effectiveness, as in many cases the risk retention is financed by external investors, not by managers' 'skin-in-the-game'.

This does not mean that risk retention does not achieve a risk reduction in other securitised asset classes, but it shows that it is not the only way to align interests and include managers' 'skin-in-the-game'. In the case of CLOs, risk retention requirements add a cost and operational burden to managers but do not change the risk profile meaningfully. Instead, the key to the CLOs' risk profile is the origination of collateral and the additional structural protections that are present in the market.

Importantly, the CLO market includes structural features and protections that differ from other securitisation products. Firstly, CLOs are unique in that a CLO manager can actively manage, within a set of well-defined constraints, the pool of underlying loans to optimise returns for their investors. In practice this means that the CLO manager seeks to identify better performing borrowers and loans rather than simply 'buying the market'. This is an important distinction between CLOs and other securitised products, where there may be little or no ability to actively manage the investors' exposure to the underlying pool of assets. Figure 7 below shows the impact of this active management on CLO performance.

[32] https://www.spglobal.com/ratings/en/research/articles/221031-default-transition-and-recovery-2021-annual-global-leveraged-loan-clo-default-and-rating-transition-study-12535652

Figure 7: Performance of actively managed CLO compared to 'static' CLO (Source: S&P[33])

U.S. BSL CLOs | Value Of Active Management During A Turbulent 2022

- Turnover of assets in BSL CLO collateral pools in 2022 was just over 30.5%, meaning that just over 30% of the loans that had been in CLO collateral pools at the start of the year were no longer in the collateral pools at the end of the year.
- We wanted to look at the impact that portfolio turnover had on CLO credit metrics. To do this, we looked at:
  - The actual change in BSL CLO credit metrics during 2022, including portfolio turnover (Table 1).
  - Metrics from the same BSL CLO collateral pools, but assuming they were static CLOs with no trading or asset turnover during 2022 (Table 2).
- For the hypothetical static pool CLO scenario, the same assets were in the collateral pools at the start of the year and end of the year.
- The difference between the actual CLO portfolios and hypothetical static CLO portfolios is shown in Table 3.
- On average, the trades increased the proportion of loans from 'B-' companies, because when a company saw its rating lowered to the 'CCC' range a manager would often sell loans from that company and purchase loans from a 'B-' rated company.
- On average, all other CLO credit metrics benefitted from the trading activity: exposure to 'CCC' assets and defaulted assets was lowered, the SPWARF was lower (indicating higher average portfolio ratings), the par value of the assets was greater, and the junior O/C test cushion was greater.

Table 1 - Actual BSL CLO Performance in 2022

Metric	01-Jan-22	31-Dec-22	Change
Portfolio Turnover	n/a	30.55%	30.55%
Exposure to 'B-' Assets	26.36%	30.03%	3.67%
Exposure to 'CCC' Assets	4.93%	5.23%	0.30%
Exposure to Defaulted Assets	0.17%	0.50%	0.33%
SPWARF	2699	2764	65
Portfolio % of Target Par	99.66%	99.85%	0.19%
Junior O/C Test Cushion	4.35%	4.45%	0.09%

Table 2 - Hypothetical Static Pool BSL CLO Performance in 2022

Metric	01-Jan-22	31-Dec-22	Change
Portfolio Turnover	n/a	0.00%	0.00%
Exposure to 'B-' Assets	26.36%	28.14%	1.78%
Exposure to 'CCC' Assets	4.93%	7.33%	2.40%
Exposure to Defaulted Assets	0.17%	0.81%	0.65%
SPWARF	2699	2804	105
Portfolio % of Target Par	99.66%	99.66%	0.00%
Junior O/C Test Cushion	4.35%	4.15%	-0.20%

Table 3 - Manager Impact On CLO Metrics

Metric	Year-end Results: Managed vs. Hypothetical
Portfolio Turnover	30.55% higher
Exposure to 'B-' Assets	1.89% higher
Exposure to 'CCC' Assets	2.10% lower
Exposure to Defaulted Assets	0.31% lower
SPWARF	40 lower
Portfolio % of Target Par	0.19% higher
Junior O/C Test Cushion	0.30% higher

It is also important to bear in mind that CLOs benefit from extensive levels of diversification, as they typically have several hundred borrowers in their portfolio. This reduces investor exposure to individual defaults. Additionally, CLOs operate within 'constraints', which limit the discretion of the CLO manager when managing the underlying pool of loans. These are generally designed to align the interests of the CLO manager with the investor. For example:

- CLO managers can only turn over a limited portion of the collateral, generally between 20-30%, each year.
- CLO managers can only replace the loans in the portfolio with loans that meet the eligibility criteria of the CLO structure used to determine the initial asset pool.
- The eligibility criteria used to determine the initial asset pool are typically set by external ratings agencies rather than the asset manager.
- CLO managers typically report details of trading of underlying exposures in the context of the CLO manager's management responsibilities, providing investors with transparency.
- A proportion of the CLO manager's fees are subordinated, which means that this proportion only gets paid when the CLO's debt tranches have paid interest. This

[33] https://www.spglobal.com/_assets/documents/ratings/research/101572430.pdf

incentivises strong performance of the CLO transaction and aligns the CLO manager's interest with their investors.

- The Volcker Rule restricts CLOs from investing more than 5% of their value in debt securities (such as high-yield bonds).

Lastly, CLO offering documents require managers to comply with various performance tests and criteria prescribing how the CLO should be managed rather than on a solely discretionary basis. These tests and criteria are outlined in the table below:

Standardised tests	Description
Over Collateralisation (OC)	The OC tests protect noteholders against a deterioration in the value of the portfolio collateral. This is tested by comparing the value of outstanding notes versus collateral and ensuring it is sufficiently over collateralised.
Interest Coverage (IC)	The IC tests protect noteholders against a deterioration in interest income from the portfolio. This is tested by comparing the interest income received versus the liabilities due to ensure there is sufficient coverage.
Weighted Average Life (WAL)	The weighted average life of all the loans in the portfolio. Designed to prevent the total risk horizon of the portfolio from exceeding a covenanted level.
Weighted Average Spread (WAS)	The average effective interest rate spread for the loan portfolio over an index rate such as LIBOR. This test ensures a minimum level of income from the underlying portfolio that should be sufficient to pay interest on the liabilities.
Weighted Average Rating	A measure of the average credit rating of the portfolio, which is an indicator of the portfolio's average credit risk.

We believe that these practices ensure that investors' interests are being protected, promote consistency across the market and support the efficient allocation of capital across the economy. The strong performance of CLOs during the past decade demonstrates the effectiveness of these protections and the resilience of the CLO structures. We believe that regulators and policymakers should consider other structures beyond risk retention to achieve the policy objectives of interest alignment and risk reduction. Equivalence with third party regimes that achieve the desired risk

alignment is also desirable and would free the market from a number of strict and unnecessary requirements.

Finally, we would also note that in jurisdictions like the UK and the EU, AIFMs are also subject to multiple risk management disciplines and requirements under the AIFMD that apply to all its activity – including any potential investments in CLOs – which sit atop the product level requirements imposed by the UK and EU Securitisation Regulations.

9. *Resilience metrics for the non-agency RMBS market: Does the report accurately describe the evolution of resilience indicators for the RMBS market? To what extent can the evolution of these indicators be attributed to the reforms?*

We welcome the acknowledgement that key issues, such as the collateral quality in the RMBS class, have considerably improved over the past decade with the consequent decline in defaults. The consultation report notes that collateral quality does not seem to have improved in CLOs relative to the pre-GFC environment and compared to RMBS. However, as shown by S&P data, CLO defaults have not been comparable to RMBS defaults historically, which indicates that the quality of collateral in CLOs was of superior quality.

12. *Simple, transparent and comparable (STC) securitisations: Does the report accurately describe the impact of the introduction of the STC framework on the securitisation market? To what extent has the reform met its objectives?*

We agree with the introduction of STC labels like the EU's Simple, Transparent and Standardised framework, and we believe that it has alleviated, to an extent, the capital charge burden for STS securitisations. We agree with the consultation paper that the growth of STC/STS securitisations is a possible factor in creating more transparent structures and reducing risk in some asset classes. However, STS securitisations continue to make up only a small fraction of the market and it is likely, as noted by the FSB, that the STC/STS label might have led to the relabelling of some transactions rather than stimulate new activity.

Overall, we believe that the evidence of the European market is that the STS framework is not currently fit for purpose and has failed to achieve its key objectives, including reviving insurers' interest in securitisation markets. For example, European insurers still find more value in the non-STS category, which, despite the unfavourable capital treatment, represents more than 70% of insurers' investments in securitisation between 2019 and 2020.[34]

[34] https://www.eiopa.europa.eu/system/files/2022-06/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf

While the STS regime was introduced to reinvigorate the securitisation market, the framework has failed to achieve that goal due to the constrained scope of assets that are eligible for STS certification. STS securitisation as a percentage of total issuance in Europe has oscillated between 39% and 27% since 2020, which shows the limited impact that the framework has had.[35] The focus of STS reform should therefore be on expanding the scope of assets that are STS eligible. This reform has previously been undertaken, albeit on a very small scale, with the expansion of the framework to synthetic securitisations, which has successfully supported the competitive European SRT market.

A proper risk-based calibration of the capital treatment is also needed in line with a revision of non-STS capital treatments, along with an expansion of the scope as argued further below. If these problems are addressed, the STS framework will become a useful label to designate simple, vanilla securitisation products. Ultimately, the STS label should be a way for less sophisticated investors, including mid-tier insurers, to access the securitisation market. In this function, the STS framework is key to expanding the investor universe and invested capital of the EU securitisation market.

Expanding the scope of eligible assets

The most important challenge faced by the STS framework in Europe and by the STC system in general, and where reform would generate the widest improvement, is that the scope of eligible assets is particularly constrained by the rejection of 'actively managed' structures. This outright exclusion of active management from the STS regime does not correspond with the realities of the market, as is most evidently seen in the case of CLOs. Under the EU and UK SR, CLOs are considered to be 'actively managed', which disqualifies CLOs from STS certification. The exclusion of CLOs from the STS framework acts as a brake on the provision of finance to European borrowers, while also limiting the ability of banks to de-leverage their balance sheets. Active management, as recognised in the FSB's consultation paper can mitigate credit deterioration and avoid collateral defaults by trading distressed loans.

We believe that the perimeter of what is STC/STS-eligible should be broadened significantly. Requirements around active portfolio management should be clarified and modified to explicitly include transactions where active management occurs within the clear criteria, as is the case with the criteria established by the CLO manager and their investors. The requirements on homogeneity should also be made more flexible to allow CLOs to qualify for STS treatment if they invest both in bonds and loans, which is sometimes the case in the market. These CLOs would not qualify for STS treatment even if the active management hurdle is fixed.

[35] https://www.afme.eu/publications/data-research/details/securitisation-data-report-q4-2023--2023-full-year

Reducing the operational burdens on investors by automating the process by which preferential capital treatment under the STS framework is granted

A key limitation of the existing European STS framework is that it does not directly guarantee preferential capital treatment for qualifying transactions and excludes certain types of investors from preferential treatment.[36] If a securitisation transaction obtains the STS label, investors are not guaranteed to receive preferential capital treatment. Qualifying investors must undertake a multi-step process and tests under the Securitisation Prudential Regulation (2017/2401) which adds costs and hurdles. The application process for preferential capital treatment under the STS certification must be streamlined and improved.

We believe that authorised third-party certification of the STS designation for a securitisation transaction, followed by notification to the relevant regulators, should automatically grant a preferential capital treatment under the STS framework, thus reducing the operational burden imposed on investors.

Broader effects of the reforms

13. *Effects on financing the economy: Does the report accurately describe the main effects of the reforms on financing the economy? Is there additional analysis that could be undertaken to estimate the benefits and costs of these reforms and to assess their impact on securitisation as a financing tool?*

The FSB's consultation claims that there is no evidence that post-GFC reforms impaired the aggregate supply of credit to the economy. While there is no data to quantify this claim, a useful proxy is to analyse the size of the European securitisation market since the GFC, particularly compared to other markets like the USA where the post-GFC reforms were applied differently and where securitisation is a key driver in the robust performance of its economy.

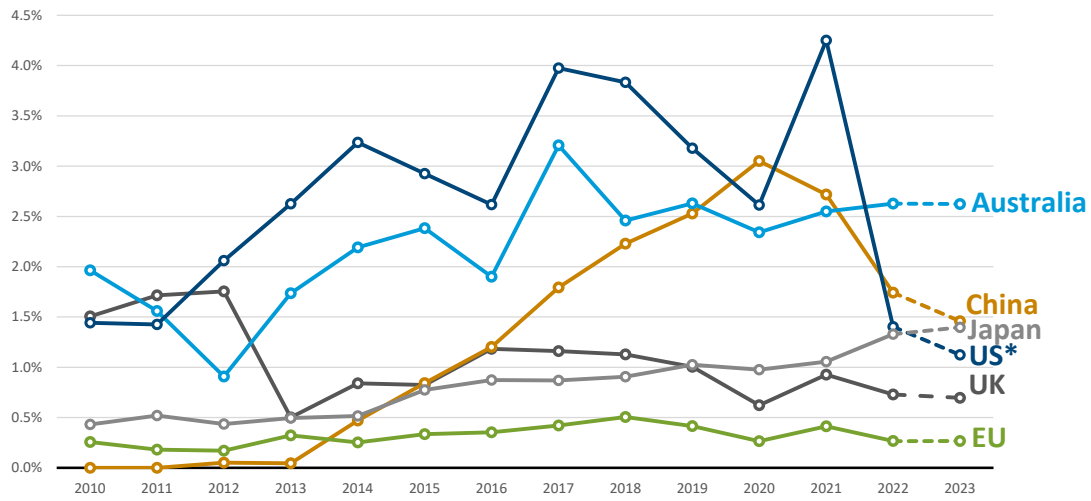
Overall, the size of the European securitisation market has decreased significantly since the Global Financial Crisis, and arguably since the introduction of the EU Securitisation Regulation. The trend before the GFC had been of considerable growth in the market, peaking at more than EUR 2tn in Europe in 2008-2009. Issuance then halted and the market size dropped significantly to EUR 1.5tn in 2013. In Q4 2022, the EU securitisation market was around 540bn EUR. By contrast, in the US, the total amount of securitisation reached USD 13.7tn in 2021, well above its 2008 levels (USD 11.3tn).[37]

[36] https://www.nortonrosefulbright.com/en/knowledge/resources-and-tools/capital-markets-union/securitisation/sts-securitisation-practical-guide

[37] https://www.esma.europa.eu/sites/default/files/2023-09/ESMA50-524821-2908_TRV_risk_analysis_-_EU_securitisation_markets_overview.pdf

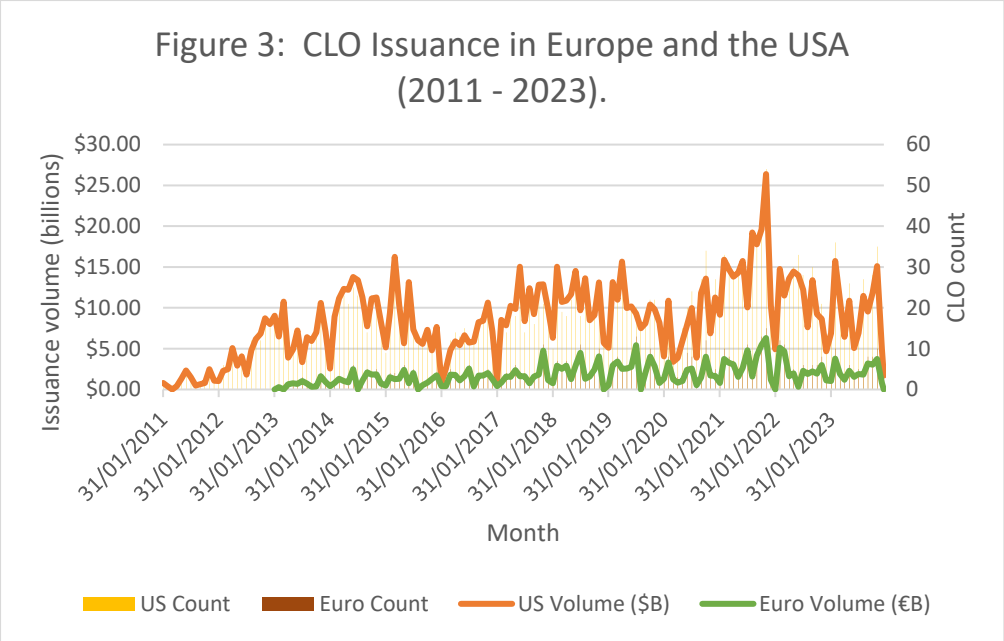
This difference between the US and the EU can partly be explained by structural differences between the two markets, with more widespread use of securitisation for market-based finance in the US and a large share of some of these products (in particular RMBS) guaranteed by state agencies such as Fannie Mae and Freddie Mac. However, the comparison with the US clearly shows that the EU market is small in relative terms and the European market is thus missing on the economic benefits of a well-functioning securitisation market, including additional finance to the real economy. Looking at securitisation issuance as a proportion of GDP is one way to illustrate this point, with the EU lagging behind other markets in terms of the amount that domestic securitisation markets contribute to the financing of the economy. This comparison illustrates that the EU Securitisation market remains small in relative terms and that the benefits of a well-functioning securitisation to the capital markets union remain below par. The fact that the UK also lags below its peers reinforces the view that the Securitisation Regulation plays some part in this.

Figure 8: International securitisation issuance as a proportion of GDP (2010-2023H1, %)[38]



[38] AFME CMU KPIs report.

Figure 9: CLOs issuance, performance and default rates[39]



The issuance CLO structures in Europe since the GFC confirms the underperformance of the European securitisation market relative to its relevant peers. The failure of the European CLO market to achieve its potential is particularly grave considering the role that these structures could play in the European economy, as well as their strong performance over the past decade.

The FSB's consultation report claims that other factors such as the accommodative financial conditions of the past decade, the use of other financial market instruments and central bank refinancing operations, such as those spearheaded by the ECB, might mean that the overall financing to the economy has not been negatively affected by the post-GFC reforms. We would add that the global rise of private credit, with particular focus on the USA, UK and EU, has also contributed to mitigating the impact of the post-GFC reforms. In fact, the rise of private credit has in part been a consequence of the more restrictive regulatory environment and increased capital requirements for banks in the post-GFC context. Nevertheless, we believe that in jurisdictions like the EU and UK, the severe underperformance of the securitisation market over the past decade has meant that the net impact of the post-GFC reforms has been negative and that more capital would have reached the real economy if securitisation markets had been more vibrant.

[39] Pitchbook

14. *Effects on financial system structure and resilience: Does the report accurately describe the extent to which there has been a redistribution of risk from the banking to the non-bank financial intermediation sector? What role did the reforms play in this process and what are the main benefits and risks from a system-wide perspective? How have the reforms impacted the demand and supply of liquidity in securitisation markets?*

The FSB report echoes the concerns expressed in recent times by other global and national regulators around the redistribution of risk across the financial system, particularly from banks to the non-bank financial intermediation sector ("NBFI") and with a special focus on the private credit market.

We believe that the NBFI concept is not only unhelpful but also misleading in understanding potential financial system risks. The acronym NBFI, formerly known as shadow banking, unwisely groups diverse business models, such as money market funds, insurers, hedge funds, private credit, and private equity funds under one umbrella. This oversimplifies complex financial ecosystems while assuming banking regulation is the pinnacle of financial stability management.

The FSB and other regulators generally repeat popular misperceptions about the sector's opacity and lack of regulation and assess the risks of the NBFI sector by comparing it to the banking regulatory and supervisory framework. Today, all financial market entities are regulated and supervised with extensive reporting requirements to their respective sectoral regulators.

Applying bank-centric regulations to non-bank entities is problematic. Banking rules address risks associated with a business model that combines retail deposit-taking, liquidity and maturity transformation, and high leverage. This means that the funding provided does not suffer from liquidity mismatches seen in traditional banking or market volatility associated with bond markets. Loans are generally held to maturity in vehicles that do not provide redemption or withdrawal rights with capital returned to investors only when loans are repaid. Leverage used in funds is generally low and matched with the underlying asset maturity.

Private credit firms, regulated under the EU asset management framework, exemplify this point. They maintain lower leverage and better align assets and liabilities, eliminating the banklike "run" risks witnessed in recent banking crises. In addition, as our research and the recent IMF report show, private credit market activity is less susceptible to a sudden credit shock than the high-yield bond and bank loan markets.

Global regulators dismiss the benefit of moving assets from precarious bank balance sheets funded by flight-prone depositors to those funded by stable, long-term, risk-bearing professional investors. It is difficult to understand how the rise of models that demonstrably generate less

financial stability risk per dollar invested should be seen as anything but a positive step in delivering a more stable and faster-growing economy.

We welcome the FSB's recognition that the transfer of risks outside of the banking sector can lead to a more diverse and robust financing ecosystem. We believe that non-bank investors like private credit managers are well placed in their funding structure and ability to with stand losses. This should allow private credit investors and their managers – AIFMs in the EU – to assume more securitisation risks, such as sponsoring securitisation structures and retaining the 5% risk exposure.