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Securitisation

Deloitte Norway

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1. Executive summary

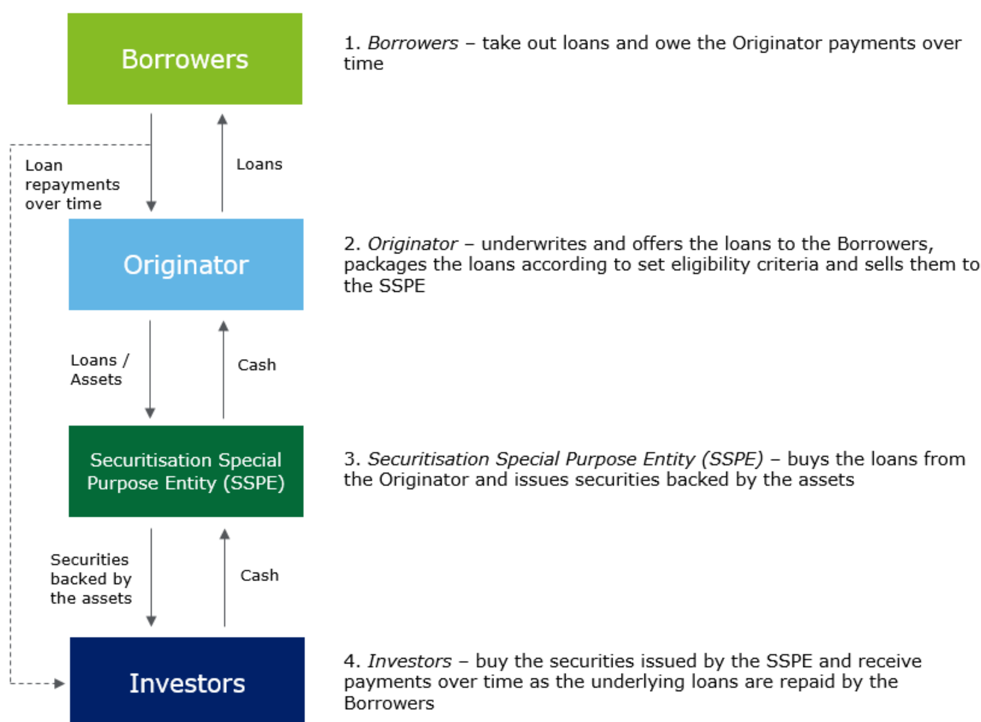
Securitisation can be used as an alternative funding source to provide financial institutions with additional tools to effectively navigate an uncertain post-pandemic future. Through the EU Securitisation Regulation, which was recently adopted into Norwegian law, there is a solid regulatory framework in place to support the economic recovery and promote financial stability through simple, transparent and standardised securitisation transactions. Although securitisation has been present among niche players in the Nordic region (1) for some 15 years, market activity in Norway has been limited. The new securitisation regulation presents a real opportunity for Norwegian financial institutions to diversify their funding, free up regulatory capital and reduce systemic risk, which would benefit not only individual market participants, but the economy as a whole.

2. Introduction to Securitisation

2.1. What is it?

Securitisation is a financing technique whereby banks and other credit institutions package loans such as residential mortgages, auto loans or consumer loans into securities and sell them to investors (asset-backed securities (ABS)). It allows banks to transfer the risk of these assets to other banks or long-term investors such as insurance companies and asset managers, thereby freeing up the capital that was set aside to cover the risk in those loans to create and sell new loans. (2)

There is a minimum of four parties in a securitisation transaction, illustrated by the flowchart below. In addition, several other parties are often involved, such as investment banks, rating agencies and legal advisers, but ultimately the structure revolves around the key four.



2.2. A brief history

Securitisation dates back to the late seventeenth and early eighteenth centuries when Great Britain restructured its sovereign debt by offloading it to its wealthiest mercantilist corporations, which in turn sold shares backed by those assets. It was, however, not until some 200 years later, when the US government-sponsored corporation Fannie Mae issued the first collateralised mortgage obligations in 1983, that the debt securitisation market really took off. (3)

By the early twenty-first century, securitisation had grown to a multi trillion-dollar market and the structure of the trades had become more and more complex. A rise in US subprime lending, i.e. loans offered at a higher interest rate than prime to individuals with poor credit ratings or other factors that suggest they are at increased risk of defaulting on their debt repayments (4), and increased housing speculation by investors, meant that a large portion of the loans being packaged into securitisations were of poor quality. When the US housing bubble eventually burst in 2006, property prices dropped sharply, making it more difficult for borrowers to refinance their loans and resulting in soaring mortgage delinquencies. Consequently, securities backed by US sub-prime mortgages held by international investors lost most of their value, triggering the 2007-2008 global financial crisis. (5)

Understandably, securitisation was to a large extent blamed for triggering the crisis, and the market significantly contracted for a few years. Nevertheless, although securitisation can be argued to have been the vehicle causing the crisis to expand across the globe, the practice itself does not need to be risky and can play an important role in diversifying funding in the economy, if structured soundly. As securitisation activity returned in the years following the crisis, focus was on transparent and simple structures backed by high quality assets, the backbone of what was to become the EU Securitisation Framework.

3. The EU Securitisation Framework

Following the financial crisis, European securitisation markets were subdued, however unlike the US this cannot be ascribed to poor performing securitisation assets but rather a combination of factors including stigma attached to securitisation and easy access to central bank liquidity. Tellingly, the worst performing EU securitisation products rated AAA saw only 0.1% defaults at the height of the crisis, and the riskier BBB-rated securities defaulted in only 0.2% of the cases, compared to 16% and 62% defaults respectively in the US. As a result, the losses incurred by investors in EU securitisations were a fraction of those incurred by investors in US transactions. (6)

3.1. STS framework

Various EU and international bodies launched initiatives to boost the market for securitisation and in 2015 the European Commission published a first draft for creating a European framework for simple and transparent securitisation. Over the next few years, the proposed framework was reviewed, discussed and redrafted and eventually resulted in the EU Securitisation Regulation which came into force in January 2019, superseding all other European regulations and directives concerning securitisation. It brought to an end the previously fragmented approach to regulating securitisation in the European Union and is a cornerstone of the EU's efforts to establish a capital markets union. (7)

Regulation (EU) 2017/2402 (the "Securitisation Regulation") together with Regulation (EU) 575/2013 (the "CRR Regulation") establish a general EU framework for securitisation and aims to revive the market through the creation of a specific framework to identify simple, transparent and standardised (STS) securitisations. (8) To qualify as a STS securitisation, the transaction must meet the following criteria (9):

- *Simple*: the ownership of the underlying exposures is transferred from the Originator to the SSPE and the securitised assets must be homogeneous, originated in the ordinary course of business and not be in default.
- *Transparent*: the Originator must provide a liability cash flow model and historical data on default and loss performance to investors, and there must be external verification of a data sample by an independent third party.
- *Standardised*: the Originator must retain on an ongoing basis at least 5% of the nominal value of the securitised exposures, interest rate and currency risk mitigation measures must be disclosed, the transaction must provide for early amortisation and actions to handle delinquency and/or default of debtors must be clearly documented.

Whilst there is always an element of risk in any investment decision, the STS framework attempts to make securitisation transactions easier to understand and the risk retention requirement aligns the interests of originators and investors, which should ensure a minimum level of quality of the asset pool being securitised.

3.2. Extended framework

The Covid-19 pandemic has had a dramatic effect on all aspects of our lives, and the economic decline is expected to be worse than that following the financial crisis in 2007-2008. To support a speedy financial recovery in the aftermath of the Covid-19 crisis, it is vital that banks are able to continue lending to the real economy to help businesses absorb the economic shock of the pandemic. Accordingly, in response to the pandemic the EU Securitisation Regulation has been amended to extend the STS framework to include securitisations of non-performing exposures (NPEs) and on-balance-sheet synthetic securitisations (10) in order to foster economic recovery by giving financial institutions more tools to maintain or enhance their lending capacity. If needed, the former can be used to manage NPEs as a result of an increased number of borrowers defaulting on their loan repayments due to the crisis, whilst the latter allows for risk to be removed from systemically important parts of the financial system and for financial lenders to strengthen their capital positions.

The amended regulation is in effect as of 6 April 2021 and includes specific wording relating to the STS criteria adopted for on-balance-sheet securitisations and NPE securitisations. (11) (12).

4. Securitisation in Norway

4.1. Background

Although securitisation has been present in the Nordic region for some 10-15 years, used primarily by niche players such as Bluestep (residential mortgages) (13), Santander Consumer Bank (SCB) (auto loans) (14) and Nordax Bank (personal loans) (15), the securitisation market in Norway has always been modest. This is largely due to the complexity of the rules, limited domestic knowledge and lack of beneficial treatment of securitisations under the Norwegian capital adequacy regime (16). Until 2016 Norwegian law allowed for securitisation, however there were only a few active issuers, most notably SCB which did regular issuances under their Bilkreditt securitisation programme between 2011 and 2016 (14). Then, on 1 January 2016 the existing Norwegian Financial Institutions Act was replaced by the Norwegian Act on Financial Undertakings and Financial Groups, which did not provide for securitisation, thereby making it practically impossible for financial institutions to securitise (16). As a result, issuance from the Bilkreditt programme stopped (14) and there has been no securitisation activity in Norway since.

4.2. *New regulation – new opportunities*

Five years later and this is all set to change as in March 2021 the Norwegian Parliament, Stortinget, approved the implementation of the EU Securitisation Framework into Norwegian law (17) and the new legislation is thought to come into effect in late 2021 / early 2022 (18). However, for a market that has never been very keen on securitisation in the first place, the question is if anyone, other than presumably SCB, will notice or even care about the possible opportunities this new legislation presents? Revealingly, when asked about it a Norwegian legal professional simply stated "no one is talking about it" (18), a sign perhaps that the response from the domestic market will be tepid at best.

Whilst securitisation can be argued to be complex and sometimes expensive, there are a number of benefits to be realised, not just for the originating entity but for the economy as a whole, including but not limited to (19):

- *Funding diversification:* securitisation allows Originators more flexibility in managing their risk exposure by diversifying their funding to reduce overreliance on one source;
- *Creates liquidity:* securitisation creates liquidity in the market by turning illiquid assets (individual loans) liquid by letting investors purchase shares in instruments that would normally be unavailable to them;
- *Capital relief and increased funding capacity*: the securitised pool of assets is sold to a SSPE and removed from the Originator's balance sheet, thereby reducing the amount of regulatory capital the Originator must hold to cover the risk of those assets. The freed-up capital can subsequently be used to underwrite additional loans, and;
- *Risk management*: the credit risk associated with the assets being securitised is transferred from the Originator and spread to a wider group of institutional investors, thereby reducing the risk in the banking system and promoting financial stability.

Despite these benefits, as Norwegian banks have good access to capital compared to many other European countries and covered bonds (20) backed by residential mortgages is their preferred funding tool, they may not be incentivised to securitise. Instead, the drivers of growth of securitisation in Norway may be financial institutions that do not have access to the covered bonds market, such as originators of other asset classes, including auto loans and consumer loans, which due to their standardised nature are well suited for securitisation. (21) Certainly, based on SCB's previous track record and statements from their financial statements, securitisation is likely to remain an important part of their funding strategy, and indications are that they are planning to revive their issuance programme in Norway as soon as the market allows (22).

5. The road ahead

Securitisation offers an alternative funding strategy which has come far since the initial transactions some 200 years back, and the market has adapted and learnt some valuable lessons along the way. The EU Securitisation Framework aims to further dispel the myths of obscure and complex structures understood by no-one by making STS securitisation more accessible to a wider group of originators, and more transparent and easier to understand for investors and the wider market.

Norwegian financial institutions enjoy a solid, well-functioning capital market, however faced with an uncertain future caused by the Covid-19 pandemic, they may be forced to challenge and re-evaluate previously established business practices in order to remain competitive in the years to come. The implementation of the EU Securitisation Regulation into Norwegian law facilitates this by giving originators more tools to effectively manage risk and improve liquidity in order to enhance their lending capacity to support the financial recovery post crisis. Whether Norway will adopt also the amended legislation allowing synthetic and NPE securitisations within the STS framework remains to be seen, but

either way the new securitisation regulation brings opportunities previously unavailable to Norwegian financial institutions and there are potentially exciting times ahead as the market responds to the change in regulatory landscape and the international securitisation investor community can once again access this attractive market.

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Deloitte has extensive experience of advising our European and Nordic clients in the securitisation space, including accounting and regulatory capital treatment and review of asset portfolios to comply with STS requirements. Please contact us to learn more.

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(20) The structure of covered bonds is similar to that of a securitisation, with the important difference that for covered bonds the asset pool remains on the originating entity's balance sheet, whereas in a true sale securitisation the asset pool is sold to the SSPE and thereby removed from the originating entity's balance sheet. (Covered Bond Definition (investopedia.com))
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