Reviving European Securitisation—Translating Ambition into Reality

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PGIM recently responded to the European Commission's (EC) targeted consultation on the functioning of the EU securitisation framework.[1] This paper reflects the views within our submission to the EC.

- Expanding access to funding sources and credit are critically important objectives as Europe seeks to maintain its competitiveness in the global economy. As highlighted in the recent Draghi and Noyer reports, the securitisation market can facilitate this expansion by connecting consumers and businesses in need of financing with global investors who are keen to diversify portfolio exposures.[2,3] In doing so, securitisation can boost funding to the real economy and strengthen Europe's financial stability by decreasing its overreliance on the banking system.
- European bank funding accounts for nearly 90% of the debt financing to non-financial entities in the region compared to 25% in the U.S.[4] Europe's dependence on bank financing increases the risks that sector dislocations may adversely affect economic activity across the region. Securitisation can assist in appropriately calibrating the economic role of banks by integrating a global investor base into Europe's lending markets.
- Unfortunately, Europe's securitisation market is not in a state to meet the current or future needs of its economy. Since the Global Financial Crisis (GFC), the contraction in Europe's securitisation market is visible from several vantages: it is now only 17% of the size of the U.S. market (down from 85% pre-GFC), annual issuance only comprises 0.3% of European GDP (vs. 2.6% for Australia, 1.2% for

[1] "Targeted consultation on the functioning of the EU securitisation framework," https://finance.ec.europa.eu/regulation-and-supervision/consultations-0/targeted-consultation-functioning-eu-securitisation-framework-2024_en. Consultation closed 4 December 2024.
[2] Draghi, Mario. "The Future of European Competitiveness – A Competitiveness Strategy for Europe," 9 September 2024.
[3] Noyer, Christian (Committee Chairman), "Developing European capital markets to finance the future," 25 April 2024.
[4] SIFMA, 2024 Capital Markets Factbook.

the U.S., and 0.7% for the UK), and the market's size has been dwarfed by Europe's own covered bond market.[5,6]

- Yet, securitisation is available to a wider range of issuers and helps transfer risk beyond bank balance sheets, creating more dynamic funding opportunities than the covered bond market. We provide additional details on the benefits of securitisation in the first sections of our paper.

- We follow with our recommendations for regulatory reform, including those that pertain to the EU's Securitisation Regulation (EU SR) and were put forth in the Draghi and Noyer reports.[7] For example, issuer transparency requirements should be rationalised to only include data that are material for institutional investors to assess risk. In many cases, additional data do not equate to better information, rather, they often result in more "noise" through which participants must filter.

- A review of the European securitised market should consist of a broad assessment of the challenges facing investors as well. Currently, EU investors find themselves at a competitive disadvantage given the prohibitions from investing in securities that do not comply with EU regulations. Indeed, the addressable European securitised market of about €1.1 trillion is roughly evenly split between the EU and the U.S. However, there is another €2.5 trillion of securitised assets that are not accessible to EU investors. Hence, we recommend regulatory adjustments that may allow EU investors to access the broader opportunity set in order to boost their global competitiveness. Furthermore, one of the key objectives of a European capital markets union is to make financing more accessible to all European companies, which implies making these assets visible and accessible to cross-border investors.

- Efforts to focus reporting on more relevant market information will likely lower issuance barriers, reduce costs, and improve the breadth of issuers and investors participating in the sector. Furthermore, investors' due diligence requirements should be streamlined to encourage greater participation in a market where an elevated fiduciary standard already exists. Capital standards should also be

[5] AFME Securitisation: Q4 2023 and 2023 Full Year.
[6] Op. Cit., "Developing European capital markets to finance the future."
[7] The EU Securitisation Regulation (Regulation 2017/2402) is the legal framework that establishes rules for securitisation activities within the EU. The UK's legislative framework was "onshored" after Brexit and remains largely similar. However, the UK has embarked on amending its framework and plans more reforms in 2025. Many of the views expressed in this paper apply to both the EU and UK regimes.

recalibrated to increase participation by prudentially regulated entities, such as insurance companies.

- Our recommendations also pertain to the 10% single-issuer limit under the UCITS framework. Given the various tranches and respective risk profiles within a single securitised capital structure, this limit introduces difficulties for investing in some issues due to their smaller tranche sizes.[8] When applied to the securitisation market, this regulation—which is aimed at avoiding undue influence on corporate issuers—fails to accomplish its intended objective as “control” in securitisations generally requires more than a 50% holding (at least) of either a super-senior or a subordinate tranche.
- We are confident that regulatory reform can contribute to the rebuilding of Europe’s securitisation market, thereby enhancing the global cohesiveness and competitiveness of Europe’s capital markets. The process of reviving Europe’s securitisation market would also allow European financial intermediaries to increase and diversify their funding sources, rationalise balance sheet risks, and deploy capital more efficiently.

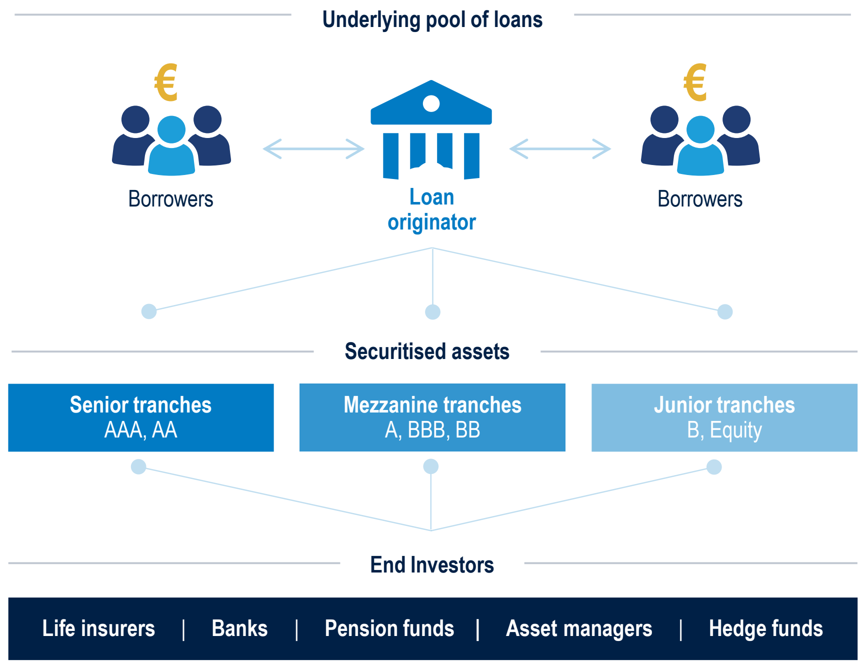
THE BENEFITS OF SECURITISATION

Through securitisations, the economics of a pool of assets—say auto loans, corporate loans, or mortgage loans—are aggregated and sold from an originator’s balance sheet to investors as tradeable securities (Figure 1). The senior tranche at the top of the capital structure is the highest quality portion, making it first in line to receive principal and last in line to take losses, whereas the junior most tranche bears more of the credit risk. The transfer of an illiquid pool of assets to investors via securitisation transforms them into a more liquid, tradeable form. The tranching process creates securities that satisfy the risk-adjusted return hurdles for different investor bases, consequently generating demand for underlying loans and supporting securitisation liquidity.[9]

[8] The Undertakings for Collective Investments in Transferable Securities (UCITS) Directive (Directive 2009/65/EC) is the EU regulatory framework governing investment funds.

[9] The European securitisation market is often referred to as the asset-backed securities (ABS) market.

Figure 1: Connecting borrowers to investors through the process of securitisation



Source: PGIM Fixed Income

A strong and stable securitisation market supports financing of the real economy by expanding access to credit.

After the GFC, bank capital requirements were designed to transfer risk from somewhat opaque bank balance sheets to more transparent capital markets. Securitisation is a key mechanism in that transfer. However, due to differences in the regulatory implementation, markets in certain regions, such as the EU and the UK, have fallen behind others, such as those in the U.S. and Australia.

Without a modernised securitisation market, European banks' higher capital requirements leave them with less balance sheet capacity to provide loans, thus constraining economic activity in the EU. A strong and stable securitisation market supports financing of the real economy by expanding access to credit. It also improves market functioning, provides economic transparency, and helps underpin financial stability as we detail in the following sections.

BENEFITS—BORROWERS IN THE REAL ECONOMY

Securitisation's most significant role is to open funding channels to the real economy, thereby providing businesses and consumers with capital and boosting economic growth. It can do so across a wide range of sectors.

Mortgage loans: By enabling banks and other loan originators to recycle capital, securitisation increases the availability of mortgages, making it easier for individuals to buy homes. This supports housing construction, goods consumption, and related activities. Covered bonds also play a role in European mortgage markets, but securitisation provides the ability to transfer risk away from bank balance sheets to a broad array of investors and across a wider range of mortgage products. Furthermore, commercial real estate (CRE) loans are largely absent from the current iteration of the European securitisation market. In the U.S., about $1.7 trillion in CRE debt is financed via securitisation, or slightly less than 30% of the sector's outstanding debt.

Consumer loans: The pooling and securitisation of many varieties of non-mortgage consumer loans, such as those tied to credit cards, auto purchases/leases, and education financing, etc., helps support consumer spending and the broader economy.

Small business and corporate loans: Collateralised loan obligations (CLOs) consist of pooling corporate loans, including those with higher credit risks, into securities that are subsequently sold to investors with varying risk appetites. CLOs facilitate more lending to non-investment grade companies that may otherwise struggle to find financing. This process is crucial to job creation, innovation, and local economic growth. As previously indicated, this activity also frees up banks' balance sheets to lend more to other economic sectors.

Infrastructure: Securitisation is also applied to revenue streams from infrastructure projects. Large scale projects, such as toll roads, airports, and utilities, can be financed more efficiently via securitisation, leading to improved public services, job creation, and regional competitiveness.

Renewables: Cash flows from renewable energy projects are increasingly securitised into green bonds or other types of securities that can assist with the energy transition. Green securitisation is growing, particularly in the U.S. despite the EU's status as the global leader in sustainable finance.

The end beneficiaries of a revived European securitisation market would be domestic pensioners and savers. Their investment performance would ultimately benefit from increased exposure to a diversified set of securitised investments that also fund Europe's real economy.

The list above is just a subset of potential securitisation sectors. Establishing a successful European market will allow a global investor base to fund additional, diverse sectors that can foster growth, drive innovation, and otherwise boost the region's economic growth.

BENEFITS—INVESTORS' PORTFOLIO DIVERSIFICATION

Securitisation also allows investors to further diversify their investments away from mostly corporate and government bonds, creating more resilient portfolios for beneficiaries. Through securitisations, investors gain targeted exposure to different levels of credit risk and non-corporate exposure to the various industries referenced above.

For example, the performance of auto loan securitisations is mostly driven by whether a diversified pool of consumers is able to pay their auto loans. The financial health of the car manufacturer or the financial entity that originated the loan—which has the potential to affect corporate debt and equities—has no bearing on the performance of the securitisation. In this sense, securitisations act as true diversifiers of credit risk within investors' portfolios as the assets' performance is independent of the sponsor or issuing entity. Conversely, it is often challenging to establish direct exposure to these sectors and this form of credit risk via non-securitised investments.

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BENEFITS—FINANCIAL STABILITY AND TRANSPARENCY

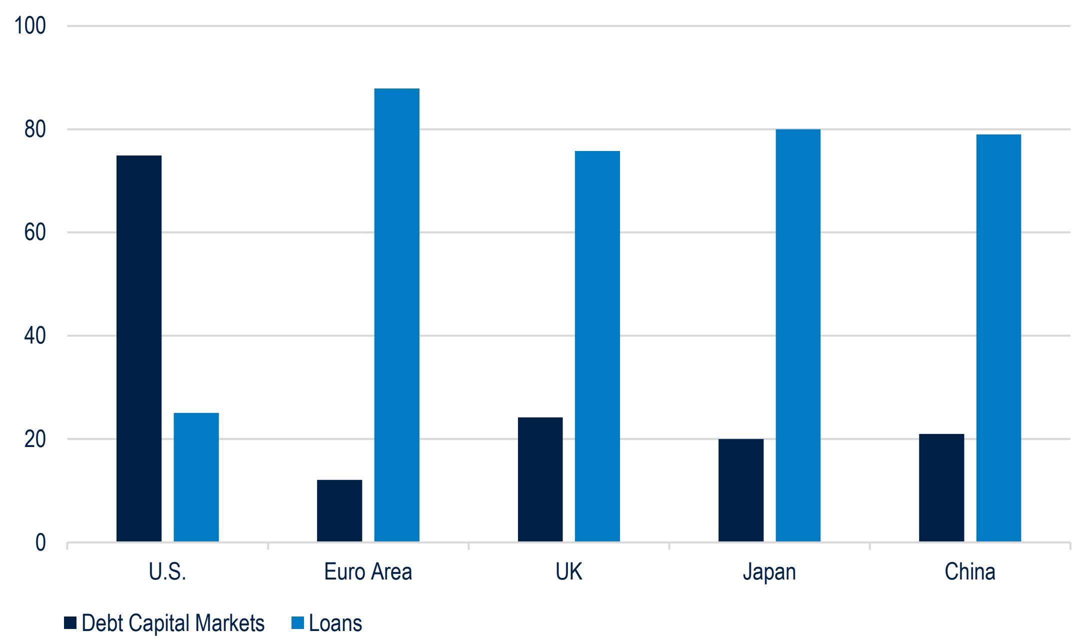
Securitisation improves financial stability in several ways. It provides transparency into the performance of assets that serve key economic functions. Once a securitisation is priced and distributed to investors, the market demands regular reporting of the underlying asset performance given that it is a core driver of credit risk and the related assessments. The aggregation of performance throughout a wide range of asset classes, such as mortgages and consumer loans, provides another perspective on the underlying growth and trends across large segments of the real economy. While this transparency is helpful, it can be challenging to identify, track, and interpret these data, especially given the pace of innovation in the industry. As discussed later in this paper, improvements to the European reporting regime—through simplification and standardization—should facilitate this interpretation.

The trading of securitisations provides real-time insight into the pricing of risk by sophisticated, institutional investors. This provides banks and other originators with independent, risk-based pricing on their loan originations, creating a feedback loop where market dynamics ultimately feed into the appropriate borrowing rates for consumers and businesses. Improving the transparency and pricing of credit are two key aspects that support the efficient deployment of capital throughout an economy.

Transferring risk exposures outside of the banking system is another process that contributes to broader financial stability. However, the European economy remains overly reliant on banks to fund growth, particularly from a global perspective (Figure 2).

Improving the transparency and pricing of credit are two key aspects that support the efficient deployment of capital throughout an economy.

Figure 2: Europe's reliance on bank financing is the highest across major economic regions (%)



Source: SIFMA 2024 Capital Markets Factbook

Therefore, periods of stress within the European banking system often hinder economic activity across the region. Diversifying funding towards capital markets via securitisations would enhance financial stability by pulling non-bank funding sources into the European economy. It could also help address asset and liability mismatches as well as liquidity risk within the banking system given the sector's reliance on short-term funding (e.g., bank deposits) and longer-term loans.

It is important to acknowledge the potential risks of securitisation. The process can contribute to a "short-term bias" when financial institutions create loans yet, through the pooling and selling of these loans, do not feel the ultimate consequences of their potential underperformance. This increases the chances that they originate riskier loans to capture a short-term profit. Certain types of securitisations—namely subprime residential mortgage-backed securities (RMBS) and collateralised debt obligations (CDOs) of RMBS—fuelled problems during the GFC, which consequently cast a long shadow on the broader, non-mortgage securitisation sector.

While securitisation certainly played a role in fuelling the GFC, we would argue that poor loan underwriting, fraud, and misaligned incentives were the root causes. Nearly two decades later, these problems have yet to re-emerge due to far more stringent underwriting of underlying assets (amidst regulatory adjustments), various fraud mitigants, and re-alignment of the market's long-term incentives. As a result, the global securitised markets have generally performed well in recent years, which is a trend we expect to continue.

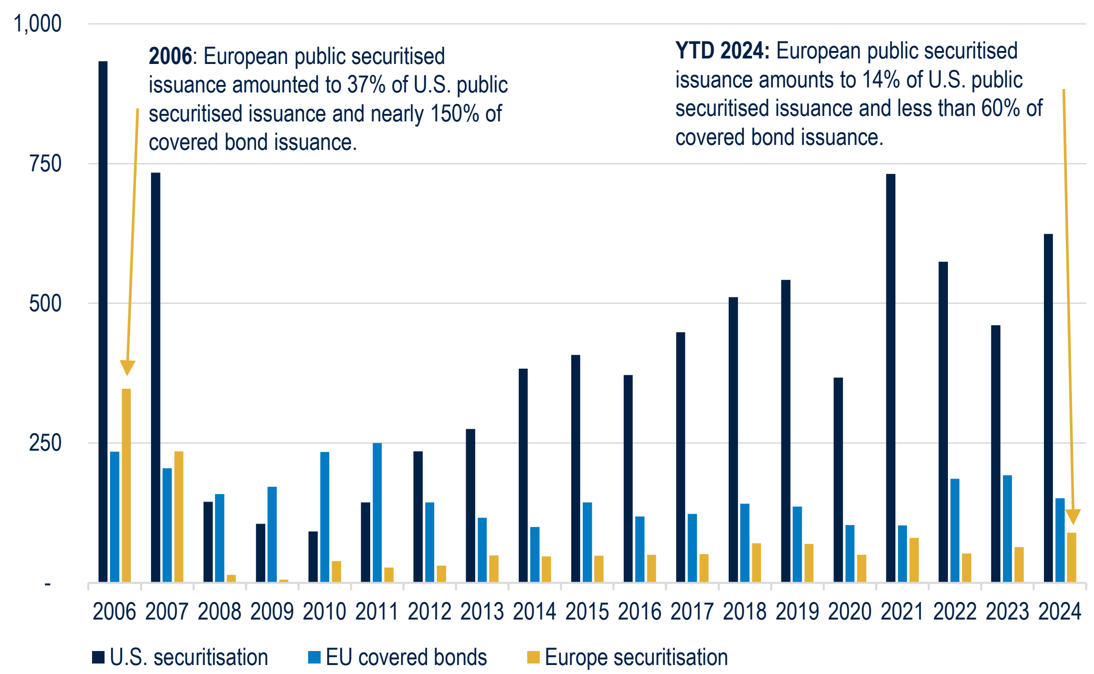
Although subsequent regulations have helped to address these risks, their inconsistent and burdensome application has cast an equally long shadow on the viability of the European securitisation market.

WHAT NEEDS TO BE DONE?

Although subsequent regulations have helped to address securitisation risks, their inconsistent and burdensome application has cast an equally long shadow on the viability of the European securitisation market.

Since the GFC, the EU has not fully realised the benefits of securitisation as the market has contracted and continued to cede ground globally (Figure 3). While the EU and the U.S. markets both contracted in the wake of the GFC, the latter started to recover in 2011. The subsequent stagnation in the European market is even more apparent as it has failed to overtake the region's covered bond market, which has far narrower applications. However, if annual European public securitisation issuance were to approach levels of peer economies, such as Australia (2.6% of GDP), Japan (1.4%), or even the UK (0.7%), that could increase the size of the public market by two to nine times, meaning that—even during the initial revival stages—it could likely surpass the domestic covered bond market as a viable financing option.[10]

Figure 3: EU securitisations have languished in the context of those in the U.S. and EU covered bond issuance (€bn)



Source: PGIM Fixed Income, J.P. Morgan, and Bank of America. Note: Excludes government guaranteed securities. EU Covered Bonds and Securitisation only covers Eurozone and excludes UK and Australia. EU Securitisation only includes placed securities. As of October 2024.

While covered bonds serve an important purpose in Europe, they do not facilitate the same credit expansion for several reasons: the liabilities remain on banks' balance sheets, pertain to very specific industries, and appeal to a limited investor base. Europe also has an active significant risk transfer (SRT) market, which allows banks to reduce regulatory capital by buying

[10] Op. cit. "Developing European capital markets to finance the future," page 49.

mezzanine risk protection from third-party investors. The SRT market provides some of the same benefits as securitisation, such as transferring risk and optimising bank balance sheets. However, the SRT market can be less transparent and less liquid than an established securitisation market. SRT is also a bank capital management tool that has little direct effect on Europe's reliance on banks for economic growth. Furthermore, the unfunded nature of certain SRT trades brings its own risks. Unfunded SRTs increase the probability that the issuing bank loses its SRT benefits if the protection seller faces credit headwinds. Moreover, many EU transactions are "blind pools," meaning they only provide minimal investor transparency and, therefore, do not provide market participants with real insights on the underlying collateral.

Ultimately, while SRTs and covered bonds are complimentary markets to securitisation, they should not be viewed as a comprehensive source of credit. Indeed, covered bond issuance can provide funding to a bank, but it does not transfer risks away from the bank. Furthermore, whilst the SRT markets help banks to reduce their capital requirements, these instruments are typically used by larger banking institutions with the sophisticated capital-optimisation teams.

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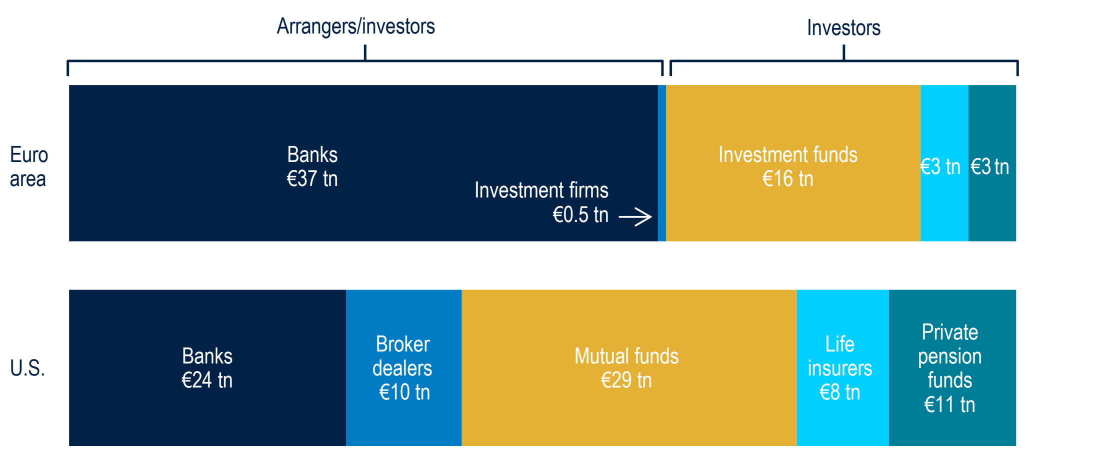
A revived EU securitisation market could also broaden investor participation beyond the current cast. At this point, the bulk of the market is dominated by banks and asset managers, with limited participation from insurance companies and private pensions (Figure 4). Banks acting as both loan originators and securitisation investors simply compounds Europe's reliance on the banking system. In comparison, the U.S. market has a more diverse buyer base where retail, insurance, and pension investors are quite active. Furthermore, a varied buyer base allows for more asset types and levels of risk to be financed through securitisation, all of which fosters a more comprehensive, liquid market.

Figure 4: The structure of the European securitised market also remains far narrower than its U.S. counterpart.



Source: ECB Flow of Funds, U.S. Federal Reserve Flow of Funds, EBA (2015), and IMF. Note: 2022 Q4 data except for investment firms' assets, which are based on EBA 2015 data. Security brokers and dealers include holding companies, funding corporations. Mutual Funds include real estate and investment trusts, excluding hedge funds and private equity funds.

Regulatory reform is a critical aspect of reviving the European securitisation market. The following sections outline our proposals to reduce participation barriers and re-establish the foundation of a larger, more active European securitisation market. Ultimately, these changes will benefit a broad set of constituents, including European pensioners and savers, who will have more resilient portfolios as well as the businesses and individuals that will be able to access a more efficient, sustainable source of credit.

WHAT NEEDS TO BE DONE—INCREASE EU INVESTORS' ACCESS TO GLOBAL MARKETS

The constraints on the European securitised market are straightforward—EU investors are only able to invest in securitisations that satisfy EU regulations. The global securitised market is roughly €4.3 trillion in size. Yet, due to market dynamics and regional regulations, the investible universe for European investors is approximately €1.1 trillion (~25% of outstanding). This is a sufficiently large market to allow some investors to construct a relatively diverse portfolio (consisting of roughly half non-EU/non-UK issuance). However, there is another €2.5 trillion of assets that are not accessible to EU investors due to regulatory constraints (Figure 5).

Figure 5: European investors can only invest in 25% of the global securitised market, putting them at a competitive disadvantage globally (€bn)

€1.1 trillion available as eligible securitised investable universe

European & Australian securitised	Retained	Distributed	Total
ABS	244	128	372
CLO	13	220	233
CMBS	5	24	29
RMBS	421	198	619
Total	683	570	1,253

U.S. securitised	EU RR not compliant	EU RR compliant	Total
ABS	440	120	560
CLO	683	258	941
CMBS	1,000	99	1,099
RMBS	360	84	444
Total	2,483	561	3,044

€2.5 trillion inaccessible due to regulatory hurdles

Source: PGIM Fixed Income, Bank of America, and J.P. Morgan. As of October 2024.

The €2.5 trillion of inaccessible assets is driven by the scores of U.S. issuers that choose to opt-out of EU regulations—often due to costly transparency requirements—in an otherwise deep domestic market that can absorb a diverse set of issuance. In many cases, U.S. issuers comply with rules that are very similar to EU SR requirements (e.g., a 5% risk retention holding in a securitiation), but—because the reporting standards in the two jurisdictions are not identical—EU investors are locked out of a significant portion of the market. For example, in certain U.S. sectors, such as broadly syndicated CLOs, the 5% risk retention hold is not required as long as the portfolio is not originated by the issuer and the assets are purchased in the open market. For private credit CLOs where assets are originated by the issuer, the 5% risk retention requirement remains. Importantly, despite the divergence in CLO risk retention methods in the U.S. and Europe, the risks of the underlying collateral are nearly the same as indicated by a comparable number of covenant-lite defaults and distressed credits across the two markets.

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The existing investment constraints can skew EU investors' portfolios towards certain securitised sub-sectors that do not necessarily offer them the best risk-adjusted return, but instead meet EU regulatory requirements. Hence, EU investors' inability to access these assets hampers the ability to earn greater returns for their beneficiaries compared to global peers.

In theory, EU investments that mostly stay within the EU may sound like a positive development. However, in practice, these restrictions can have a dampening effect on EU investors' participation in securitisation given the available market size and limited liquidity

as many institutions are reticent to sell given the replacement challenges. As compensation for the size and liquidity, these investors often seek higher yields, making the market less attractive and potentially more expensive for EU issuers over the long term. This creates a vicious cycle: a small market leads to reduced investor demand, which leads to limited issuance and a constrained market.

To break this cycle, regulators might consider allowing European investors to invest in global securitised products more easily, especially those issued within the U.S that do not currently qualify due to reporting nuances. The UK has recognised this, and it is refining its rules to address global market fragmentation. Similar legislation could benefit European markets in a scenario where issuers increase volume to satisfy the needs of their local, growing investor base.

WHAT NEEDS TO BE DONE—REMOVE DUPLICATIVE DUE DILIGENCE REQUIREMENTS

Regulators might consider allowing European investors to invest in global securitised products more easily, especially those issued within the U.S that do not currently qualify due to reporting nuances.

Conducting appropriate due diligence should be a universal investment requirement. However, the additional due diligence requirements that apply for securitisation investments in the EU SR can be duplicative to what is already required and often do not improve the risk profile of securitisation portfolios. Specifically, the regulations require investors to verify that securitisation issuers meet granular reporting specifications as well as their legal risk retention requirements—neither of which is relevant in the investment underwriting process. Such unnecessary verification creates operational burdens, especially on smaller investors who may not have the resources to perform these additional certifications. At the very least, a more principles-based approach, such as the recent changes to the UK framework, should be considered for adoption in the EU.

European asset management regulation already prescribes a detailed and stringent due diligence process pertaining to other aspects of a fund's investments. For example, both the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD) require strict due diligence for all investments, including areas pertaining to: investment strategy and objectives, credit risk, liquidity risk, operational risk, valuation, pricing, ongoing performance and risk monitoring, compliance and legal review, and counterparty risk.[11] We continue to welcome these requirements as they are consistent with investors' fiduciary duties. However, the additional EU SR requirements pertaining to verification of issuer risk retention and reporting compliance are beyond what should be required of investors. Verifying risk retention compliance on an ongoing basis is operationally challenging as it requires manually checking trustee/servicer reports for a statement confirming the ongoing compliance of each issuer. In cases where the statement is missing, investors have to reach out to the trustee/issuer to confirm that risk retention requirements are being met. Given that context, existing regulatory and supervision measures should ensure issuer compliance, without redundant investor verification as well. This would be a similar approach to the U.S. regulatory framework.

We are not advocating that issuers neglect their own detailed due diligence required under the Article 7 transparency requirements of the legislation (though these could be streamlined, as

[11] The Alternative Investment Fund Managers Directive (AIFMD) is the EU regulatory framework for managing and marketing alternative investment products, e.g. hedge funds, private equity, private debt and real estate funds and other vehicles falling outside of the UCITS framework.

noted below). However, requiring asset managers and other institutional investors to verify compliance with each regulatory step, including many that are duplicative, is a burdensome requirement that does not exist in other jurisdictions and does not confer tangible benefits to investors. Streamlining investor due diligence requirements would help foster a deeper, more liquid market that would facilitate greater global investment into EU-issued securitised products.

WHAT NEEDS TO BE DONE—RECALIBRATE TRANSPARENCY REQUIREMENTS TO REDUCE ISSUANCE HURDLES

EU SR reporting costs CLO managers ~€10,000 per deal per year for European transactions. For those U.S.-domiciled CLOs that are compliant with European due diligence standards, the reporting costs are ~$31,000 per deal per year… These costs are borne by investors and may ultimately be passed on to issuing enterprises.

The EU's securitised reporting requirements make it an outlier among global capital markets. While it may create a need for third-party data providers (larger investors can generally handle the operational burden), it provides little or no value to investors in securitisations.

ILLUSTRATIVE EXAMPLE: CLO REPORTING

CLO managers typically use third-party providers to assist in EU SR regulatory reporting as most market participants do not request the required data fields to make investment decisions. There are a total of 120 collateral data fields required under EU SR. In our experience, we estimate that data for two of these fields are provided by the collateral manager, 58 are sourced by trustee reports, and the other 60 are provided by a third-party provider. Nearly 50% of these 60 fields are coded as "data not collected as not required" or "not applicable." Given the low hit rate and marginal utility of this quarterly data-gathering exercise, we question whether it is warranted from a cost-benefit perspective. The existing trustee reports are more than sufficient in terms of utility and transparency.

In summary, the level of granular reporting complicates compliance for issuers, who must supply many data points of little value. Streamlining these reports by focusing on key performance and risk indicators—rather than niche details that may not effectively serve their intended purpose—could be a significant step to improving efficiency within the European securitised market.

In continuing with the CLO example, we calculate that EU SR reporting costs CLO managers ~€10,000 per deal per year for European transactions. For those U.S.-domiciled CLOs that are compliant with European due diligence standards, the reporting costs are ~$31,000 per deal per year.[12] These costs are associated with paying a third-party provider to compile detailed reports, which can run ~250 pages per month for each CLO. When the EU SR reporting framework went live, it provided little guidance or definitions for many reporting fields, and the industry expended a great deal of time and cost to align its interpretation of these data fields. These costs are borne by investors in the transactions and may ultimately be passed on to enterprises in the form of higher borrowing costs.

As investors, we would be less sensitive about those incremental costs if we accrued a meaningful benefit from the reporting requirements. In our experience as a CLO issuer, investors and other parties rarely, if ever, request this detailed information as it is redundant with information already provided in the normal course of business via the monthly trustee report.

[12] Cost estimates based on PGIM Fixed Income information.

European insurers' lower allocations to securitised products is largely a function of the substantial capital reserves associated with these assets.

Most investors require transparency into collateral composition as part of their due diligence process, but they do not necessarily need the information presented in the format required by the EU SR. As one of the largest CLO tranche investors globally, we do not process data in that particular format.

We welcome the European Securities and Markets Authority's (ESMA) recent consultation on the revision of the securitisation disclosure framework, but if a Level 1 review (EU SR) of the EU rulebook is forthcoming, it would be sensible to look beyond simple Level 2 (templates and their data fields) fine-tuning. A more fundamental rethink of reporting rules and the associated due diligence should seek to reduce the regulatory burden on EU securitisations. The review is an opportunity for policymakers to take a step back and design a purpose-driven reporting framework with data pertinent to regulatory authorities and markets. While a move toward less transparency is not the objective, it makes sense to re-assess the data that provide value for investor due diligence.

WHAT NEEDS TO BE DONE—ADJUST CAPITAL REQUIREMENTS TO INCREASE INSURANCE PARTICIPATION

Although many securitised products present a natural match for insurance liabilities, risk-based capital requirements for insurers, specifically under the Solvency II framework, can be quite stringent and prohibitive to investment. In Q4 2023, securitised products accounted for 0.7% of EU insurance company portfolios, according to the European Insurance and Occupational Pension Authority (EIOPA).[13] Contrast this to the U.S., where private label ABS (including CLOs), CMBS, and RMBS accounted for 17.5% of insurance holdings at the end of 2022, according to the NAIC.[14]

European insurers' under-allocations to securitised products is largely a function of the substantial capital reserves associated with these assets. Even for more highly-rated securitisation tranches, insurers face higher capital charges compared to other asset classes with similar profiles.

For example, a European senior AAA-rated CLO with a six-year spread duration attracts a 75% capital charge compared to a 8.5% capital charge for a 10-year duration AA rated corporate bond (Figure 6). This capital discrepancy of nearly nine times exists even though there is no historical record of any AAA CLO taking an impairment or a loss since their introduction in the late 1980s.[15] For lower-rated securities, such as those defined by credit-quality step 1 (equivalent to AA) securities, non-STS capital charges of 100% are multiples of the 8.5% capital charge on similarly rated corporate bonds.[16]

Finally, these Solvency II capital charges for securitisation are much higher than those in other regulatory frameworks. As a result, they put European insurance companies at a disadvantage relative to their global peers as they cannot access investments that may provide diversification benefits and, in some cases, more attractive credit spreads/yields. For instance, the six-year AAA CLO capital charge in Europe is more than double that of a six-year CCC corporate loan in the U.S.

[13] Financial Stability Report June 2024 - EIOPA (europa.eu)
[14] Asset Mix YE 2022 (naic.org)
[15] Although Collateralised Loan Obligations (CLOs) and Collateralised Debt Obligations (CDOs) sound similar, they are starkly different. The key difference is the underlying collateral, which in the case of CLOs consists of loans made to businesses. The CDOs that became notorious in 2007-2008 were backed by poorly underwritten residential mortgages, which defaulted during the financial crisis.
[16] STS refers to simple, transparent, and standardised requirements under Article 27(1) of the EU SR.

Figure 6: Capital charges for 10-year duration for three credit quality steps (CQS)

	CQS 1	CQS 2	CQS 3
Covered bonds	7.0	—	—
Bonds/loans	8.5	20.0	58.5
STS senior	9.5	22.5	73.5
STS non senior	26.5	63.0	100.0
Non-STS (other)	**100.0**	**100.0**	**100.0**

Source: EIOPA, PGIM Fixed Income

The Financial Stability Board's own analysis states that "it would take a loss rate more than twice as severe as that of the financial crisis for AAA-rated tranches to incur losses."

Clearly, capital charges need to be more appropriately calibrated to capture an asset's respective credit risk. Capital requirements should reflect an evidence-based approach and not artificially drive investment allocations through overly conservative or overly lenient capital requirements. The focus should be on practical, consistent capital requirements across asset classes and credit profiles. We believe there is strong evidence for less punitive requirements on the most senior investment-grade securitisation tranches (rated AAA and AA) and are prepared to work with regulators to support a change. However, we do not believe that EU regulation should artificially incentivise insurance investment in more junior tranches, as can be the case in other jurisdictions. Policymakers in these jurisdictions are beginning to recognise this issue, and we see evidence that they may recalibrate capital requirements to more accurately reflect the risk in some mezzanine tranches.

AAA-rated collateralised loan obligations (CLOs) are a clear candidate for less punitive capital charges, particularly in the context of zero AAA-rated tranche defaults since their inception nearly four decades ago. The Financial Stability Board's own analysis states that "it would take a loss rate more than twice as severe as that of the financial crisis for AAA-rated tranches to incur losses."[17] Less punitive capital charges would incentivise allocation towards AAA CLOs, thus improving CLO liquidity and potentially reducing spreads. These tighter spreads would be transferred to European corporations in the form of lower borrowing costs. Capital charges for AAA CLOs can be lowered by reviewing the prudential standards or making AAA CLOs eligible for the STS label.

WHAT NEEDS TO BE DONE—FACILITATE GREATER UCITS INVESTMENT IN SECURITISATION

The ability for funds governed under EU law to invest in securitisation is hampered by the strict limit under Article 56 of the UCITS Directive.[18] The Directive allows a fund to acquire no more than 10% of the debt securities by a single issuing body—in this case, a single securitisation issuance.

This may make sense for corporate debt securities for which this rule was devised. However, securitisation issuances are naturally more diversified than bond offerings. Also note that an investment that is more than 10% of a securitisation is not necessarily less liquid than a smaller allocation as the market is more focused on the ultimate issuer and not the issuance. We understand that this rule seeks to ensure that a UCITS fund does not have undue influence over

[17] Financial Stability Board (FSB). "Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation". (2024), 41. https://www.fsb.org/uploads/P020724.pdf

[18] UCITS stands for Undertakings for Collective Investments in Transferable Securities. The UCITS Directive is the EU regulatory framework for managing and selling mutual funds.

a single issuer. While this may make sense in the context of a corporate issuer, it makes less sense when applied to a pool of underlying loans within a securitisation.

Furthermore, single securitisation issuances are often smaller than large corporate debt transactions. Therefore, it can be easier to trigger the 10% threshold when investing in securitised products. This requirement can also work against the overall diversification of UCITS and puts them at a disadvantage to funds in other jurisdictions. When the issuer is a securitised vehicle, policymakers should consider an exemption from the rule that limits the percentage of a single issuer's debt that may be acquired.

More broadly, some EU regulators treat securitisation investments with extreme caution in the context of UCITS supervision, only allowing very limited investment in some securitisations. This is to the detriment of UCITS investors and the overall competitiveness of Europe's asset management sector. We note that recent improvements indicate that supervisors may be getting more comfortable with securitisation investments and further familiarisation may be warranted. Nearly two decades of sound performance in the most senior securitisation tranches (AAA and AA rated) provide constructive context when considering lingering concerns regarding securitisation investments.

CONCLUSION

A stable financial system together with well-functioning securitisation markets are vital for Europe's economic growth. Securitisation has the potential to fund the real economy, enhance financial stability, improve transparency, and diversify investment portfolios. However, securitisation reforms implemented in the wake of the GFC have prevented the European market from flourishing. Instead, the European securitisation market remains small in nominal terms and as a percentage of GDP when compared to other jurisdictions.

Fortunately, regulatory reforms can revive this market, and we are advocates for reform on several fronts. Recalibrating transparency and due diligence requirements can ease the burden on issuers and investors, thereby expanding the investor base. Adjusting capital requirements for insurance companies can increase insurance investments in securitisation and support their global competitiveness. Furthermore, when applied to securitised funds, addressing the 10% asset limit under the UCITS framework should bring more investments into UCITS funds and provide investors with tangible benefits. Finally, in an effort to encourage European investors to become more active in securitisation markets, they should be allowed to invest in the full suite of assets that are available to global investors.

The current, political momentum behind a European securitisation revival gives hope that regulatory reforms along the lines above are under consideration. We have heard policymakers who are concerned about the underinvestment across Europe, making this a critical moment for the Savings and Investment Union and Europe's global competitiveness.

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of December 2024.

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