Position
on the proposed changes
in the regulatory framework for credit securitisations

Revision of the Basel Securitisation Framework,
Liquidity Coverage Ratio according to the Capital Requirements Regulation and
capital adequacy requirements for insurance companies under Solvency II

Preliminary remarks

The automobile financial service providers are an indispensable partner for motor vehicle manufacturers in the marketing of passenger and commercial vehicles. As part of their refinancing, the securitisations of customer receivables – the so-called Auto ABS – are an important instrument. Auto ABS are to be classified as highly liquid investments with high credit quality. They are secured both by the sold receivables of vehicle financing and the leasing of vehicles as well as by the vehicles themselves and thus have a comparable quality to German covered bonds (Pfandbriefe). Banks and insurance companies are among the largest and most important investors. In the context of current discussions to amend the regulatory framework for securitisations, it is therefore imperative that Auto ABS be given appropriate consideration. Otherwise, there is a danger of a serious deficit occurring in the refinancing of captive banks and leasing companies and a concomitant impairment of the sales of the German automotive industry. This would have serious negative repercussions for the real economy.

I. Revision of the Basel Securitisation Framework

On 19th December 2012, the Basel Committee on Banking Supervision (hereafter: "Basel Committee") initiated a consultation process on the reform of the securitisation framework. The framework forms the basis for future regulations of the European Capital Requirements Regulation. The planned revision, according to the current status, leads to a drastic increase in equity capital requirements for securitisation positions in banks. Banks must expect an approximately three- to ten-fold increase in capital requirements if they keep Auto ABS on their books. As a result, the placement of Auto ABS with banks would be almost impossible. Banks will therefore withdraw as investors (term securitisations, ABCPs) from the securitisation market, which would then be severely hampered in its ability to function
as a consequence. We estimate that the shortfall in demand for term securitisations following the withdrawal of bank investors will lie in the range of around 30%.

The Basel Committee has published the position statements from the banks that were submitted as part of the consultation process.¹ These statements reflect considerable concern about the proposals put forward.

From the perspective of the automobile industry, the following points of criticism are particularly significant:

• The calibration of the various approaches presented by the Basel Committee takes place in a completely undifferentiated manner and is based on empirical data for the US market as well as a standardised model true to the "one size fits all" principle.

• Numerous analyses show that the quality of European securitisations with a relation to the real economy, notably securitisations of the automobile sector, are diametrically different to those of the US subprime Residential Mortgage-Backed Securities (RMBS) or arbitrage-driven CDO products that have damaged the reputation of the entire securitisation market.

• The risk weights even for high-quality transactions such as Auto ABS will become so high that securitisation investments will only be profitable for bank investors with all other variables remaining constant if the risk premiums rise to a level that is higher than those of unsecured bonds. This makes such transactions uneconomical for originators.²

• Numerous banks as sponsors of ABCP programmes report that, as a result of the higher capital requirements for liquidity facilities in future, the conduit business will no longer be feasible for them in economic terms.

• The risk weights for securitisation positions often amount to many times (about a factor of 2 or 3 depending on the procedure) the risk weights for the assets underlying these securitisation positions prior to securitisation. This is not commensurate with the risk.

• The Basel Committee does not take into account that, since the outbreak of the crisis, the securitisation market has been characterised by extensive structural changes, which in many ways give securitisation as financial product a benchmark character, in particular: (1) a tightening of the regulatory framework (e.g. the rules on the risk retention of originator, cf. Article 122 CRD and §§ 18a and b KWG (German Banking Act)), (2)

¹ The comments are accessible at http://www.bis.org/publ/bcbs236/comments.htm
² Research analysts have calculated that, for a representative German Auto ABS transaction, the capital adequacy (equity backing) requirement of the AAA tranche would increase from today’s 0.56 % to 4.64 % (RRBA approach) or 7.83% (SSFA approach). For the A tranche, the backing increases from today’s 1.6% to 32.64% and 93.64%. In order for a bank investor to keep its RAROC constant in comparison with the present situation, the credit spread for the AAA tranche (today around 25-28 basis points) would have to increase to around 200 basis points (RRBA approach) or 350 basis points (SSFA approach). For the A tranche (today around 75 basis points) a rise to around 1,000 basis points (RRBA approach) or 3,000 basis points (SSFA approach) would be required (cf. Bank of America Merrill Lynch “Killing me softly, Basel?” from 28th February 2013). It is evident that the widening of the credit spreads directly entails an increase in the refinancing costs of this instrument for the originators, i.e. in this case the automobile manufacturers and their financing companies.
industry initiatives to increase transparency and standardisation (TSI, PCS), implementation of the ECB loan-level data requirements through the establishment of the European DataWarehouse, and (3) diverse tightening of rating criteria and the further development of the rating methodology by the agencies.

- Through the one-sided focus of the review of the capital adequacy (equity backing) requirements for securitisations, another regulatory discrimination occurs in comparison to other capital market products, especially the covered bonds, which in this form have an adverse effect on the risk-return profile, on the portfolio allocation of investors as a result and, in the medium term, possibly on the stability of the financial system as well.

An improvement of the proposals is urgently necessary on the one hand to enable banks to carry out an investment or sponsorship of securitisations structures in future as well and, on the other hand, so as not to restrict the refinancing the automobile industry through Auto ABS. In our view there is no doubt whatsoever that the special features of the European securitisation market and the outstanding qualitative status of the Auto ABS securitisation segment has not been given adequate consideration up to now in the design of the securitisation framework.

We strongly recommend departing from the blanket approach of equal treatment and considering the adoption of a differentiated treatment of the most important securitisation segments, to which Auto ABS clearly belong.

In this connection, we also point out that, following the non-implementation of Basel II in the USA, it must now also be feared that a different path than in Europe will also be taken in the USA in the context of Basel III and the securitisation framework. Owing to the much greater importance of capital market financing, and in particular of the securitisation market, in the USA, many market participants expect that everything will be done there to keep the securitisation market functioning. This could be achieved in the USA through a more differentiated and, in parts, more favourable calibration. **Owing to the importance that the Auto ABS segment has both in Europe and in the USA, substantial disadvantages over the American competition would have to be feared and reckoned with for European automobile groups in the sales financing of their vehicles.** This is especially true in the context that already today almost every second newly sold vehicle is either financed or leased and that financing and leasing have meanwhile grown into significant instruments of sales promotion.

It should be noted here that the investor base for ABS in the USA differs considerably from that in Europe: whereas in Europe it is primarily banks that make up ABS investors, in the USA it is the large institutional investors and financial intermediaries such as pension funds, which, however, are not subject to the insurance or bank regulation. Consequently, the proposals for the re-regulation of the securitisation regulations would have a much more serious impact on the European ABS market than on the ABS market in the USA.
II. Liquidity Coverage Ratio according to the Capital Requirements Regulation (CRR)

On 21st February 2013, the European Banking Authority (EBA) published a discussion paper with the aim of finding a definition of highly liquid assets that can be used for the calculation of the minimum liquidity ratio (Liquidity Coverage Ratio/LCR).

The LCR is part of the new Basel capital adequacy regulations and has its foundation in Article 404, Para. 2 and Article 481, Para. 2 of the CRR. The LCR aims to ensure that a bank maintains a reasonable stock of unencumbered, first-class liquid assets. It should be possible to convert these assets into cash in private markets with no or minimal loss so that a bank can meet its liquidity needs for a 30-calendar-day liquidity stress scenario. The LCR consists of two components: the value of the portfolio of highly liquid assets and the total net cash outflows. It is calculated by the ratio of these components relative to one another over a period of 30 days. The ratio must – gradually until 2019 – be the same, i.e. amount to 100%.

According to the current state of the discussion, securitisations will only be admitted for inclusion in the LCR to a very restrictive degree (formal limitation to the RMBS asset class, a share of maximally 15% of the liquidity buffer, supplementary requirements for the minimum rating).

In contrast, no distinctions are made on the part of the European Central Bank (ECB) as regards the asset classes in assessing the deposit eligibility of ABS securities, but it is only the quality of the securities that is evaluated. Asset-backed securities with a very good rating have been accepted as central bank-eligible for many years and allow the institutions to draw liquidity through participation in the tender procedures of the ECB.

The restrictions mentioned would lead to a de facto exclusion of the entire securitisation market in the calculation of the LCR – with the exception of prime RMBS. To comply with the LCR, banks would therefore no longer invest in Auto ABS and withdraw from the securitisation market.

For this reason, the German Automotive Industry Association (VDA) has presented its comments on the discussion paper of the EBA on 21st February this year.3 We strongly advocate an opening of the LCR for the high-quality Auto ABS segment.

III. Capital adequacy requirements for insurance companies under Solvency II

Within the framework of the proposed new capital rules for insurance companies according to the so-called Solvency II, the European Insurance and Occupational Pensions Authority (EIOPA) has carried out a quantitative impact study during the first quarter of this year. The basis for

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conducting the study was the discussion paper⁴ presented by EIOPA on 28th January, in which EIOPA proposed risk factors for different classes of bonds that will lead to a massive disadvantage for asset-backed securities and, in particular, Auto ABS.

It is envisaged that insurance companies set equity capital aside in future as a buffer against the risks of their capital investments. In this way, they are to be placed in a position to absorb the widening of credit spreads in the form of a credit shock through the maintenance of own financial resources. The amount of capital that is required to be held is determined according to risk factors to be calibrated on the basis of the rating and the maturity of the individual bonds.

The disadvantage for Auto ABS is particularly evident in comparison with other securities segments: the risk factor of a Triple-A-rated ABS bond with a term up to 5 years is, for example, 777 % higher in comparison with a Triple-A-rated corporate bond. The isolated capital adequacy requirement lies at 35 % with a term up to 5 years. In the case of junior ABS tranches, the difference compared to a similar-rated corporate bond with a term up to 5 years even amounts to 1,454 %. The isolated capital requirement is 80 % for a 5-year term. In comparison with German covered bonds (Pfandbriefe) with a term up to 5 years, the risk factor is 1,000 % higher.

Even more serious is the disadvantage compared to government bonds. Irrespective of their rating, EU government bonds are to receive a risk factor of 0 % and need therefore not be backed by equity capital. The same applies for the government bonds of other countries with a top rating.

The new capital adequacy requirements for capital investments will have a direct effect on the capital allocation of the insurance companies. The extreme differences in the equity requirements for certain types of bonds and the equity requirements for investments in Auto ABS, which must indeed be described as prohibitive, will lead to the disappearance of insurers from the segment as investors.

IV. Quality and importance of securitisations for automobile financial service providers

Auto ABS are subject to high quality standards and can demonstrate an impeccable performance history.

In 2012 Auto ABS accounted for 21 percent of the entire European securitisation market. With a volume of 24.7 billion euros, Auto ABS were among the most frequently issued class of asset.

Already today, the financial service companies belonging to the German automobile manufacturers cover a significant portion of their financing requirements through the securitisation of their customer receivables. 57 % of the total European volume is securitised

through German loan and leasing receivables. The Auto ABS issued in Europe during 2012 are split up as follows:

![Pie chart showing the distribution of Auto ABS issuances by brand.](image)

*Source: Standard & Poors*

In addition, Auto ABS enjoy a very high reputation among investors. Thanks to their low default rates and their high granularity, they are assessed as particularly low-risk investments and, thus, exceptionally valued by investors. Even during the finance crisis, Auto ABS have proved to be extremely crisis-resistant and have not caused investors to suffer any losses.

It is meanwhile generally recognised that some sectors of the securitisation market, such as subprime mortgage financing in the USA in particular, have developed very badly. The development in Europe, on the other hand, has been completely different. An analysis from Standard & Poor's, for example, reveals that between mid-2007 and mid-2011 European transactions showed a default rate of only 1.2 % whereas the losses of US transactions totalled 9.7 %. The default rate of German Auto ABS transactions during the same period was 0.0 %.

Banks, which are among the largest investors in the European securitisation market with a volume of 30 %, will fall away as investors as a result of the new capital requirements and the exclusion of Auto ABS from the LCR calculation. The proposals of EIOPA on capital adequacy requirements for ABS transactions within the framework of Solvency II serve to exacerbate the situation and, indeed, have an alarming dimension. **If the proposals become reality in this form, that vital segment of investors – the insurers – would also be lost.**

To make matters worse, the automobile financial service providers are themselves directly affected by the new capital requirements and the exclusion if they buy back their securitised receivables. Redemptions are used to obtain liquidity at the ECB. The repurchased securities are deposited by the automobile banks as collateral in a separate pledged account to participate in the tender procedure of the ECB. **However, an increase of own capital and the exclusion from their own LCR calculation makes the deposit unattractive for the automobile financial service providers. As a result, they are deprived of a further refinancing option.**
The eradication of the investor base and the increased difficulty of making deposits with the ECB will lead to a refinancing gap among the automobile banks and leasing companies. This has serious repercussions for the real economy.

V. Impact on the automotive sector

The automotive value-added chain

The refinancing of the automobile financial service providers plays an essential part in ensuring that the motor vehicle sales of the automobile manufacturers are guaranteed and that the automotive value-added chain is not breached.

The value-added chain of a motor vehicle begins with Research & Development. In procurement the activities of the automotive component suppliers and the integrated distribution logistics are in the forefront. Vehicle production is followed by sales. This is where the three milestones in the domain of car-related services take effect: credit and leasing, insurance and services, and mobility services. This is followed by after-sales, repair and maintenance.

Providers of automobile financial services (captive banks and leasing companies) stabilise the following sections of the automotive value-added chain in particular:

- **Sales**: market entry through an importer is supported by import financing and sales via a dealer network is supported by wholesale financing.
- **Financing & Leasing**: credit financing and the leasing of new and used vehicles to end customers via the point-of-sale or direct marketing.
- **Insurance & Services**: motor vehicle insurance cover, residual debt insurance, wheel and tyre service, guarantee insurance for end customers. Full-Service Leasing and fleet management for end customers and corporate customers.
- **Mobility Services**: various models of ownership or use (car on demand, car-sharing).
- **After-Sales, Repair, Maintenance:** for workshops, loyalty programmes can be offered that particularly support after-sales turnover (e.g. mobility packages). In addition, guarantee insurance contracts can be concluded.

*Risks for the real economy*

A restriction in the refinancing of automobile financial service providers through Auto ABS would result in captive banks no longer being able to carry out their financing along the value-added chain depicted. This would have considerable negative implications for the real economy. During 2012, the motor vehicle market in Germany recorded the following figures:

- The total sales in Germany amounted to approx. 3.4 million vehicles (German and non-German passenger and commercial vehicles). Altogether, 420,000 staff were employed at the German manufacturers.
- The sale of the motor vehicles was conducted through the manufacturers’ dealership networks, which comprise approx. 18,000 firms. The support provided to the dealer network through wholesale (dealer) financing amounted to 13.6 billion euros.
- 42% of the vehicles sold were supported by credit or leasing financing (penetration rate). The volume of receivables in this domain amounted to 30.8 billion euros.

The average refinancing through Auto ABS amounted to 9% during the same period. A corresponding refinancing gap for the automobile financial service providers would mean that adequate financing options could no longer be made available to the customers in future. This would ultimately lead to a decline in sales figures and therefore to a decline in economic production. In addition to private sales, small and medium-sized enterprises in the real economy would be particularly affected. In order to diversify their sources of financing and to increase their resilience against a scarcity of credit funds, these companies primarily finance or lease their fleets and car pools. This allows the companies to increase their scope for investment and thus create growth and jobs. However, without the funding instrument of Auto ABS, the financing, and in particular the leasing, of motor vehicles is no longer conceivable and feasible.

**VI. Conclusion**

To avert the risks for the German real economy, we consider it imperative to revise the proposed changes to the regulatory framework for securitisations and, in the process, to take the special importance of Auto ABS into due account. The aspired objective should be that refinancing through Auto ABS is not restricted by inappropriate increases in equity capital for bank investors and insurance companies and by the exclusion in the LCR calculation. These measures would have serious negative repercussions for the refinancing, and therefore the sales, of the German automobile industry.

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