FSB FINANCIAL STABILITY BOARD

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

Response to Consultation

Association for Financial Markets in Europe (AFME)

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?**

Firstly, the Association for Financial Markets in Europe (AFME) would like to thank the FSB for the opportunity to comment on its interim consultation report, (from now on the "Report") which highlights the markedly different approaches in implementing global standards adopted across the world.

The Report states that "the G20 launched a comprehensive programme of financial reforms to increase the resilience of the global financial system, while preserving its open and integrated structure." By its own admission, it acknowledges the challenges in doing this (cf. p. 37). The findings in the Report evidence that both BCBS and IOSCO recommendations have been implemented in very different ways. For these findings to be meaningful, the Report should a) investigate the impact of implementation of regulatory reform upon key metrics across G20 states, member by member, focusing on those member states with highest issuance outstanding, and b) ensure that the selection of metrics used focus on both objectives. Only in this way can one attempt to attribute how the effects of specific implementation by member states have had their own outcomes.

By way of illustration, European RMBS markets have proved resilient with low default rates over the last 40 years. As such, it is not clear that post-GFC regulations have made a positive improvement to these markets' resilience. In fact, there is a risk that post-GFC regulation has actually had a negative impact on the vitality of the European securitisation market by making it less open and integrated. Conversely, in the US, there was a need to address the markets' resilience post-GFC. However, what may be more interesting to investigate is how differences in implementation have influenced issuance levels between regions, in particular why European markets have not yet returned to pre-GFC levels, whilst the US markets have.

Is there other evidence on the effects of the reforms to complement the preliminary findings of the report?

In order to test market hypotheses in relation to the effects, additional metrics should be considered:

• Annual placed issuance volumes is an important metric to include and would be a critical indicator to evidence success in preserving an open and integrated market structure. It is important to draw a distinction between issuance placed with investors and issuance that is retained by the originating entity intended for central bank repo operations.

• Evolution of investor base since pre GFC across relevant regions, focusing on North America, UK, EU, Australia, APAC across key constituent groups, e.g. banks, insurers, asset managers, pension funds and central banks.

• Standardisation of implementation - which measures the extent of global standardisation in terms of coordinated implementation – is important when one thinks about the effect of divergent regulation on inhibiting global capital flows. Section 3.2.2 covers at a high-level divergence in implementation of BCBS securitisation reforms. In order to discern causality between implementation and impact on market structures (both in the context of domestic and international capital flows), a more detailed analysis of implementation is needed. One example could be the significant limitations imposed upon EU investors investing in non-EU securitisations as a result of divergent implementation. The need for more detailed analysis is equally true for Sections 3.2.4 – Incentive Alignment, 3.2.5 – Investor Due Diligence requirements, Disclosure Requirements. We also wish to draw the FSB's attention to the fact that there is a material difference between the scope of certain EU and non-EU securitisation reforms in relation to the non-prudential (i.e. unrelated to regulatory capital requirements) regulation of securitisations (such as risk retention requirements), which is not fully acknowledged in the Report.

• While outside Europe (e.g. in the U.S.) any risk retention, disclosure or transparency reforms apply only to certain (more narrowly defined) ABS products, the Securitisation Regulation in Europe ("SECR") brings in scope any transaction that meets the very wide definition of "securitisation" that turns on there being credit risk tranching, payment dependence upon the performance of the exposure or pool of exposures, subordination of tranches determining the distribution of losses during the ongoing life of the transaction, with an exemption for transactions that demonstrate certain "specialised lending" characteristics. This results in the SECR's net being cast very wide, capturing financial arrangements for which the SECR regime was never designed in the first place and sometimes bringing in-scope transactions which the market does not see as securitisation, which in practice gives rise to unintended consequences and compliance challenges.

• Finally, in order to overcome the inherent challenges in identifying specific cause and macro effects, we would think there is value in complementing this analysis with specific case studies to understand what impact banks and non-banks experience from the implementation of SECR across the G20. A combination of case studies that incorporate within scope, global lenders, funding and managing capital across multiple regions and regional lenders impacted solely by local regulation.

Specific points noted from the Report:

- Page 38 (footnote 73, which references/paraphrases the European Commission's report on the functioning of the SECR) reads "There are few studies on the effects of prudential reforms on securitisation markets, but these also indicate that the reforms have contributed to a higher level of investor protection and hence to more resilient markets." It should be clarified that the relevant text in the Commission's report (page 6) stops at "…investor protection", i.e. the Commission's report does not correlate investor protection and market resilience. This is important, because market resilience can only be achieved through appropriate levels of investor protection. European investors have been arguing that the existing rules intended to provide investor protection, such as due diligence and reporting, are actually too prescriptive and burdensome, and as such, they end up preventing them from investing. The rules, therefore, have the direct opposite effect of the one intended and result in undermining the envisaged objective of creating an open market structure.

- Several references to risk retention and resilience reference footnotes referring to CMBS. However, CMBS is a very different product to RMBS. Consequently, drawing inferences about RMBS based on academic research focused on CMBS may lead to questionable results.

- Annex 2 – the part of the Report that addresses "resilience": In drawing a comparison between pre GFC and post GFC, the focus is heavily skewed towards the US experience. As evidenced in the Report, performance in Europe has differed little over the period. It has been and will continue to be, therefore, very difficult to develop empirical data to draw conclusions either way regarding a change in resilience resulting from these reforms.

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?**

Are the descriptive analyses used to evaluate the effects of the securitisation reforms appropriate?

- Please see response in Question 1 above.

Are there other such analyses to consider?

- Analysis will arise from the inclusion of the additional metrics described in this response.

What types of empirical analysis based on available data could inform the evaluation?

- Annual placed issuance volume - AFME / SIFMA / other historical data by asset class, placed and retained by issuance year.

- Evolution of investor base – Data to be provided by AFME / SIFMA / other members (type and jurisdiction of investor / by risk appetite).

- Standardisation of implementation – creation of a scorecard, measuring different factors.

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?**

Are the securitisation market trends presented in this report adequate given the scope of the evaluation?

- We would suggest to also track the market trends mentioned below.

Are there other important trends that should be included and, if so, what additional data sources could be used for this purpose?

The following market trends should also be tracked and reflected:

- Retained vs. sold issuance per year. To more accurately measure the size of the market, switch from outstandings (which incorporates both retained and sold) to issuance per year, for which primary market issuance vs. retained issuance can be measured.

- Defaults by tranche (original rating).

- Ratings transition by asset class / jurisdiction, vs. other asset classes, eg. corporate credit risk – pre and post GFC.

- Market liquidity – drawing on academic research that covers c.20 years of data.

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?**

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?

- We reiterate our response in Q.1, namely the Report should also drill down on member state specific causality given divergence in implementation.

- Also, it would be worth referring to supplemental regional regulation that would support increasing resilience, e.g. EU credit granting standards (Article 9 of the SECR), which we could not see referenced, but is important in mitigating moral hazard, especially when combined with risk retention and resecuritisation prohibition.

Are there other important aspects of these reforms that should be considered for inclusion?

- No comment.

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?**

Does the report accurately identify other G20 and domestic financial reforms that are most relevant for securitisation markets?

- As per above, the Report would be more accurate if it also considered credit granting standards (Article 9 of the SECR).

Are there other reforms that should be considered in terms of their impact on market participants?

• Solvency II. The effects of Solvency II in isolation had the effect of the withdrawal, prior to its implementation, of substantial insurance capital from investment grade securitisations. These effects are worthy of further consideration.

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?**

Are the objectives of the reforms adequately explained in this report?

• Generally, yes.

Are the transmission channels of the reforms adequately explained in this report?

• Not clear what transmission channels mean in this context.

Are the expected outcomes of the reforms adequately explained in this report?

• It is perhaps worth distinguishing between ex ante and a priori expected outcomes. That is to say, the expected outcomes from BCBS and IOSCO standard setting broadly addressed the shortcomings of pre GFC securitisation, however in certain regions, a priori expectations are now misaligned to those ex ante expectations, especially when considering preservation of an open and integrated structure.

What other metrics to assess the impact of the reforms should be considered?

• Annual placed issuance volume would be a useful metric to include and would be a critical indicator to evidence success in preserving an open and integrated structure.

• Evolution of investor base since pre GFC in the context of local implementation across banks, insurers, asset managers, pension funds.

• Standardisation of implementation - which measures the extent of global standardisation in terms of coordinated implementation – is important when one thinks about the effect of divergent regulation on inhibiting global capital flows.

AFME agrees with the FSB's general comments in Section 3.3 where it sets out the intended effects of the reform and specifically that capital charges should be commensurate with the risks. However, it challenges the presumption that the Basel III reforms have delivered this outcome. Capital calibration derived from historical performance data neither representative of non-US regions issuing into a pre GFC global market, nor representative of the product that is permitted under the current regulatory framework, is more than likely to be misaligned to expected performance of the product in many regions.

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?**

Does the report accurately describe the evolution of resilience indicators for the CLO market?

- Section 4.2, page 40, 3rd paragraph, final sentence:

o “Market conditions sometimes favour the reset or reissuance of outstanding CLOs, making it difficult to predict expected losses of CLO tranches over longer periods.”

o It is not correct to consider this as a factor that makes default rate of CLO tranches low. By definition, the tranche is crystalising no loss at the time of the refinance/reset, since the original tranche is repaid in full by new money.

- Section 4.2, page 42, Box 5:

o The Report should have considered the fact that sustained elevated interest rates across the global economies put additional stress on corporates, particularly when borrowing costs (floating rate for loans) were originally locked in during prior economic periods when base rates were historically low.

o This deteriorates interest coverage ratios and free cash flow generation without any active underlying revenue performance deterioration.

o In other words, defaults can spike not just by underperformance but also by macro-economic policy and conditions.

- Section 4.2, page 43, final paragraph, final sentence:

o “If test levels fall below their trigger levels, cash flows from loan interest and principal payments are diverted away from equity and mezzanine tranches, and these cash flows are used to pay down the liabilities in order of seniority to deleverage the CLO and bring tests back into compliance.”

o The reference to cash flow diversion mechanics is correct, but this is not a new feature enacted post 2008.

- Section 4.2, page 44, final paragraph, middle:

o “Larger average deal or tranche volumes tend to increase the complexity in securitisation, as they represent more loans, underlying collateral, and geographic dispersions.”

o Not necessarily, as often a larger deal simply means pro rata larger individual position sizes.

o Also, greater diversity in the pool is credit-positive for senior CLO debt holders.

- Section 4.2, page 46, final paragraph:

o This is not a crucial point for the conclusions of the Report, as in fact the FSB says it does not have enough evidence to conclude. However, it is worth mentioning, in case it fits

in a broader narrative, that the Report could be better-researched or more in line with market thinking.

o The Report also does not acknowledge that an important factor for risk retention is in relation to the size of capital commitment and the cost of such capital (i.e. the target return the CLO manager needs to provide to the investors from which this capital has been raised).

o Indeed, in case of horizontal risk retention, the return on the risk retention interests will be greater, but it will be needing a greater usage of such permanent capital in terms of absolute amount.

- Section 4.2, page 47, 1st paragraph, middle and 2nd paragraph, start:

o "However, subordination levels increased somewhat since 2018 and until recently, which would be consistent with the hypothesis that investors in non-retention deals require higher subordination for AAA-rated tranches."

o "During the pandemic, newly issued CLO deals in the US with voluntary risk retention exhibited a slightly higher share of lower-rated loans compared to deals without risk retention (see Graph 20), which is consistent with some of the literature on this topic."

o We are sceptical about the conclusions here. Any increase in subordination level has been driven rather by market dynamic factors, such as heightened default concerns / outlook from COVID and then elevated base rates. It is hard to believe in an active relationship between risk retention and initial share of loans rated CCC.

- Section 4.2, page 48:

o The Report should also mention another important factor that is credit positive, namely having a dedicated CLO manager who is actively selecting the inclusion of exposures into the CLO. It is an inherent quality control where incentives are appropriately aligned to encourage the CLO manager to do their job well, e.g. through performance fees and desire to continue to raise fee generating CLO vehicles from prospective investors in future too.

To what extent can the evolution of these indicators be attributed to the reforms?

- No comment.

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?

Does the report accurately describe risk retention practices in the CLO market before and after the reforms?

- It is important to confer with other industry participants to ensure a coordinated response to CLO risk retention questions.

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?

- We agree with the comments made by A&O Shearman Sterling. Please refer to their separately submitted response for more fulsome discussion of the applicable analysis. In short, we support the view that, from a policy perspective, managed CLOs should not be subject to the European risk retention rules contained in the SECR. However, to the extent they are, both CLO managers and Third-Party Originators should be eligible retainers. In fact, where Third-Party Originators are involved in the establishment of a CLO, having risk alignment between such Third-Party Originators and the investors in a CLO is more effective in achieving the goal of investor protection than having risk alignment between the CLO manager and the investors in a CLO.

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?

Does the report accurately describe the evolution of resilience indicators for the RMBS market?

- EU vs. US indicate very different experience.

- As explained above, CMBS is a very different product to RMBS. Drawing inferences about RMBS based on CMBS may lead to questionable results.

To what extent can the evolution of these indicators be attributed to the reforms?

- It is very challenging to infer this in the EU from a resilience standpoint. The SECR that prohibits resecuritisation and sets credit granting standards reduces the scope of permissible securitisation to bank / non-bank core business.

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?

Does the report accurately describe risk retention practices in the RMBS market before and after the reforms?

- Academic studies for the European securitisation market find that, in general, risk retention leads to a lower risk premium, especially if the originator selects the vertical method.

What additional analyses could be included to assess the effectiveness of risk retention in RMBS across FSB jurisdictions?

- No comment.

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?**

    Does the report accurately describe the changes in bank behaviour following the implementation of the BCBS securitisation framework reforms?

    • The core motivation for European originated issuance remains unchanged and so, the behaviours associated with the motive to issue also remain unchanged.

    To what extent can the effects of these reforms be disentangled from the broader Basel III framework, other reforms and confounding factors?

    • No comment.

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?**

    Does the report accurately describe the impact of the introduction of the STC framework on the securitisation market?

    • Europe is the only bloc to have adopted a version of the STC framework through its implementation of STS (Simple, Transparent & Standardised).

    • To date, if measured by growth of STS issuance, it is not deemed to be a success, notwithstanding that there is an expectation that issuance that can be STS eligible, should be. A review of STS criteria with a view to simplifying, where appropriate, the complex and onerous requirements and enhancing its relevance through targeted adjustments would support its success in the future.

    • There is little evidence to suggest that spreads are lower for transactions issued with an STS label.

    • Banks and insurers are the two constituent investor groups that can derive a capital benefit, but the associated prudential frameworks and due diligence requirements disincentivise these groups from investing, thereby minimising the relevance of the capital benefit to the product. Please refer to AFME's paper EU Securitisation back on track: AFME's 5 point plan - here: https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Position%20Paper%20on%20Securitisation%20-%20Final%20for%20upload(11.6.2024)%20Clean.pdf

    • The STS label is not deemed by investors as a label that is an indicator of low credit risk but one that facilitates comparison through standardisation. Prescriptive due diligence requirements for investors, such as risk assessment, verification of risk retention, review of disclosure, ongoing monitoring etc. make securitisations less attractive compared to other assets where such prescriptive requirements do not exist.

To what extent has the reform met its objectives?

- On the basis that the STS label has only been adopted in Europe and represents only a small percentage of the European market, as yet, it is not deemed to be a success.

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?

Does the report accurately describe the main effects of the reforms on financing the economy?

- No comment.

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?

- There is a significant challenge, acknowledged in the Report, in unpacking the various macro factors upon wholesale and retail lending. An alternative approach would be to survey lenders and generate a couple of case studies to substantiate thinking.

- Individual case studies from banks and non-banks evidence the impact of limited access to public ABS markets on their ability to lend.

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?

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?

- No comment.

What role did the reforms play in this process and what are the main benefits and risks from a system-wide perspective?

- No comment.

How have the reforms impacted the demand and supply of liquidity in securitisation markets?

- EU bank capital and liquidity rules have been cited by EU policymakers and industry representatives as disincentivizing the use of securitisation by EU banks in their capacity as investor in securitisation. Compared to covered bonds, securitisations face higher risk weights, higher risk floors and stricter reporting obligations.

- Unlike securitisation, covered bonds do not transfer risk from bank balance sheets nor do they free up bank capital. This is secured lending in bond form which is purchased by other banks or institutional investors and does not remove risk from the banking system overall.

- Certain commentators are challenged by the concept that these reforms can, on the one hand, achieve their objective of disincentivising banks from holding this risk on their balance sheets whilst on the other, reforms should support banks retaining senior tranches. This would presumably originate from their perceptions of performance of limited segments of the pre-GFC market that is prohibited under SECR. A review of historical performance over 40 years of the product permitted under SECR demonstrates that the senior risk is commensurate with corporate credit risk.

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

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

- The FSB should also consider the impact of jurisdictional reporting and due diligence requirements on securitisation issuers and investors to ensure that overly prescriptive and burdensome requirements do not disincentivise issuers and investors in this market.