PGIM FIXED INCOME

Reviving European Securitisation

Transcript

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Peter Gibson, CFA, Consultant Relations, EMEA: Hello, thanks for joining our webcast today, Reviving European Securitization. My name is Peter Gibson, and I'm responsible for consultant relations at PGIM across EMEA. I'm joined by Kaustub Samant, who leads our Securitized Credit Research Team, and Taggart Davis, head of Government Affairs for EMEA. The securitization market is a vital tool that enables capital markets to function efficiently and also provides businesses with a diverse source of funding. Since the global financial crisis, the U.S. has built a robust and mature market, whereas the Europe has lagged. It has lagged because it's hindered by regulatory barriers to entry, and fragmented market practices. To unlock its potential, Europe needs targeted reforms to enhance investor confidence and pave the way for more dynamic and competitive financial markets. Today we're going to look at how securitization has a role to play in this. So, Kaustub, is it okay if I start with you, please? Perhaps you could take a look at how the securitization markets have evolved and indeed diverged since the global financial crisis in 2008.

Kaustub Samant, Head of Securitized Products Research: Yeah, thanks Peter, and thanks for -- thanks for having me. So, I think it's worth putting the market in perspective. Obviously the market was at the center of the financial crisis in 2008, and a few things have happened since then. A lot of these have been regulatory changes that have been global. So, things like [inaudible], where issuers have to retain a certain amount of credit risk when they do a securitization, that's been a global change. And some of these have been changes that have happened for individual markets, right? So obviously the mortgage market in the U.S. was, and that was at the heart of the crisis. And so there have been changes made to improve underwriting, improve the credit risk profile of the mortgages [inaudible] in the U.S. And at the same time, you've had structural changes, so there have been changes made in terms of the structural offerings and how these things are packaged into securitizations, right? So there's been sort of this new foundation that has been built for that securitization market, and if you think about what's happened on top of that, post-GFC, if you turn to the next slide what you'll see is issuance has really moved up. So, the U.S., in the U.S. market, if you look at issuance in 2021, it hit almost $750 billion. That's the same level of issuance that we had pre-GFC in 2007. So at least from an issuance perspective, we're back to where we were pre, pre kind of financial crisis around that time. Obviously since then rates have gone up a little bit, so volumes have come down, but that's a very healthy place for the market to be on top of what I said were new foundational changes to the market. And then once you dig deeper into kind of what's being financed to the securitization market, it's a much broader range of assets than has been financed kind of in the years after the GFC, right? So post-GFC we just had sort of your traditional mortgages, your credit cards, your autos, your student loans. You had, you had you know, leveraged loans and you had kind of real estate, right? Over the next, last few years rather, there has been new forms of lending that's happened. So just look at the consumer space. In the U.S. you're no longer just borrowing through credit cards, you can now borrow through the buy now, pay later market, you can now borrow through the home improvement market. If you want to put up solar panels on your house, you can borrow for that specifically, right? So there's new forms of lending that's happening, and that is all getting financed through the securitization market. So, the market is providing access to a much broader range of assets than, kind of in years past. And at the same time, from an investing standpoint, all major investor groups are very well represented in the U.S. securitization market, right? So insurance companies are active, money managers active, hedge funds are active, banks are active. In different parts of the capital structure, in different [inaudible] profiles, in different asset classes. But it's still a very vibrant market with a lot of players and a lot of buyers, which is really, really good to see, because that's obviously the very sustainable place for the market to be. Compare that to Europe. Right? So in Europe issuance has obviously also come back since the years after the financial crisis. But on a relative basis, the market has lagged. So in 2024, what this chart shows is that the European public securitization issuance amounts to about 14% of the U.S. market. And pre-GFC that number was a third of the U.S. market. Right, so on a relative basis, European issuance has actually come down relative to the U.S. And so, what has that resulted in? So if you turn to the next slide, what that's done to the European economy is more of the financing is reliant on banks. And direct bank lending, right? So nearly, what this chart shows, more than 50% of lending in some form or the other, is bank driven. And I think that is, on one hand you can argue that it's positive because banks are [inaudible] entities, but I think what's happening because of this is obviously the stuff that's getting financed is something banks want to lend towards. So it may not be some of the newer asset classes, some of the more cutting-edge types of lending, types of products that are really needed to sort of drive the European economy, right? So, I think securitization has a part to play to help that process, but obviously if it's -- if it's curtailed because of regulation, then it's harder for that market to help in that process. So I'll turn back to you, Peter.

Peter: Super. Thank you, Kaustub. So, what do you think's holding back the European securitization market from developing and evolving as much as the U.S.?

Kaustub: Yeah, maybe I'll take the question a little bit differently. Before we actually go into what's kind of holding the market back, let's maybe talk about some of the benefits of kind of opening up the European securitization market, right? Like what is, what is the benefits of that? So, if you think about securitization it really -- it really funds the real economy, right? Securitization is ultimately what is it funding? It's directing financing mortgages, so it's directly financing homeowners, directly financing kind of credit card loans, auto loans, directly financing consumption in the economy. You can argue it's financing real estate to the commercial real estate market, it's providing for access to credit to kind of small and medium enterprises, right? So it's funding hard assets and it's funding the real economy. And then for investors what's happening is it's, is it's providing kind of higher spread and so better relative value, we would argue. If you look at kind of same duration, same credit profile, securitized assets trade wider than kind of comparable assets maybe in the corporate market. So that's having a huge positive. And then when you dig into it, but what's driving your credit profile if you buy securitization. It really isn't, it really isn't single name risk to specific issuer. So for example, if you buy an auto loan ABS, you're maybe a little bit less -- your credit risk is less correlated to how that auto manufacturer's going to perform from a credit perspective. And it's really your credit profile's going to be driven by how each consumer is choosing or not choosing to pay back their auto loan, right? So from a credit profile you get access, you can tap different parts of the market that are actually very, very difficult to access. I think for policy makers the benefits is that it provides transparency into the economy, right? So it basically tells [inaudible] policy makers, okay, how are borrowers performing? How's consumers performing when it comes to paying back their car loans, paying back their auto loans? How are small and medium enterprises doing, right? So loans that would otherwise be just stuck on bank balance sheets or in sort of held to majority [inaudible] elsewhere, are now being publicly, that performance is now being publicly disseminated. So I think policy makers have a real-time view into how these key parts in the economy are functioning. Which I think has a tremendous amount of benefit. And so, I think maybe just to -- just to hand it over to you, Taggart, how do you think these benefits tie into kind of Europe's broader economic goals?

Taggart Davis, Head of Government Affairs, EMEA: Well thank you, Kaustub, and thanks to you and Peter for having me today. Well I really agree with your synopsis there Kaustub, but maybe just putting our political hats on for a minute, I think it's worth mentioning that securitization can also really help the EU realize its political goals, especially around competitiveness. We had the Draghi Report last year, where Mario Draghi set out the need for the EU to enhance its competitiveness, especially in the areas of innovation, defense, and renewables. And securitization can really help with all three of those goals. Ultimately, the EU economy benefits through opening channels of capital to finance growth, whether it's for its technology ambitions, its infrastructure ambitions, its defense or renewable ambitions. Maybe just to give one nice example in the decarbonization space, last year we saw the first heat pump asset backed finance initiative in Germany, that really helped to make installation of heat pumps more affordable for homeowners. So this helps the EU deliver on its decarbonization goals as well as reduce its energy dependencies.

Peter: So Kaustub, coming back to you then, what reforms do you believe are needed to revive the European securitization market?

Kaustub: Yeah, so I think this has been a key sort of focus of ours. And if you go to the next slide, let's maybe talk about some other reforms that are needed. So there's been a lot of talk about bank capital and changes to the banking regulatory framework and how that can improve access to securitization and improve the securitization market. I'm not going to -- I'm not going to go through that here because I think that conversation has been -- has been had pretty, pretty well. Let's maybe focus more on the insurance side. So the insurance buyer base in the U.S., especially in recent years, has been very active, especially in kind of the mortgage market and the ABS market and so on. And we just don't see that same level of activity in Europe. And so I think it's really important that insurance companies be more active in the European market simply because they have, they have preferences for certain duration profiles and credit risks, that -- that can be well-served by securitization. But I think what's holding it back simply is just capital, right? Because ultimately what banks and insurance companies try and maximize is this return on capital. So, just these capital rules I think for insurance companies have to be better calibrated. So what we see in this chart here is, and I just focused on the CQS1 step, and look at the capital regulations there, right? So on CQS1, there is -- there is capital that is differentiated between sort of STS and non-STS. STS just stands for certain securitizations that meet the Simple Transparent and Standardized framework in Europe. And fortunately that's not a big part of the market. But as you can see, there are lower capital requirements for STS seniors, than for STS non-seniors, which makes sense because STS seniors are more [inaudible] than non-seniors. But when you go to the non-STS market, which as I said is the bigger chunk of the market, there is no such differentiation. We are basically at 100% capital, regardless of whether you buy a super safe, super short duration bond, or whether you buy the equity bonds. So naturally if you're an insurance company, you're probably not going to buy a lot of non-STS products simply because the capital doesn't work and the return doesn't work. And so these the are types of things that need to be addressed, and capital regulations have to be better risk calibrated to address the kind of the needs of the insurance community. Because that's kind of an important buyer base, that's there in the U.S. and that's maybe less active in Europe. And I think Taggart is going to talk about sort of broader reforms in terms of due diligence and transparency and so on, but before we go there, if you just go to the next slide, what I want to touch on is maybe sort of a framework maybe that's needed when we think about this sort of investor community, right? So, if you think about European investors in the securitization market, right, because of a bunch of regulations that are put around this, they currently have access to about 1.1 trillion of available assets globally, right? So, I would argue that that's a pretty big market, I think most would say that's a pretty large market, which is great. But, there's another 2.5 trillion that's sitting out there that is not compliant with European regulations and so cannot be, cannot be accessed by the European investor base. Right? And that's a shame, and I think what it does is by limiting market access to this entire market, naturally in some way will reduce interest in this market, right? For Europe to have an active securitization market you need active issuers but you also need active investors. And an investor base that can only invest in a small chunk, or maybe a subset I should say, of the broader market is naturally not going to be as interested in securitization versus let's say corporates, or equities, or some other broader asset class. So we need asset allocators, people that think about whether I need to be in corporates, or whether I should be in securitized products, or whether I should buy government bonds. These people, they need to think and those are ultimately our clients, our clients need to have access to I think entire securitization market globally, just to make this market more appealing. And I would argue that's ultimately going to help Europe. Because if you have a domestic investor base that is very active globally, you're going to then bring out issuers that want to tap into that investor base, right? And so, that's just something that we hope isn't lost to regulators as they think about what regulatory forms are need in Europe for securitization. So with that, I guess that broad overview, I want to turn it to Taggart, and Taggart, maybe you can talk about some of the specific changes that we've advocated for within securitization for issuers and investors.

Taggart: Well sure, thank you Kaustub. I think there are a few other areas where the EU has kind of come down with a very heavy regulatory footprint, and I'll mention a couple of those. One is due diligence, in Europe, securitization is singled out as a special asset class that needs extra investor due diligence. And this really kind of makes Europe an outlier but not in a good way. So we have sectoral legislation in Europe, like UCITS that governs mutual funds, AIFMD that governs all -- governs alternative funds, IORP, which deals with workplace pensions, and all of these regulatory frameworks have pretty detailed risk management frameworks and due diligence frameworks that ensure investors carry out due diligence on all the investments in their portfolio. And so, it's duplicative and onerous to have this extra layer of due diligence that focuses on securitization investment only. Especially given the strong track record of the asset class. When we think about due diligence at PGIM, whether we're carrying out due diligence for a U.S. investor or a European investor, really it's identical for us. We do really detailed and robust risk assessments in each instance and we won't invest in an asset if we can't properly assess the risk profile. But what's different in Europe is when we're investing here, there's a lot of documentation and paperwork that's involved, given the regulation demands it. And we are, at PGIM we're a larger asset manager, so we can handle the compliance costs, and we can do all this pretty quickly, but for a smaller asset manager, this can really be a barrier to entry because of the high cost and the time involved. And when you take this market wide, we're concerned that all of this daunting documentation can really dampen demand in the overall market. So, what we've suggested is really significantly streamlining investor due diligence for securitization. We suggest to policy makers that they take the sectoral legislation, UCITS or AFIMD for example, and look at the due diligence there and then think very carefully about any extra due diligence that you put on top of that, given the extra cost involved. We really encourage policy makers to take a principles-based approach to the extra due diligence that they have to do when investing in securitization. A second issue that I wanted to raise was reporting. The reporting that issuers in Europe have to comply with is much more detailed than what issuers face in other parts of the world. There are literally hundreds of data fields that issuers must report that add a lot of cost to issuing in Europe, as well as being a large investor in securitization, PGIM is also a top issuer of collateralized loan obligations, and we estimate that the cost associated with EU reporting on our CLOs is between 10,000 euros and 31,000 euros per CLO per year. And that's just additional cost that just doesn't exist in other parts of the world, making European products more expensive and potentially muting supply as some issuers just might be turned off by those, those additional costs. When we think about this, our -- the investors in our CLOs really value the transparency that they get from trustee reports, and they don't request the additional detail in the ESMA templates. We've actually password protected some of that ESMA reporting and we haven't had investors even ask us for the password, so that suggests that they don't really need all that information. Now perhaps supervisors want some additional information, but we think they should take what investors use as a starting point and then think really carefully about what additional information they need, knowing that those additional data fields come with extra cost. So we, again, we think this is an area where some simplification of the regulation is needed. A last issue that I wanted to raise was around UCITS. We think that securitization could comprise a greater part of the portfolios of UCITS funds but investors are held back both by regulatory pressures and supervisory pressures. So on the regulatory side, the UCITS directive limits funds from holding more than 10% of issuance of a single bond issuer. And that might make sense in the context of a corporate issuer or a sovereign issuer, where you wouldn't want one investment fund to have a sort of undue influence in that single entity. However, in the case of securitization, which is a diversified pool of assets, we just feel this rule doesn't make sense. So we've advocated that policy makers just think about exempting securitization pools from that single issuer limit. The other issue that I wanted to talk about in the UCITS context was supervisory pressure. So we've just noticed that some national [inaudible] authorities looked a bit dubiously at securitization and place pretty strict limits on investments in the asset class. And we just feel that the data and evidence doesn't really justify that skeptical approach. So we just hope that the current review of the regulation also maybe focuses regulators' minds and encourages a bit more open-mindedness to the asset class based on the evidence of the -- of the, and their proven track record. Just one sort of final point that I think kind of brings this all together, it's not just about what policy makers do, it's also about how they do it. If they really want this effort to succeed where past efforts have fallen short, they need to approach these reforms with really the right mindset. To be honest, we just, we need to look at this comprehensively, but we also need to really look at it boldly and ambitiously as we reform this market. This is the third time that EU policy makers have really had a crack at this agenda, and if we don't get it right this time, there might not be a fourth shot at it. So, we see this as kind of a now or never moment to set the securitization agenda on a more positive path. All that said, I'm feeling quite positive that we can get it right this time, given the strong political momentum to improve this market.

Peter: Thank you, Taggart. So you've alluded to working with the financial regulators across Europe. Could you give any indication on where we are in that legislative process? And also, any indication of potential reforms that you think might start coming through?

Taggart: Yeah, thanks so much, Peter. But before we even get into that, first I might talk a little bit about why we're so engaged in this debate. Firstly, it's because well, we're just one of the largest investors globally in securitized assets, so of course we take an interest in it. But secondly, it's because we're very invested in and committed to Europe. We have 750 professionals working across 11 European jurisdictions, so we take interest in the European market. And lastly, kind of related to that, and I hope this doesn't sound trite, because it's very true that we take a long-term and holistic view on the markets in which we operate. So we don't just look at our own performance, but we really also think a lot about the broader ecosystem and the health of the broader ecosystem in which we're operating. So where are we, getting back to your question. The European Commission consulted late last year and we expect the European Commission to propose legislation on the 17th of June. So it's coming up very shortly. But that June publication is only the start of a political process. And that's the political process of the EU codecision. Essentially the European Parliament and the EU member states and the counsel have to take the European Commission's proposals, debate and amend them in their respective institutions and then finally, they have to come together and reach a final compromise between those respective positions. There's political momentum to move quickly on this agenda, but we also can't ignore the fact that there's political stigma around securitization, especially in the European Parliament. One senior EU policy maker said to me very recently that we're still haunted by the ghosts of the past. And she was alluding to the global financial crisis. So, what does that mean as far as timing is concerned? It means it might be ambitious to expect a political agreement before late 2026, or early 2027, and those rules wouldn't actually come into force probably before late 2027 or early 2028. An MEP said to me just last week that he would prefer to take the time to get this right, rather than rush through proposals. We've put a tentative time table together, which is this slide that you're looking at now, but I would remind folks that this is a political process and so you really can't predict these things with too much accuracy.

Peter: Thank you. And just one final thing to say before we wrap up, can you give some examples of how you're actually engaging in this review process?

Taggart: Sure, absolutely Peter. And we do have a final slide which is really, this is kind of a non-exhaustive list of the many government and regulatory bodies that we've been engaging with already on this topic. So, despite this being non-exhaustive, it looks a little bit exhausting, because there's quite a few on there. But just to kind of give a little overview, we engaged with the European Commission extensively in advance of their consultation paper last year. We responded to the consultation, but we also published a public white paper on reviving securitization to really set a marker down on this issue and start a dialog, start conversations. We continue to engage with the European Commission, even last week we sat down with them, as well as other stakeholders, the European supervisory authorities, IOPA and ESMA in particular, EU member state finance industries, regulatory bodies across Europe, and of course the European Parliament. As I mentioned previously, just last week we hosted a panel event in Brussels, with a Spanish MEP called Fernando Navarrete, who is widely speculated to play a key role in these discussions. That was quite a successful event, we had nearly a hundred participants join us. But looking forward, as we look beyond the June publication of the legislative proposals, we'll start intensifying our advocacy with the European Parliament and member states even more. And of course in addition to the direct advocacy that we do with policy makers, we've also marshaled a number of our byside [phonetic] associations to engage on our behalf and on behalf of the industry as a whole. So that's a bit of a summary, but I'll leave it there, Peter, and hand back to you.

Peter: Smashing, thank you Taggart, and thank you Kaustub as well. We've covered quite a lot of ground in the past, past 30 minutes or so, so I'd like to give a quick recap before we sign off. So we've explained how the U.S. securitization market is a lot more dynamic, it's got wider breadth and is more robust than Europe, and we feel that change does need to happen within the European securitization market. Indeed, we believe that the lack of development of the European securitization market is perhaps holding back the European financial system. May also be hindering European economic growth. We've also mentioned how we believe change is needed, and we're lobbying hard for this change. And if you're interested in this topic, or want to discuss it further, please reach out to one of your existing PGIM contacts, or as Taggart's just mentioned, we do have a white paper on our website. Thank you. Goodbye.

[Music]

IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of May 2025.

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