Position Paper

Insurance Europe response to ECB and Bank of England discussion paper on securitisations

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Key Positions

- Insurance Europe supports the idea that diversification of lending in the economy is beneficial for financial stability.

- The discussion paper appropriately identifies insurers as a potential investor in securitisations.

- The approach of separately identifying "good quality" (ie "qualifying") securitisations is needed and welcome. However, in the Solvency II framework the definition of the high quality "type A" class is too restrictive and the proposed capital charges remain unnecessarily punitive.

- Insurance Europe believes that any approach for defining "good quality" securitisations should be principle-based.

- The following three main pillars should be used as a guide to apply the principles around "good quality" securitisations:
    1. A higher selectivity of underlying pool of assets, which should be homogenous, granular and with measurable risk profiles
    2. Simplified and standardised securitisation structures
    3. Further transparency and disclosure obligations

- While the development of a "qualifying securitisation" framework is necessary and welcome, a more liquid secondary market is desirable; secondary market liquidity would limit (extreme) cases of market-to-market (balance sheet) volatility and would thus increase the attractiveness of securitisations.

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General Comments

Insurance Europe welcomes the ECB and Bank of England discussion paper on securitisations and the opportunity to contribute to it.

Reviving long-term financing remains one of the most pressing policy issues in Europe. As the largest European institutional investor, holding €8.6tn of assets under management at the end of 2013, insurers are well positioned to support long-term financing to the real economy, as their long-term liabilities enable them to hold long-term assets.

The availability of assets is crucial to the significant investment role that insurers play in the economy. Insurers need access to a wide range of assets that enable them to match their liability needs and that allow for portfolio diversification. As noted in the discussion paper, ensuring that securitisations can be part of insurers' asset pool has a range of benefits for policyholders but also for the wider economy.

The paper correctly identifies high Solvency II capital charges for securitisations as a barrier to a well-functioning securitisation market in the EU. Despite some improvements following EIOPA's proposals and the Commission's drafting changes to the Solvency II Delegated Acts, capital charges for securitisations remain unnecessarily high and will continue to restrict the ability of insurers to invest in this asset class.

While we welcome that Solvency II will now recognise that high quality securitisations can and should be identified, the definition of the high quality "Type A" is unnecessarily restrictive and the calibrations proposed are still far too high. For example, a AA 5-year securitisation will still have a capital charge of over 21%. This should be compared to the total actual accumulative default rate during the crisis (2007 to 2013) of only 0.14%. This discrepancy arises because in the current Solvency II draft implementing measures the capital charges for the credit risk posed by securitisations have been calibrated based on the worst case spread movements instead of worst case defaults. However, insurers with a long-term nature of liabilities can avoid being forced sellers during market volatility and are therefore exposed to default risk rather than risk of losses due temporary price changes due to spread movements.

Detailed comments on various aspects raised in the discussion paper

- **Insurance Europe supports the idea that diversification of lending in the economy is beneficial for financial stability and insurers as investors can play an important role in the stability of financial markets**

  Insurers' buying and selling of assets is inclined to be counter-cyclical. Even in periods of market stress with significant market volatility, insurers have a stable flow of premiums which, together with predictable liability outflows, can enable them to hold or even buy assets that are temporarily undervalued during a downturn and to sell or avoid assets that are temporarily overvalued during a boom.

- **The discussion paper appropriately identifies insurers as a potential investor in securitisations**

  Alongside other assets, securitisations can provide suitable and attractive investment profiles that satisfy the asset allocation objectives of insurers.

  A survey run on 13 large European insurance companies, managing €3.4tn of assets at the end of 2012, indicated that insurers' exposure on securitisations is larger than €50bn. This however represents less

than 4% of total outstanding European securitisations and less than 2% in terms of average weight in the asset portfolio.

While the survey indicated that all respondents would like to increase their allocation to securitisations, a number of barriers and disincentives were also mentioned by respondents to the survey. The vast majority of respondents indicated that Solvency II capital charges applied to securitisations represent the biggest investment barrier. Some respondents noted that, besides Solvency II capital charges, a number of market related barriers emerge, namely regarding the lack of deal flow, the low liquidity and the lack of transparency of these assets. Such concerns are appropriately identified in the ECB and BoE discussion paper.

- **Securitisations were a key discussion point in the long-term investment debate launched by the European Commission in 2013**

The insurance industry welcomed the European Commission request to EIOPA to review the design and calibration of solvency requirements for long-term assets in order to avoid unnecessary disincentives for long-term investment. As the discussion paper mentions this resulted in an EIOPA's technical report, published in December 2013. The conclusions of the report were also reflected in the Solvency II draft Delegated Acts.

- **Even after recent changes in the Solvency II draft Delegated Acts, a number of concerns remain**

The approach for charging securitisations in Solvency II is to split them into 2 classes (ie high quality "type A" and lower quality "type B"). While the insurance industry welcomed recognition that high quality securitisations can and should be separately identified, the definition of the high quality "Type A" is restrictive and the calibrations proposed are too high. This will restrict the ability of this asset class to be viable for insurance companies.

For example, a AA 5-year securitisation will still have a capital charge of over 21%1. This is an improvement of the original calibration which would have been an 80% capital charge2. However, as noted above, these excessive capital charges for credit risk arise because the calibrations are based on market value changes and include the most extreme spread movements in securitisations during the crisis period. We believe that, for insurers with long-term liabilities, the real exposure is to defaults and worst case default calibrations would result in more appropriate capital charges. EIOPA's study did not even consider whether default based calibrations were a more appropriate basis. The insurance industry recognises that further analysis and time may be needed before a default based approach is adopted for calibrations and therefore it recommended for the current Solvency II Delegated Acts a pragmatic and conservative solution of basing capital charges for high quality securitisations on those used for corporate bonds. This would have resulted in 5-year AA high quality securitisations having a capital charge of 5.5%.

- **The criteria for defining "high quality" securitisations should be principle-based**

While Insurance Europe agrees that a split between "high" and "low quality" securitisations is needed and welcome, the approach should be principle-based. In the Solvency II discussions the insurance industry raised a number of concerns regarding the very prescriptive criteria used.

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[1] Based on latest Solvency II draft implementing measures of March 2014

[2] Based on Solvency II draft implementing measures of October 2011

For example, in the current draft Delegated Acts, junior tranches of securitisations are considered to be, by definition, "low" quality (ie in the "more risky" basket, "type B") only because of their junior status. Insurers are however investing in junior tranches (because of eg their longer maturities) and a currently foreseen charge of more than 12% per year of duration3 would represent a strong disincentive to invest. Insurance Europe believes that considering all junior tranches as "more risky" is a quite rough estimation of risk and recommended excluding high quality non-senior securitisation from "type B" since high quality non-senior securitisation showed much better performance than non-high quality securitisation both from a credit and spread perspective since the financial crisis. Switching from "type B" to "type A" the high quality ABS mezzanine would make sense as there is less and less evidence of significant deviation of spread volatility performance between high quality ABS mezzanine tranches and high quality ABS senior tranches.

Insurance Europe therefore supports the view of the ECB and BoE on the fact that a quality designation should apply to all tranches of securitisations.

- **Insurance Europe believes that the principles set in Box 3 are broadly sensible and in line with the objective of promoting securitisations amenable to risk assessment**

The call for more standardisation is key: securitisation markets would strongly benefit from more harmonised standards across the EU, and also from improved data availability. This would ultimately make the asset class more attractive for institutional investors, including insurers.

Insurance Europe believes that the following three main pillars should be used as a guide to apply the principles described in Box 3. This would help to address the impediments identified in the discussion paper and to re-build investors' trust and interest in the securitisations market:

1. A higher selectivity of underlying pool of assets, which should be homogenous, granular and with measurable risk profiles
2. Simplified and standardised securitisation structures
3. Further transparency and disclosure obligations

Detailed examples on how to elaborate each of the three pillars are provided in the **Appendix.**

- **Once a framework of "qualifying securitisation" is defined, it should be used and applied across industries, including as part of the Solvency II approach for determining capital requirements for investments in securitisations.**

Insurance Europe believes that ccompliance with such principles for "qualifying securitisations" should be checked and assessed by an independent, private or public body and could be rewarded by the granting of a label (similar to the PCS label), which could become compulsory and delivered before any new issuance.

- **While the development of a "qualifying securitisation" framework is a necessary and important step for a sustainable revival of the European securitisation market, other steps would also be important for investors. For example, as appropriately noted in the discussion paper, a more liquid secondary market would act to limit cases of mark-to-market (balance sheet) volatility.**

[3] Based on latest draft Delegated Acts

As noted in the discussion paper, it’s likely that “qualifying securitisations” will benefit from better secondary market liquidity thanks to standardisation of the structures and increased transparency, both in terms of loan data disclosure and accurate modelling tools availability. Nevertheless, it is important to thinks of additional mechanisms allowing to limit the price volatility risk by, for example:

- ensuring the implementation of an effective and regular market making
- considering the implementation of specific solutions in case of liquidity crisis
- introduction of the idea of a “last recourse buyer” via specific programs (such as the asset purchase program implemented in the US or the program on European Covered Bond during the financial crisis)

APPENDIX

Insurance Europe believes that the following three main pillars should be used as a guide to apply the principles described in Box 3. This would help to address the impediments identified in the discussion paper and to re-build investors' trust and interest in the securitisations market:

1. A higher selectivity of underlying pool of assets, which should be homogenous, granular and with measurable risk profiles
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More details on the implementation of these pillars are provided below.

1 A higher selectivity of underlying pools of assets, which should be:

- **homogenous and consistently originated in the ordinary course of the originator's business**
  - The underlying pools of assets have to include one single type of debt / sub-asset class such as SMEs loans, prime residential mortgage loan, auto loan, etc.

- **granular**
  - The capacity to assess the risk and reward of a securitisation transaction in a consistent and predictable manner relies on the ability to perform statistical analysis to determine the behaviour of the assets under various scenarios. Any non-granular pool will require performing a detailed analysis of every receivable belonging to the pool of assets; while possible, the assessment does not correspond to the principles of transparency in securitisations.

- **with a measurable risk profile**
  - The analysis of risk profile of the underlying pool of receivables will be based on historical performance data of similar receivables (eg debts with similar features and originated under the same criteria).
  - **Historical performance data must be available for a long-enough period of time (ie to cover multiple economic cycles.** Generally, this requires a minimum 5-year history, with the ability to cover 10 years for assets with long cycles. If not available, credit data or information from credit registers should be made available to investors in an open way and with sufficient details. This is a necessary condition for the future development of eg securitisation of SME loans where the level of historical performance is often lacking, inconsistent or incomplete.
  - **Historical performance data provided must be relevant enough to determine the risk profile of the securitised pool** by**:**
    - including the key risk factors of the pool of receivables from which the historical performance data is extracted (such as LTV, DTI, delinquencies, prepayment, etc).
    - reflecting specificities of the originators' underwriting criteria and process, as well as their development in time. The origination criteria and process have a significant and direct impact on the performances of the securitised receivables. Moreover, any substantial change of the origination criteria should be identified and disclosed to investors to allow them to determine whether the historical data is still relevant to assess the risk profile of the securitised pool.
  - In the case of pools of assets with limited historical data, it would be advisable to set up databases to start collection of information (eg similar to the ECB initiative on databases)

    From an investor perspective, it is key to obtain confirmation that securitised transactions comply with these criteria of homogeneity, granularity and measurable risk profile. It is also likely that only certain types of pools or sub-asset classes will comply with these criteria; this

will eventually incentivise the development of a securitisation market based on assets which are transparent and with measurable risk profiles.

2 Simplified and standardised securitisation structures

Simplification and standardisation of securitisation structures are necessary and will incentivise liquidity of the secondary market for securitised products. The following areas could be explored:

- **Definition of standard structures by asset class including, but not limited to:**
    - a standardised "waterfall" of payments
    - a standardised credit enhancement mechanism
    - a simplified note structure
    - predefined replenishment criteria for only short dated assets
    - standard representations & warranties on the assets made by the originator per jurisdiction.

- **Standardisation of definitions of key concepts and risk factors**
    - Today, in Europe, there is no homogeneous definition of the main factors characterising the risk profile of securitised assets. This often leads to significant difficulties in performing transactions' comparison. For example, there exist differences across jurisdictions in the definition of defaulted assets, delinquencies or loan to value.
    - The AQR currently in progress in the banking industry could be a good opportunity to begin this difficult but necessary work.

- **Development of modelling and performance measurement tools available to investors**
    - On the basis of more standardised structures, it becomes possible to provide additional and standardised information for investors on the risk profile of the notes issued by the securitisation under various risk scenarios.
    - The arranger and/or trustee should provide investors with the results of this cash flow modelling under various risk scenarios at both issuance date and during the life of the transaction (to assess the evolution of the risk/reward profile of the notes). This will enable investors to compare outcomes of these cash flow scenarios with the ones from other transactions and also with outcomes of their own cash flow modelling.

3 Further transparency and disclosure obligations

Over the past years the European securitisation market has benefited from improvements in terms of information transparency thanks to the requirement by both ECB and BoE for loan-by-loan data as part of their collateral eligibility criteria and the launch of market-led securitisation label initiatives (ie the PCS). Further improvements in not only loan data transparency, but also in information disclosure relative to the securitisation structures and participants would enrich investors' assessment process. The following areas are examples of information that would be useful for investors to assess securitisations and would enable them to monitor transactions in a consistent and predictable manner:

- For any new transaction investors should have access to:
    - detailed characteristics of the underlying pool of assets at both loan-by-loan and aggregate level
    - accurate and detailed cash flow models either directly from the issuer or through external providers. Having access to accurate and detailed cash flow models is key and requires the disclosure of elements that are today generally not publicly available such as : fees due by the securitisation structure to the different participants and details of structural features like swaps or liquidity facilities.

- During the life of the transaction investors should have information on the performance of the notes issued by the securitisation transaction and on the underlying pool of assets.
    - Detailed reporting on transactions' performance are today provided by the securitisation trustees and by rating agencies. It is important to strengthen these reporting aspects by ensuring minimum standards of disclosure.

- Transparency on the role played by all parties involved in the securitisation structure is important
    - This could include description of roles and responsibilities of the originator and seller of the assets, servicer, swap counterparties, credit enhancement providers, guarantors, trustees and management companies, rating agencies (important to get more info of the rating agency selection process)

- Identification of potential conflicts of interests and implementation of mitigants should be required
    - Alignment of interest between the originator/seller of the assets and investors could be achieved by applying retention principles throughout the life of the deal, without hedging possibility (as already implemented or under discussions in a number of jurisdictions)
    - In Europe, where the responsibility of checking the retention requirement lies upon investors, the disclosure of this information by the sellers during the life of the transactions in a consistent, transparent and detailed way is key for investors. Some investors may find such responsibility falling on them too heavy and decide not to invest in securitisation.

- Disclosure of particular positions of specific investors in the transaction (such as an originator investing in the capital structure at equity level) would represent useful information for investors

- Alignment of interests of the different parties via fee structures and payment mechanisms should be promoted