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Towards a More Realistic View on the Market Potential of EU Securitizations

Ongoing global trends like climate change require firms to invest in projects that support their transformation. In order to unlock the huge sums of private capital necessary for these investments, the engagement of institutional investors appears to be crucial. In a project funded by ZEW's Sponsors' Association, we investigate whether and how a better integration of the European banking system and capital markets can be an effective short- and medium-term solution to unleash the financial sector's potential in supporting the green transformation. Capital markets can support bank lending by financing assets on- and off-balance-sheet. Securitizations allow institutional investors to directly invest into cash flows from specific assets. Our analysis shows that the current market potential of European securitizations is much smaller than wished for and that the securitization model envisaged by the Capital Markets Union (CMU) project does not seem to fit the European context. Instead, policymakers should embrace a realistic view on the market potential of European securitizations. They also need to be clear in their communication about the trade-offs between unconventional central bank policies and the development of securitization markets. Additionally, they should closely watch the incentives that come with the new non-financial reporting indicators for banks regarding securitization. Most importantly, to accelerate the green transition, policymakers need to encourage the necessary private real investments in the first place by creating a conducive economic environment and the right incentives.

KEY MESSAGES

- The current market potential of European securitizations is much smaller than desired and the securitization model envisaged by the CMU project does not seem to fit the European context.
- Policymakers should embrace a realistic view on the market potential of European securitizations.
- Banks will only sell off loans if (i) they have more attractive lending opportunities compared to their existing portfolio, (ii) their funding needs exceed what can be financed via more attractive sources and/or (iii) they are restricted by their capital ratio.
- Policymakers need to be clear in their communication about the trade-offs between unconventional central bank policies and the development of securitization markets. The incentives that come with the new non-financial reporting indicators for banks on securitization should be closely watched.
- To accelerate the green transition, politicians need to encourage the necessary private real investments in the first place by creating a conducive economic environment and the right incentives.
- Securitization plays an important role in better integrating the European banking sector and capital markets, but it will likely not be the most significant boost towards more market-based funding.

MOBILIZING PRIVATE CAPITAL IN A BANK-BASED FINANCIAL SYSTEM

Better integration of European banking system and capital markets may be a solution to fund green transition

Ongoing global trends like climate change require firms to invest in projects that support their transformation. In order to unlock the huge sums of private capital necessary for these investments, the engagement of institutional investors appears to be crucial. In addition to strengthening the European markets for equity capital (stock markets, private equity and venture capital), which are less developed compared to the US markets, it is therefore particularly important to link the European banking system more closely with the capital markets. In the medium term, the European economy will remain significantly dependent on bank financing – also because, according to survey results (e.g. the European Central Bank's Survey on the Access to Finance of Enterprises in the euro area), a clear majority of small and medium-sized enterprises (SMEs) in Europe are not interested in financing themselves via capital markets. A better integration of the European banking system and capital markets can therefore be an effective short- and medium-term solution to unleash the financial sector's potential in supporting the economy's transformative efforts.

Securitization could be an option to improve institutional investors' access to green projects

One commonly cited option to link the banking system more closely with the capital markets is to develop the European securitization markets, which collapsed for understandable reasons after the global financial crisis of 2008 and 2009. Despite the problems that arose during the financial crisis, which mainly affected US securitizations, securitizations are fundamentally suitable for supporting the economy in their transformation efforts.

In its basic form, securitization means that banks identify a pool of loans that they want to remove from their balance sheet to sell to a separate entity. This entity then finances the assets by selling tradable, interest-bearing securities with differing return-risk-profiles to institutional investors. By buying these securities, institutional investors therefore gain direct exposure to the underlying loan pool. In the context of the green transformation, the advantage over holding a green bond is that institutional investors know exactly which projects they are funding, which facilitates climate risk management and reporting.

Given that loan portfolios only become investable for institutional investors when they exceed a critical size (i.e. in the range of tens or hundreds of millions), the possibility to bundle many small loans to a larger pool appears to be a very attractive feature of securitizations. A vibrant EU securitization market could therefore fundamentally improve institutional investors' access to financing green projects.

EU Capital Markets Union project has made little progress

Politicians at the national and the EU level have been trying for years to strengthen the European capital markets, including securitization markets, as part of the EU Capital Markets Union (CMU) project. But the topic is complex and difficult to oversee, there are few scientifically based recommendations for action and the political process at the European level is slow-moving. As a result of these obstacles, new proposals continue to emerge and disagreements arise as to which of the many proposed measures should be prioritized. With regard to the CMU, there have been few signs of progress so far. However, at their meeting in March 2024, the EU finance ministers made recommendations regarding the CMU to the EU Commission for the period 2025-2029. In particular, a need for action in further developing and (re) vitalizing the EU securitization market was emphasized.

THE SUPPLY SIDE OF SECURITIZATIONS

Banks use securitizations to raise liquidity, to transfer credit risk off the balance sheet, or to achieve both

In practice, securitization transactions can be considerably more complex than outlined in the previous section. The type of the securitization transaction banks choose depends on whether they want to increase the liquidity of a pool of loans, to transfer credit risk off their balance sheet, or to do both.

Both objectives can be achieved by selling loans to a special purpose vehicle (SPV), which issues multiple tranches of debt securities against them. These tranches differ in terms of their seniority, where the most senior tranches have the first claim on any cash-flows coming from the loan pool, and the least senior tranche - the equity tranche – gets paid back last. The transaction is usually structured in such a way that the most senior tranche receives the highest possible credit rating (i.e. AAA/Aaa). This is achieved by heavily over-collateralizing the tranche, i.e. the share of the loan pool that is earmarked for repaying the senior tranche is significantly larger than the tranche's share of the SPV's total liabilities. If the aim of the bank was to sell the loans – the most straightforward way to raise cash and free up regulatory capital - the securities created by the SPV would then be sold to investors. However, due to regulatory requirements and to signal that the loan pool is of good quality, banks keep some exposure to the newly created securities, which often entails retaining the equity tranche.

If banks only want to increase the liquidity of the loan pool, they can retain the newly created securities on their balance sheet. In doing so, they swap an illiquid pool of loans against the debt securities with differing levels of market and funding liquidity issued by the SPV. The bank then has the option to borrow against the safer tranches of the securitization from central banks or on wholesale funding markets. Used in this way, the securitization of existing loans facilitates balance sheet growth for banks that are not restricted by their regulatory capital ratios. Depending on the type of the securitizations, the retained securitizations may also partially count against the banks' pools of high-quality liquid assets under the Basel III Liquidity Coverage Ratio regulation. Since banks retain the newly created securities, this type of securitization transaction does not create investment opportunities for institutional investors.

Banks that only want to transfer credit risk off their balance sheet usually do this via derivative transactions. In these transactions, called synthetic securitizations, the loan pools remain on the banks' balance sheets. Hence, these transactions do not increase liquidity, but decrease risk-weighted assets. Lower levels of risk-weighted assets in turn imply higher regulatory capital ratios, thereby creating room for additional bank lending. Synthetic securitizations can be done with or without SPVs between the sellers and buyers of credit risk, whereas the latter is cheaper and less complex to implement. The institutional investors that act as counterparties in these transactions buy a direct exposure to the credit risk of the loan pool.

The supply of securitizations depens on banks' access to cheaper funding sources and capital ratios

The supply of securitizations depends on several factors. Two very important ones are banks' access to cheaper funding sources and their capital ratios.

Banks will only use securitizations for funding purposes if their funding needs exceed what can be financed via more attractive sources. Retail deposits are usually the cheapest form of funding for banks and enjoy preferable treatment in regulatory liquidity and funding regulations. According to calculations by the ECB and the ESRB (ESRB, 2022), since 2012, covered bonds have been the cheapest market-based form of refinancing for banks, cheaper than senior unsecured bonds and securitizations with the highest possible credit rating. In certain periods, the central bank might also offer a cheaper longer-term alternative to securitizations, like the ECB did between June 2014 and March 2019 with its targeted longer-term refinancing operations.

If the capital position of the bank does not support the size of the balance sheet the bank wants to achieve – due to, e.g., regulatory restrictions, internal risk limits, or leverage targets – the bank has two options to keep lending. The first option, which is rarely used in practice, is to raise additional equity capital from investors. The second option is to sell off assets. Since loans make up a significant part of banks' risk weighted assets, loan securitization is the most practical way forward in this situation. The supply of securitizations should thus increase in situations when bank lending is restricted by equity capital.

THE DEMAND SIDE OF SECURITIZATIONS

A realistic view on the market potential of EU securitizations needs the right comparisons

Politicians and commentators commonly base their assessment that the EU markets for securitizations have a large potential for growth on two comparisons. First, they compare the current size of the EU markets to their size before the 2008/09 financial crisis (from here, referred to as the great financial crisis – GFC), when they were significantly larger. Second, they compare the current size of the EU market with that of the US market, the latter of which is much bigger relative to GDP and has recovered faster, almost fully to levels seen before the GFC. However, in our view, these comparisons are misleading.

Before the GFC, the most senior tranches of EU securitizations issued without government guarantees were regarded as safe assets, i.e. securities that are very liquid and keep their value in crisis periods. Since the GFC, privately issued securitizations without government guarantees have lost this status. Because investors now treat them as risky, EU securitizations currently belong to a different, smaller market segment, in which they compete with other risky securities. Therefore, the current market potential of private-label securitizations is significantly smaller than that before the GFC. The size of the EU securitization markets before the GFC and their current size are not comparable.

The comparison between the EU and the US securitization markets as a whole is misleading, because the US securitization market is dominated by agency residential mortgage-backed securities, i.e. securities that have a government guarantee and are therefore likely still enjoying the safe asset status. There exists no counterpart to agency securitizations in the EU securitization market. We therefore argue that agency securitizations belong to a different market segment than non-agency securitizations and should therefore not be compared directly. When agency securitizations are not considered, the volume of outstanding non-agency securitizations in the US is still significantly higher than in the EU. But the differences in market size are much smaller than for the agency securitizations, implying that there is less potential for catchup growth than policymakers would like to see.

Securitizations compete with covered bonds for investor money

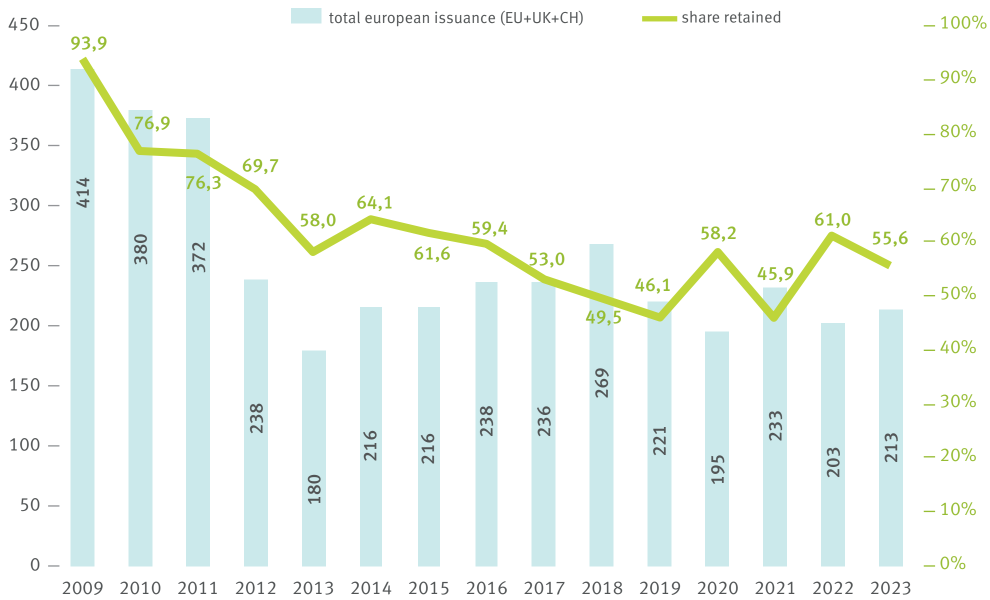
Securitizations are not the only bank securities that allow institutional investors to buy exposure to a specific pool of loans from banks. Investors can also buy covered bonds. Due to several institutional features, covered bonds are seen as a very safe asset class. For example, investors not only receive a direct claim on the collateral pool, but also a claim on the remaining assets of the bank in case the bonds default. Also, the issuing banks have to make sure that the value of the collateral pool, which usually consists of loans of very good credit quality, is never lower than the size of the covered bond. The fact that spreads of covered bonds have been lower than those of securitizations with the highest credit rating in the last ten years (ESRB 2022) suggests that investors perceive covered bonds as less risky. Since covered bonds can be very close substitutes for securitizations, lower spreads for covered bonds lead banks to refinance via covered bonds instead of securitizations (Boesel et al. 2018).

THE CURRENT STATE OF THE INTEGRATION OF BANKS AND CAPITAL MARKETS

Statistics on the holders of European securitizations published by the ESRB (ESRB 2022) reveal that, with a share of 84 per cent, a large majority of EU securitizations are held by EU banks. As Figure 1 shows, a major contributing factor for these large holdings is that banks retain the majority of new issuances on their balance sheets instead of selling them. The high share of retained securitizations means that European banks mainly use securitizations to increase the liquidity of the underlying loan pools. Accordingly, asset-backed securities make up about 20 per cent of the collateral that is pledged to the Eurosystem (ECB 2024). The large holdings of EU securitizations by EU banks suggest that EU securitizations are currently not particularly attractive for investor groups other than banks.

European securitizations do not leave the European banking system

FIGURE 1: TOTAL EUROPEAN SECURITIZATION ISSUANCE AND PERCENTAGE RETAINED BY BANKS OVER TIME



The figure shows total European securitization issuance and the respective percentage of retained securitizations over time. Total European issuance includes issuances from the EU, UK and Switzerland. Collateral types are Auto, Cards, SME ABS, CMBS, Consumer, Leases, RMBS, CLO and Other. Source: AFME, own calculations.

There is, however, one market segment of securitizations that already promotes the integration of European banks and capital markets, which is the market for Significant Risk Transfer (SRT) (see Gonzalez and Triandafil (2023) for more details). Statistics on the SRT market are only partially included in statistics of the European securitization market, because these transactions are predominantly implemented via derivatives or on-balance sheet transactions. The market for synthetic SRT securitizations has been growing over the past years, jumping significantly from about 80 billion euros in 2021 to over 140 billion euros in 2022. Adding the latter to the 203 billion euros in traditional securitizations increases the size of the European securitization market for 2022 by more than two thirds.

Synthetic Significant Risk Transfer securitizations promote the integration of banks and capital markets

While traditional securitizations are mainly based on residential mortgage loans and held by banks, corporate and SME loans make up 66 per cent (58 and nine per cent, respectively) of the underlying collateral pools and the group of investors is dominated by specialist credit funds (45 per cent) and asset managers (30 per cent).

Remarkably, SRT securitizations are only supplied by a small group of very large EU banks. Large banks are able to use the tool because they are already strongly integrated with capital markets, the complexity of derivative transactions is less of a problem for them, their international presence provides them with more lending opportunities and they typically operate with much lower capital ratios than smaller banks. It is encouraging that large banks at least have the opportunity to sell the credit risk of large volumes of corporate loans to institutional investors.

STRUCTURED FINANCE AND THE GREEN TRANSITION

The originate-to-distribute model of securitization does not seem very realistic for Europe

The discussion so far shows that politicians and commentators usually have the originate-to-distribute model of securitization, i.e. banks grant loans with the intention to sell them and not to hold them on their balance sheets, in mind when they talk about reviving the European securitization market and using it as a catalyst for the green transition. But this narrative does not seem very realistic for Europe. As laid out above, banks will only sell off loans if (i) they have more attractive lending opportunities compared to their existing portfolio, (ii) their funding needs exceed what can be financed via more attractive sources and/or (iii) they are constrained by their capital ratio. None of these factors seem to have played a restrictive role for European banks since the GFC, with the exception of very large banks. At the same time, investors will only demand the securities if they fit their return-risk preferences, which is the case for a limited class of investors. These arguments still hold when looking at the green transition. In addition, there are several further demand and supply factors limiting the market potential of European securitizations as a means to support the green transition.

It is questionable whether SME and retrofit loans are suitable asset classes for (cross-border) securitization

For the green transition, loans to small and medium sized enterprises (SMEs) that seek external financing for their green projects as well as loans to households that want to finance investments in the energy efficiency of their homes (retrofit loans) are central when it comes to linking the banking system with the capital markets via securitization. Banks could bundle many of these smaller loans and sell the newly created securities to institutional investors, improving the latter's access to financing green projects. Banks could then use the liquidity and freed-up capital from selling off these loans to fund further green projects of their borrowers. In principal, such securitizations work, and have worked, in reality.

As the economic reasoning laid out above and actual market size suggest, SME loans are the "tricky" asset class for securitization. Usually, assets underlying securitizations should be very similar in their characteristics so that investors can easily understand what they are buying, which is not the case for SME loans. In addition, the securitization of green SME loans may come with further data problems, as investors seem to deem detailed information on the actual greenness of their investment (i.e., the underlying loans in the case of securitizations) necessary. The European Single Access Point is a step in this direction. But very often, SMEs are not willing or able to provide the comprehensive information necessary for capital market actors' decisions.

With regard to retrofit loans, they are much more similar within specific countries, but not across European countries, due to differing legal systems. And for banks, covered bonds already exist as a more commonly used and cheaper instrument for structured refinancing of residential mortgage loans. We therefore expect the inclusion of retrofit loans into the cover pools for covered bonds to be the much more likely option to be chosen by banks than the securitization of these loans.

Overall, both asset classes do not seem to be clear candidates for creating cross-border securitization markets as envisaged by the CMU and desired by policymakers.

Non-financial reporting rules for banks may provide incentives against securitizing green loans

In addition, green originate-to-sell securitization seems to be at odds with current regulations. This particularly applies to the non-financial reporting rules for banks, potentially constraining the supply of securitizations of green loans. Since the start of 2024, banks have been obliged to report the Green Asset Ratio (GAR) and the Banking Book Taxonomy Alignment Ratio (BTAR) as indicators of the greenness of their exposures. The GAR is a bank's Taxonomy-aligned economic activities and investments as a share of total assets (excluded are only exposures to sovereigns and central banks and the trading book portfolio). Those assets not classified as Taxonomy-aligned include both assets that are not aligned with the Taxonomy and assets for which it is not possible to assess their sustainability, e.g. because they are not covered by the Taxonomy or the NFRD/CSRD. As a consequence, many banks, in particular those with a focus on SME lending, cannot meaningfully calculate their GAR. To provide further information on the extent to which banks finance sustainable activities, the BTAR explicitly includes exposures to enterprises not covered by the NFRD/CSRD in the ratio's numerator.

They imply – at face value and abstracting from the conceptual and technical shortcomings – that banks indeed have an incentive to lend to green firms (and to some extent to transitional activities of brown firms). At the same time, and at least as long as banks do not have many Taxonomy-aligned assets to report, the GAR and BTAR indicators also imply that banks would want to keep as many green loans as possible on their balance sheets. Put differently, the indicators rather provide an incentive for banks to securitize their brown assets given that banks have large brown legacy portfolios (Degryse et al. 2022). If banks use the proceeds from selling off these brown assets from their balance sheets to fund new green projects, then the non-financial reporting rules for banks may indeed help greening banks' balance sheets and the economy. However, the brown assets will then be held in less regulated and less transparent parts of the financial system and may thus pose threats to financial stability if they become stranded. Alternatively, banks could continue lending to brown firms and projects, at least for a while, and securitize these loans so that they do not compromise their non-financial reporting. In this case, the non-financial reporting rules for banks would actually slow down the achievement of the political climate goals.

A REALISTIC VIEW OF THE EUROPEAN SECURITIZATION MARKETS AND THEIR POTENTIAL

Realistic view on market potential of European securitization markets is indispensable

Overall, it seems to be essential for policymakers and regulators to adopt a realistic view on the potential of European securitization markets and communicate accordingly. The biggest game changer would obviously be a regained safe-asset status for the AAA/Aaa-rated tranches of European securitizations, which they lost during the GFC. At the national level, government backstops may help, but at the EU level it is not obvious how this could happen, particularly within the short term. The European Investment Bank (EIB) has provided credit guarantees to banks for achieving an AAA/Aaa rating for the senior tranches of securitizations of SME loans, mostly at the national level. While these programs have certainly been helpful, they have not been able to scale up the market for SME loan securitizations.

Effects of unconventional central bank policies and green regulations need to be included in the calculus

Other ways to at least encourage more securitizations, for the green transition in particular, are included in the above discussion. Unconventional central bank policy measures coming to an end will support politics in reviving private-label originate-to-distribute securitizations because banks will have an incentive to rely more on market-based refinancing in the coming years.

Policymakers need to be clear in their communication about the CMU and the reviving of European securitization markets about the trade-offs between unconventional central bank policies and the development of capital markets. Otherwise, false expectations are created. Besides, if banks use originate-to-distribute securitizations when their capital positions are tight, then increased capital requirements, as may come with the new Basel IV rules, should actually contribute to more private-label securitizations in the EU. In addition, policymakers and regulators should closely watch the incentives that come with the new non-financial reporting indicators GAR and BTAR with regard to green vs. brown lending and securitizations of the respective loan portfolios. To achieve both goals – the greening of the economy with the help of bank lending and more capital market involvement in funding sustainable activities of firms by institutional investors – it may be necessary to include the asset pools for securitization in the originator's calculation of its non-financial reporting indicators. Given that the GAR only contains limited information and thus cannot be used as a steering or risk assessment tool (EBA 2022), it is in itself different from regulatory ratios such as capital ratios to which the sold-off assets do not count, and a differential treatment regarding the inclusion of securitized assets may be justified.

Politicians and policymakers need to encourage the real investments in the first place

Most importantly, if banks only use the originate-to-distribute securitization model when they want to lend more than they can based on their current refinancing and capital positions, politicians and policymakers can support such a situation by creating the economic environment that encourages private investments into the green transition. Politicians need to price carbon emissions, otherwise carbon-intensive technologies are too cheap, and to subsidize the development of new green technologies, otherwise they will not emerge quickly enough. Then, the financial sector and its various players will fund the commercialization and diffusion of green technologies. When loan demand increases, banks will need to free up balance sheet space, and securitization can play a more pronounced role in helping with funding the economy.

Securitization will likely not be the big boost towards more market-based funding

Securitization certainly has a role to play in better integrating banking and capital markets and in funding the green transition. However, establishing more market-based funding in Europe is a long-term effort and will involve more fundamental changes, such as changing households' perceptions on stock market participation. Improving the political, regulatory and economic framework for EU securitization markets may nevertheless prove helpful within the bigger endeavor. But in light of the above discussion, too big of a boost cannot be expected, at least not in the short run.

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