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Generali Group Position Paper on Securitization

> **Key Points**
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> Generali Group views securitization as a valuable tool for European insurers, aiding capital efficiency and enabling investment in diverse assets, including those supporting the real economy. However, several factors underlie insurers' reluctance to invest in securitized assets:
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> **1.** The capital absorption under Solvency II, particularly for non-STS (Simple, Transparent, and Standardized) products, given the lower capital requirements of other asset classes providing similar yields.
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> **2.** The current excessive mandatory due diligence set-up and compliance burdens for institutional investors.
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> **3.** Lack of STS securitization in the market because of too restrictive requirements for obtaining the STS status.
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> **4.** Insufficient liquidity and a constrained secondary market.

Introduction: The Generali Group believes securitization (at least for some less speculative instruments/tranches) offers a valuable tool for European insurers to invest in a wider range of assets, helping the financing of the real economy, including energy transition and SMEs, and improving capital efficiency. However, the current regulatory environment and market conditions pose challenges for insurers, inhibiting their willingness to invest in securitized assets. This paper aims to provide an overview of the regulatory landscape and market development of securitization in the EU, identify the reasons behind insurers' reluctance to invest in these assets, and propose recommendations to EU policymakers to enhance the EU securitization framework.

Historical Development: While present in Europe for decades, the securitization market remains less developed compared to the U.S'. This is partly due to a more cautious regulatory approach following the 2008 financial crisis. As from 2016, within the context of Solvency II, securitized assets have emerged as a potential avenue for insurers to diversify their investment portfolios and optimize capital efficiency. However, the EU securitization market has faced challenges in achieving its full potential and investments remain an immaterial asset class for the average European insurer. To fix this issue, Solvency II has been subject to refinement and scrutiny[1], but even the introduction of STS (Simple, Transparent, and Standardized) securitizations in 2019 has not had a significant impact on insurers' investment behavior.

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[1] **2019** - Regulation (EU) 2018/1221 of 1 June 2018 amending Delegated Regulation (EU) 2015/35 as regards the calculation of regulatory capital requirements for securitizations and simple, transparent and standardized securitizations held by insurance and reinsurance undertakings.
2022 - Joint Committee Advice on the review of the securitization prudential framework

Current Challenges for Insurers: Several factors underlie insurers' reluctance to invest in securitized assets within the EU.

1] Capital charges

In 2019, the calculation of the dedicated SII capital requirements were revised (Regulation (EU) 2018/1221 - see footnote 1/pag.1), reflecting the introduction of STS securitizations. The stress factors were modified with the new classification in STS and non-STS, where exposures to STS securitizations receive favourable capital treatment if certain conditions are met (STS eligibility criteria). However, according to the 2022 Joint Committee Advice (see footnote 1/pag.1), 75% of insurers' investments are in non-STS securitization with higher capital charge (see also point [3]).

The capital absorption under Solvency II, particularly for non-STS products, continues to hinder investments in securitizations, given the lower capital requirements of other asset classes providing similar yields.[2]

SII Standard Formula capital charge for securitization, results as a mixture of Spread and Default risk modules. While this approach may be correct in principle, it should be noted that these instruments (typically of short-term duration) are usually managed by insurance companies on a *buy-and-hold* basis and are therefore not subject to market volatility fluctuations. As a result, if companies manage their ALM (Asset-Liability Management) properly, spread risk should be minimized. In addition, historical data shows a negligible amount of defaults over time for senior/highly rated securitizations, and this should be reflected in appropriate capital absorption (Default risk).

►*A review of securitization capital charges under Solvency II is warranted, with potential for reductions, considering that insurance companies' typical buy-and-hold strategy for these instruments minimizes market volatility exposure, and proper ALM (Asset-Liability Management) should further mitigate spread risk. Moreover, default risk merits a tailored treatment informed by historical data attesting to its infrequent occurrence over time.*

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[2] In some cases, such capital absorption regime has even been counterintuitively more punitive than the one applicable to comparable whole loan unrated exposure e.g., selectively, in case of **Whole mortgage loan pools** vs **Residential mortgage-backed securities** (RMBS) tranches or **Leveraged loan pools** vs **Collateralized Loan Obbligations** (CLO) tranches.

2] Due-diligence requirements for institutional investors[3]

Prior to holding a securitization position, an institutional investor should carry out an onerous due-diligence assessment which enables it to assess the risks involved. Furthermore, an institutional investor holding a securitization position, should monitor ex-ante and on-going the performance of the securitization position, regularly perform stress tests on the cash-flow and solvency/liquidity of the sponsor, repricing and risk monitoring valuations, etc.

In Italy, IVASS added further details and responsibilities in 2021[4].

►*The current mandatory due diligence set-up and need for intense internal controls appear from several points of view disproportionate and excessive and should be simplified. This might incentivize the insurance industry to approach the asset class with a higher degree of flexibility, putting them in a better position to exploit phases in which the embedded structured premium justifies the attractiveness of securitized products versus more traditional asset classes. This might in turn, as a consequence and all things being equal, also implicitly benefit the overall liquidity of the asset class.*

3] Lack of STS securitization and additional obligation when purchasing STS products

As mentioned in point [1], non-STS securitizations constitute the vast majority of insurance companies' portfolios.

This is mainly attributed to two factors: the availability of non-STS paper compared to STS in the markets as well as to the additional obligations (re)insurers need to address when purchasing STS products (due diligence, reporting).

Obtaining STS status for a securitization transaction involves meeting strict eligibility criteria, which can be challenging for issuers. These criteria typically include requirements related to the simplicity, transparency, and standardization of the securitized assets, as well as the structure and governance of the transaction.

►*By relaxing certain requirements, regulators could make it easier for issuers to obtain STS status for their securitization transactions, thereby incentivizing the development of the securitization market*.

3 Regulation EU 2017/2402
4 IVASS Letter to the market

4] Liquidity constraints

Unlike government bonds or actively traded corporate bonds, securitization products may have a limited secondary market. This lack of liquidity acts as a deterrent, dampening insurers' interest for allocating substantial investments to securitized assets.

►*By easing regulatory constraints and compliance burdens, policymakers can incentivize exchanging in the securitization market. Consequently, a broader spectrum of market participants would be encouraged to engage in securitization, fostering a more robust and dynamic marketplace. This, in turn, would stimulate increased activity and liquidity, thereby enhancing market efficiency and attractiveness for insurers.*