

## Response to EIOPA consultation paper on the advice on the review of the securitisation prudential framework in Solvency II

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### General comments

Insurance Europe welcomes the opportunity to comment on EIOPA's consultation on the review of the securitisation prudential framework in Solvency II.

European insurers are Europe's largest institutional investors, with over €10trn of assets under management. In their role as investors, insurers need a wide range of appropriate assets in which to invest to achieve good returns, portfolio diversification and appropriate liability matching to benefit their policyholders. These include investments in securitisation. The insurance sector therefore supports the promotion of sound securitisation and appropriate prudential treatment, in line with the objectives of the Capital Markets Union (CMU) project.

In the context of the securitisation prudential framework in Solvency II, Insurance Europe would like to:

- **Express its disagreement with the existing Solvency II capital requirements of securitised assets**, as these do not reflect the risk and yield of this asset class. More specifically, the current capital charges for non-simple, transparent and standardised (STS) securitisation are unreasonably high and are not appropriately justified based on either past data or EIOPA's analysis. EIOPA's recent consultation paper does not provide any quantitative arguments that support the retention of the current factors for this category.
- **Highlight that the standard formula capital requirements for all investment assets, including securitisations, should be based on the risk that they pose to insurers as long-term investors.** Insurers invest in securitisations, like most fixed income assets, on a buy and hold basis. This is a fundamental aspect of their asset/liability management (ALM) and risk management strategies. The risk of investing in securitisations to an insurance investor is therefore the risk of loss from default and not the short-term changes in its value due to market illiquidity, ie, spread risk (as experienced during the 2008-2009 financial crisis). The capital charges should be calibrated to reflect the nature of an insurance investor.
- Note that EIOPA's rationale on capital requirements not being a main driver for the investment behaviour of insurers in securitisations is **not fully substantiated and is contradictory**. While advocating the retention of the existing capital charges due to lack of data that suggest otherwise, EIOPA uses the same dataset to claim that insurers' low investments in securitisations are not due to the existing calibration but due to other factors such as the complexity or legal provisions of that asset class.

### **Securitisations are penalised significantly under the standard formula of Solvency II**

While insurers are willing to invest in this asset class, the high capital requirements placed on securitisations in Solvency II have clearly been one of the key obstacles to investing.

The current calibration of capital requirements for securitisations are too high, notably in comparison with equally rated corporate or covered bonds. In particular:

- As well as the absolute level of capital being too high, the differences in capital requirements between senior and non-senior tranches of a securitisation remain too high: eg, a senior five-year AA STS securitisation now has a capital charge of 6%, while the junior tranche with same AA rating is at 17%.

Non-STs securitisations remain significantly penalised, without this being justified by historical performance data.

There is inconsistency in the treatment between a whole mortgage loans pool and residential mortgage-backed securities (RMBS). The latter are heavily penalised in terms of capital.

### **EIOPA's analysis is incomplete and does not cover all aspects of an insurer's ALM policy**

EIOPA's hypotheses that the existing capital charges do not drive the insurance industry's low levels of investment in securitised products. EIOPA based its analysis on quantitative reporting template (QRT) data, which has been available since the introduction of Solvency II (2016). EIOPA's conclusion arose after observing that other securitisations, which have the highest capital charges, attract more investments than the STS category, which is less penalised.

However, Insurance Europe would highlight that:

- The STS category was only introduced in 2019 and therefore the observed trend might be temporary, as insurers might need more time to assess the value and associated risk.
- To conclude whether the existing capital charges drive the investment behaviour of insurers, one should conduct additional analyses: the level of insurers' investment capacity in securitisations before the introduction of Solvency II; the overall yield of those products with respect to the risk capital required; the availability of the securitised products in the market; and the investment portfolio of internal model insurers (which can appropriately reflect the risks of investing in securitisations) compared to those using standard formula.
- Finally, the mandatory "due diligence" actions that issuers and investors are required to undertake is disproportionate and excessive. While appropriate due diligence is vital, the current requirements are not linked to the risk and complexity of the securitisation and are very onerous, creating further disincentives. Due diligence requirements should be simplified and allow for proportionality. The outcome should be that the requirements are similar to those required for other instruments, such as covered bonds.

The conservatism of Solvency II's solvency capital requirement (SCR) for securitisation, especially in comparison with the ones for similar exposures or relative to the capital charges of the US National Association of Insurance Commissioners (NAIC), may explain such low investment levels. If the capital charges are corrected, insurers will be able to look for securitisation investments with returns and liquidity commensurate to their risk appetite. This would be likely to increase insurers' investment in securitisation.

### **Industry responses to the questions posed by EIOPA in its consultation paper**

*Question 1: Do you have any comment on the comparison of the securitisation capital charges with other asset classes with similar characteristics? (Section 1 – page 16)*

The significant capital requirements for securitisation vs comparable asset classes under the standard formula<sup>1</sup> limit the participation of standard formula insurers.

This is particularly the case for non-STS and non-senior STS (see table below). The potential additional asymmetry in capital treatment between selected residential mortgage-backed securities (RMBS) tranches and whole loan mortgage pools (as well as between selected collateralised loan obligation (CLO) tranches and pools of leveraged loans) can potentially create further disincentives for standard formula players, which can look at direct investment across underlying collateral.

	AAA	AA	A	BBB	BB	B	Below	AAA	AA	A	BBB	BB	B	Below
	1 year exposure							5 year exposure						
Corporate Bond	0,9%	1,1%	1,4%	2,5%	4,5%	7,5%	7,5%	4,5%	5,5%	7,0%	12,5%	22,5%	37,5%	37,5%
Covered	0,7%	0,9%	1,4%	2,5%	4,5%	7,5%	7,5%	3,5%	4,5%	7,0%	12,5%	22,5%	37,5%	37,5%
Residential Mortgage Loan	3% at LTV=80%							3% at LTV=80%						
STS Senior	1,0%	1,2%	1,6%	2,8%	5,6%	9,4%	9,4%	5,0%	6,0%	8,0%	14,0%	28,0%	47,0%	47,0%
STS non-Senior	2,8%	3,4%	4,6%	7,9%	15,8%	26,7%	26,7%	14,0%	17,0%	23,0%	39,5%	79,0%	100,0%	100,0%
Non-STS	12,5%	13,4%	16,6%	19,7%	82,0%	100,0%	100,0%	62,5%	67,0%	83,0%	98,5%	100,0%	100,0%	100,0%

Source: COMMISSION DELEGATED REGULATION (EU) 2015/35 of 10 October 2014, COMMISSION DELEGATED REGULATION (EU) 2018/1221 of 1 June 2018, COMMISSION DELEGATED REGULATION (EU) 2019/981 of 8 March 2019

Internal model-based investors may have more flexibility, but the very extensive due diligence requirements on a mainly floating rate product may, to a certain extent, disincentive an increase in investing, especially in market phases in which yields are not compelling enough, prompting a search for alternatives. The implicit constraints deriving from the regulation on looking globally at securitisation are also a general limiting factor in increasing overall investment in securitisation by insurance companies.

In addition, the industry notes that the differences in capital requirements between senior and non-senior tranches of a securitisation remain high. For example, a senior five-year AA STS securitisation now has a capital charge of 6%, while the junior tranche with the same AA rating is at 17%. Insurers take the view that the rating is already encompassing the level of risk, whether the concerned tranche is senior or non-senior, so that a factor of one to three in the capital charge appears much too high.

*Question 2: Do you see practical or legal difficulties in investing in securitisation with the STS label? Are you aware of any other factors, including regulatory rules other than capital requirements that could have a major impact on securitisation investment levels? (Section 1 page 16)*

From an investor perspective, the general impact of the EU Securitisation Regulation (SECR) on costs has been related to the need to ensure, through the several internal functions involved, adequate due diligence on investments both before purchase and on an ongoing basis. Being compliant with such an in-depth assessment has created a higher cost burden than the analysis required on comparable products such as covered bonds. From an issuer perspective, Insurance Europe understands that additional cost changes have also been driven by, *inter alia*, the need to comply with transparency requirements and the STS designation.

The asymmetry in capital treatment between selected RMBS tranches and whole loan mortgage pools (as well as between selected CLO tranches and pools of leveraged loans) can create further disincentives for standard formula users to invest. Similarly, the asymmetric treatment of securitisations and equally rated covered bonds can create disincentives.

<sup>1</sup> In the context of a more penalising framework for asset-backed securities versus, for instance, the US market where, paradoxically, the historical default experience has been worse than in Europe

*Question 3: Do you have evidence that the current calculation for capital requirements for securitisation (senior STS, non-senior STS and Non-STS) is not proportionate or commensurate with their risk? (Section 2 page 24)*

The industry notes that the differences in capital requirements between senior and non-senior tranches of a securitisation remain high. For example, a senior five-year AA STS securitisation now has a capital charge of 6%, while the junior tranche with same AA rating is at 17%. Insurers take the view that the rating is already encompassing the level of risk, whether the concerned tranche is senior or non-senior, so a factor of one to three in the capital charge appears much too high. In addition, under the standard formula, penalising differences in the capital treatment of senior tranches versus the whole loan underlying portfolio (eg, with regards to residential mortgages) might not be proportionate with the overall embedded risk.

In addition, the SCR for securitisation is significantly more punitive when compared to equally rated covered bonds and, to a lower extent, corporate bonds, and also becomes increasingly punitive as ratings decline. In this context, mezzanine STS are likely to miss out on significant interest from standard formula investors, bearing in mind also the required due diligence effort. The argument previously mentioned with regards to senior STS versus the underlying whole loan risk (eg, with regards to residential mortgages) might theoretically continue to apply selectively also to mezzanine tranches, adding to potential disincentives to take exposure in this format.

For example, by comparing the capital requirements for senior tranches of STS securitisations that are ranked AAA and AA and a duration under five years with comparable bonds, Insurance Europe observes:

- The corresponding risk charges for a AAA (AA) STS securitisation with credit assessment with a duration of one and three years are 1% (1.2%) and 3% (3.6%) respectively. By comparison, corporate bonds ranked with AAA (AA) and a duration of one and three years have risk charges of 0.9% (2.7%) and 1.1% (3.3%) respectively. The comparable covered bonds have risk charges of 0.7% (0.9%) and 2.1% (2.7%).

The industry notes that non-STS securitisations remain significantly penalised compared to equivalent covered and corporate bonds and STS securitisations (see table in Q1) without this being justified by historical data. This is inevitably reducing the appetite of standard formula investors for non-STS positions. While the STS label brings some guarantees to investors, non-STS tranches, when benefitting from an identical rating to STS tranches, should be treated in a similar way, and in any case should not have a capital charge more than 10 times higher. There are cases where the riskiness of an investment is not really correlated with the STS label, meaning that the difference in the credit performance between STS and non-STS securitisations does not justify the huge difference in risk charges. Therefore, the current delta between the two categories is deemed excessive, particularly within the investment grade (IG) space (eg, when looking at the very benign historical default experience on highly rated tranches of CLO 2.0). A potential disincentive specifically concerning selected CLOs tranches could also arise for standard formula players in light of the capital advantage of taking direct exposure to underlying pools of leverage loans.

Lastly, there is inconsistency in treatment between a whole mortgage loans pool versus RMBS, the latter being heavily penalised in terms of capital.

*Question 4: Do you agree with the calibration method used in this paper? Do you have any evidence that an alternative method could have been used? (Section 2 – page 25)*

While an empirical VaR calibration is suitable for calibrating many asset classes within the standard formula, it is clear that in the case of STS and non-STS securitisations, there is insufficient data to calibrate tail risks.

In light of this, EIOPA should enrich its data sources. The dataset used by AFME/Risk Control in their [paper](#), in which both for non-senior STS and non-STS the capital charges implied by the analysis are lower than those in

the current Solvency II rules, provides a useful starting point. However, additional data sets should be sought and included in the assessment.

Until the calibrations of this asset class are corrected, there is unlikely to be sufficient transactions/data points to allow EIOPA to conduct a meaningful empirical value-at-risk (VaR).

*Question 5: Do you agree with the conclusions obtained in this section? Do you have any evidence which suggests that the conclusions could be different? (Section 2 – page 25)*

The industry does not agree with the conclusion that the overall risk sensitivity of the Solvency II risk charges with regards to STS and non-STS is appropriate. However, it agrees with the conclusion that not enough observations are available as there has not yet been a full credit cycle (including recession) on which to base an empirical calibration.

The industry notes that non-STS securitisations remain significantly penalised, without this being justified by historical data. While the STS label brings some guarantees to investors, non-STS tranches, when benefitting from a rating that is identical to STS tranches, should be treated in a similar way, and should certainly not have a capital charge more than 10 times higher. There are cases in which the riskiness of an investment is not really correlated with the STS label, meaning that the difference in the credit performance between STS and non-STS securitisations does not justify the huge difference in risk charges.

The SCR for securitisation appears significantly more punitive when compared to equally rated covered bonds and, although to a lower extent, corporate bonds, and also shows an increasing penalisation as ratings decline. At least, the capital treatment of securitisation senior tranches should be aligned on the one for bonds and loans with equivalent rating level.

*Question 6: What is your view on the proposed segmentation of the STS category: should the calibration of the Non-Senior STS Securitisation be differentiated between mezzanine and junior? (Option 1 or 2 of page 31) Please explain your view. If Option 2 is your preference, do you think it would encourage you to invest more into securitisation with the STS label? (Section 3 – page 43)*

Insurance Europe supports Option 2. In principle, regulation should avoid being too complex but in the case of mezzanine versus junior tranches, a differentiated treatment could be justified. To be however noted that for equivalent rating levels, the differences between capital charges of same segmentations should be consistent (ie not too different).

*Question 7: What is your view on the preliminary conclusion not to implement the underlying exposure risk as a basis for the securitisation risk charges in Solvency II? Do you have any evidence which suggests that this conclusion could be different? (Section 3 – page 43)*

Insurance Europe would agree with the preliminary conclusion not to implement an exposure risk assessment within Solvency II for the reasons laid out in section 3.2.2. As already stated, Insurance Europe believes that the securitisation market needs a simple, transparent and risk-adequate regulation and not more complexity.

*Question 8: What is your view on the preliminary conclusion not to implement the considerations for the thickness of non-senior tranches in Solvency II? Do you have any evidence which suggests that the conclusions could be different? (Section 3 – page 43)*

Insurance Europe agrees not to implement the considerations for the thickness of non-senior tranches. On balance, the cost vs benefit of this would risk adding complexity while being unlikely to represent, per se, a driver of additional demand from insurance players (considering also the scalability of non-senior tranches particularly in the STS space). In addition, one should also consider that the riskiness of a tranche should not be associated only to its thickness, but also to its attachment point. However, when it is justified, the capital treatment of securitisation should not be more punitive than the underlying exposure.

*Question 9: What is your view on the proposed segmentation of the non STS category: should the calibration of the non STS securitisation be differentiated between senior and non-senior? Please explain your view. (Option 3 or option 4 of page 36)? If Option 4 is your preference, do you think it would encourage you to invest more into Non-STS securitisation? (Section 3 – page 43)*

Insurance Europe supports Option 4. There should be a differentiation, within non-STS securitisation, to justify different treatment for an equally rated senior and mezzanine (eg, across different asset classes) under the standard formula. However, in Insurance Europe's view this should not be excessive, assuming the currently applied capital charges remain in place.

*Question 10: What is your view on the preliminary conclusion not to implement the hierarchy of approaches in Solvency II? Do you have any evidence which suggests that this conclusion could be different? (Section 3 – page 43)*

Insurance Europe agrees with the proposal not to implement a hierarchy of approaches. As mentioned in previous points, Solvency II capital requirements are calibrated in order to be used on the market value of assets, not the exposure, and there are no requirements for insurers to report the underlying exposure of their securitisation position.

*Question 11: Do you consider that agency and modelling risks are reflected in an appropriate manner in Solvency II? If the answer is "No", please elaborate on the changes that you deem necessary. (Section 3 – page 43)*

Agency risks are intrinsic to every type of transaction, ie, across asset classes. This operational risk might not be avoidable. Models are a simplified representation of the real world, and this risk might exist across the securitisation universe. So, Insurance Europe agrees that they are already embedded in the risk charges of STS and non-STS securitisations.

*Question 12: What is your view on the preliminary conclusion not to use the maturity (as in CRR) for the Solvency II framework? (Section 3 – page 44)*

Insurance Europe supports the use of modified duration vs maturity (as in CRR).

*Question 13: Do you consider that other technical amendments may be appropriate or desirable to improve that treatment of securitisation in Solvency II? If the answer is "Yes", please elaborate on the changes that you deem necessary (Section 3 – page 44)*

Insurance Europe has no further suggestions on technical amendments but would like to reiterate that there is no adequate level playing field between securitisations, and corporate / financial bonds, covered bonds. The current capital charges for securitisations are too high and limit their attractiveness for insurers.

*Insurance Europe is the European insurance and reinsurance federation. Through its 36 member bodies – the national insurance associations – it represents insurance and reinsurance undertakings that account for around 95% of total European premium income.*