A European framework for high-quality securitisation as a priority for the European Commission for building a Capital Markets Union. March 2015.

On 18 February 2015, the European Commission (hereinafter "EC") published a consultation document (Green Paper) on its project to create a Capital Markets Union (hereinafter "CMU") for all 28 Member States of the European Union (hereinafter "EU"). In order to develop the CMU, the EC proposes a set of short-term measures, mainly the simultaneous publication of two specific public consultations: one on the review of the Prospectus Directive, and another one on a European framework for high-quality securitisation, with the aims of encouraging the financial market integration within the EU, diversifying the sources of funding and facilitating access to capital.

The consultation on a European framework for simple, transparent and standardised securitisation aims at establishing common quality standards on the securitisation procedure; the legal certainty of the securitisation structure; and the standardisation (comparability) of securitisation instruments that allows (typically institutional) investors to have sufficient information to invest in areas where they would not invest directly, e.g. small and medium-sized companies (hereinafter "SMEs").

The securitisation structure is as follows: the originator (typically a bank) may bring forward the payment of unmatured loans (e.g. mortgages, rentals, consumer loans, credit cards, etc.) by grouping them together and transferring them in exchange for a fee to a third party, who then issues securities and places them in the capital market for institutional investors. The originator has no obligation to ensure provision for transferred loans, which increases its capacity to grant financing. After the recent financial crisis, the activity in the securitisation market has been revived in the USA, but not in the EU, and that is why the EC proposes this initiative at European level.

The basic criteria identified to achieve high-quality securitisation instruments, according to delegated Regulation no. 575/2014 on the liquidity coverage requirement applicable to credit institutions and the delegated acts of the Solvency II Directive for insurance undertakings, are: simplicity, transparency and comparability.

The **simplicity criteria** require that the underlying exposures are homogenous, that derivatives are only used as underlying for hedging purposes and that re-securitisations are not allowed.

The **transparency criteria** require that transactions comply with public disclosure requirement, e.g. with the obligation to provide loan-level data. The transparency criteria also require that investors receive the optimal amount and quality of information (in terms of comparability, reliability and timeliness), which allows them to make fully informed investment decisions while, at the same time, streamlining disclosure obligations for originators/issuers. Investors' self-assessments, for example, on credit quality are usually based on credit ratings issued by Credit Rating Agencies (CRAs), which take into account country risk in their methodologies.

The **standardisation criteria** require that the securitisation structure is homogenous and that the transfer of the risk exposure from the underlying to the securitisation instrument is legally consistent. A lack of standardisation is the reason why creating securitisation structures is more expensive for originators/issuers and it makes comparability of securitisation products for investors more difficult.

Furthermore, **other criteria** such as compliance with a series of liquidity coverage ratios can be taken into account (minimum investment size or time to maturity of the investment).

Another requirement for high-quality securitisation is total or partial **risk retention** of transferred credits or other underlyings of securitisation instruments by the originator. In this way, investors' verification requirement could be alleviated, as it would lie on ascertaining the value of the securitisation instrument, rather than the risk retention mechanism.

These basic criteria apply to issuances of medium to long-term securitisation instruments; however, for issuances of short-term instruments it would be necessary to identify specific eligibility criteria to achieve high-quality securitisation.

Compliance with these criteria for high-quality securitisation could be ensured via quality certification or labelling for each securitisation instrument, or by using an authorisation procedure for each originating bank. These objective methods of criteria compliance verification would allow investors to monitor criteria and the securitisation structure in a more "relaxed" way.

Creating a harmonised European framework for high-quality securitisation would increase the legal certainty of EU securitisation, for the benefit of all parties concerned; in particular, for investors such a structure could reduce the verification requirement for the legal framework and actual practices in specific EU Member States.

The securitisation structure involves the use of a set of ancillary services and infrastructures, the cost and availability of which affect the attractiveness of the investment. An effective secondary market, which would attract a broader investor base, would also imply the development of "ad hoc" trading platforms and higher post-trade transparency.

Banks and investment firms should have a specific framework for risk exposure to securitisations, which would take into account the minor risk exposure of high-quality securitisations and reflect it in the rules on capital requirements. Other institutional investors such as insurance companies already differentiate, for the calculation of their capital requirements and according to the Solvency II Directive, whether the investment constitutes high-quality securitisation or not.

The appropriate development of SME credit securitisation could help to channel funds to one of the parts that need it most in the EU financial system. Lack of standardisation in underlying assets and of harmonisation in public disclosure requirements (which prevent investors to conduct proper verification) have been the main problems hindering the development of this market in the EU.

Relevant links:

European Commission's consultation document on high-quality securitisation in the EU

Consultation document on the European Commission's Green Paper for building a Capital Markets Union in the EU