Setting the standard
for securitisation

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Dear Sirs

**EIOPA/13/163: Discussion Paper on Standard Formula Design and Calibration for Certain Long-Term Investments**

Prime Collateralised Securities would like to thank EIOPA for the opportunity it has provided to respond to its “Discussion Paper on Standard Formula Design and Calibration for Certain Long-Term Investments” dated 8th April 2013 (the “Paper”).

Prime Collateralised Securities (“PCS”) is an independent, not for profit initiative set up to reinforce asset-backed securities as sustainable investment and funding tools for both investors and originators with the aim to maintain high standards of quality, transparency, simplicity and liquidity for ABS and thus improve market resilience in Europe and promote real growth.

Considering PCS’ remit, we have only responded to those parts of the Paper dealing with issues pertinent to securitisations.

## EXECUTIVE SUMMARY

The core of this submission is that:

- New data and information enables us to identify the characteristics of high quality securitisations (which include SME loan securitisations) and distinguish them from others;

- This new data and information, in turn, enables us to draw the lessons from this crisis regarding securitisation;

- Drawing the lessons of this crisis is not just an issue of technical accuracy but a fundamental economic one because of the impact on the funding of SME’s in Europe;

- Drawing the lessons of this crisis does not require EIOPA to modify its fundamental approach to the capital weighting of securitisations or other asset classes but simply to apply that approach in a technically accurate manner;

- This will enable a prudent yet reasonable calibration of high quality securitisations including SME loan securitisations, to emerge and be consistent with the regulatory changes that have already occurred to prevent the recurrence of some of the dangerous practices of the past.

**BACKGROUND**

Bearing in mind our mission, the future of SME loan securitisation in Europe and an appropriate regulatory approach is of central importance to PCS. The vital contribution to growth and economic prosperity made by the SME sector in Europe is well known and needs no rehearsing[1]. For at least the next five years, the funding of this sector will need to take place within an environment of severe bank deleveraging. In a recent white paper published by PCS, we very conservatively estimate the funding gap in Europe resulting from this deleveraging to be at least €4 trillion. [2] It is generally acknowledged that a substantial part of the funds needed to bridge this gap will need to come from the capital markets. In the same paper though, PCS analyses some of the hurdles faced by borrowers seeking to access the capital markets to replace lost or missing bank funding. Our conclusions are that, of all the capital market financing channels available to SMEs in the short to medium term, securitisation is the only realistic option capable of scaling up sufficiently swiftly to avoid a prolonged funding drought for European small businesses.

Before the crisis of 2007-2008, insurance companies represented a small part of the investors in European securitisations by volume. However, bank investors represented around 50%. Bearing in mind the nature of the funding contraction, if the securitisation market recovers, one should expect the volumes purchased by banks to come down: since the funding gap is being created principally by banks shedding assets, one cannot hope for banks to take the assets back in securitised form. (This does not mean that there will be no bank investors in SME loan securitisations, as some re-allocation between banking institutions can be healthy for risk diversification. But from a systemic point of view, overall bank involvement is likely to shrink).

Therefore, if robust and high quality securitisation is to fulfill its potential to bridge the funding gap that faces the European economy, in the absence of any new and yet to be identified investor class, one will need to see investment by the insurance sector grow. However, in a recent survey

[1] A 2011 report funded by the European Commission found that, in Europe, SMEs account for 58% of GDP and 67% of non-finance employment. Between 2002 and 2010, they also provided 85% of all new jobs in the EU. See “Do SMEs create more and better jobs”, EIM, J. de Kok and others, November 2011 (http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance- review/files/supporting-documents/2012/do-smes-create-more-and-better-jobs_en.pdf)

[2] “Europe in transition – Bridging the funding gap”, http://pcsmarket.org/wp-content/uploads/2013/03/Europe-in-Transition-Bridging-the-Funding-Gap1.pdf

conducted by the Association for Financial Markets in Europe ("AFME"), insurance company respondents indicated that the proposed Solvency II rules would either stop (33%) or dramatically reduce (67%) their willingness to allocate funds to the securitisation sector.[3]

Keeping in mind the impact on the European economy of bank deleveraging, the necessary role to be played by SME loan securitisation in mitigating this impact[4] but also the foreseeable outcome of the current Solvency II capital requirement proposals, the outcome of this consultation is critical to the future of the European economy.

PCS is grateful to the European Commission for its acute understanding of these matters and its resultant request to EIOPA in its letter of 26.9.2012 to revisit the relevant capital requirement proposals. PCS is also aware of the importance EIOPA assigns to this task and is grateful for the opportunity to contribute to this debate.

PCS also wishes to make clear that it does not consider the importance of SME (and other) securitisation for the growth prospects of the European economy to be a reason to ignore or even downplay appropriate prudential considerations. PCS is fully aware that certain securitisations played a very damaging role in the crisis and ensuring that insurance companies have sufficient capital to meet stressed conditions must be paramount in the architecture of Solvency II. Our contention, set out in this response to the Paper, is that the current proposals do not reflect an objective and prudent analysis of the risks when high quality securitisations are considered. We further contend that it is possible to design simple and robust rules to distinguish high quality securitisations (including SME loan securitisations) from other types of securitisation. These simple rules can easily be incorporated in a solid regulatory framework without creating difficult to manage complexity.

## METHODOLOGICAL CONCERNS

We are concerned that, in the Paper, EIOPA appears to suggest that the sole manner in which it can respond to the Commission's request to look into the proposed capital requirements associated with SME loan securitisations, is to

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[3] The survey also found that 85% of those who indicated that Solvency II would result in a reallocation of funds indicated that at least half would be reallocated away from securitisation and 22% of respondents said that if the proposed capital charges were enacted, they would never return. See www.afme.eu

[4] Commissioner Barnier stated:"nous devons aussi nous demander **comment donner un nouveau souffle au marché de la titrisation** de manière à améliorer la transformation d'échéances par le système financier." [Commission's bold]. see http://europa.eu/rapid/press-release_SPEECH-13-150_fr.htm?locale=en

Benoît Coeuré, member of the Executive Board of the ECB stated: "Finally, in a broader context, there is a need for structural market innovation to improve SME financing. Such an innovation would create a market for asset-backed securities, where the underlying assets are loans to SMEs. It could also support the revival of this market segment by increasing its transparency and therefore investor confidence. Having access to a diversified source of finance for SMEs will enhance their resilience through the business cycle." see http://www.ecb.europa.eu/press/key/date/2013/html/sp130411.en.html.

compare SME loan securitisations with “all other securitisations”. Flowing from this approach it would further appear that a revision of the current proposals would only be warranted, in EIOPA’s view, if it could be determined that SME securitisations displayed unique features, not present in any other type of securitisation.

We wish to put forward the proposition that there are in fact three reasons why the proposed calibration of capital requirements for SME loan securitisations could be unnecessarily onerous:

(a) as envisaged by the Paper, SME loan securitisations could have superior characteristics that distinguish them from all other types of securitisations; or

(b) the proposed capital requirements for all securitisations are erroneous and SME loan securitisations are caught by this global error; or

(c) SME loan securitisations are not unique products but belong to a well defined sub-category of high quality securitisations and the proposed calibration for this sub-category is unreasonably onerous.

PCS acknowledges the substantial amount of work EIOPA did in crafting the current Solvency II proposals and does not contend that the second possibility is correct. EIOPA has not, in our view, made a general error in the calibration of all securitisations.

We do believe though that the third possibility is correct and that, to fulfill the task set to it by the Commission, EIOPA should not look for allegedly unique characteristics of SME loan securitisations but rather for the unique characteristics of a clearly identifiable sub-set of securitisations, to which SME loan securitisations belong, as argued below. This subset we identify as “high quality securitisations”.

**CURRENT SITUATION**

PCS agrees that the correct prudential approach to calibrating capital requirements for any given asset type is to identify that asset type by its fundamental characteristics and then conservatively calibrate requirements off the riskiest elements of the set. It seems to us that EIOPA’s original work in Solvency II, when dealing with the calibration of “securitisation”, followed this approach. This resulted in the calibration of “securitisation” based on the catastrophic performance (creditwise and in price volatility terms) of US sub-prime RMBS and certain other disastrous securitisation products such as CDO-squared and CDO-cubed.

However, today – in 2013 and five years after the onset of the crisis – two separate but connected developments mean that this approach is no longer, in our view, correct, appropriate or reasonable. In particular, one can no longer consider a generic securitisation asset type and two different types of securitisations should be distinguished.

First, there is considerably more data and analysis as to how different types of securitisation behave under circumstances of substantial stress. It is now clear and uncontroversial that the breakdown between securitisations that performed robustly during the crisis and those that suffered credit defaults or near default is not random but represents differences in key and well understood characteristics.

Secondly, substantial regulatory action has been taken or is in the process of being taken in Europe that prohibits or makes near-impossible the re-appearance of many of the elements that created fragility and volatility for certain types of securitisations.

Not to take these two developments into account in calibrating high quality securitisations, which happen to include SME loan securitisations, is to ignore the lessons learnt from the crisis and results in calibrations that do not reflect reality. Considering the serious consequences such over-conservative calibration will have on the European economy and the funding of SMEs, PCS strongly urges EIOPA to take into account these two factors when looking at the calibration of high quality securitisations including SME loan securitisation.

## HIGH QUALITY SECURISATIONS AND THE LESSONS OF THE CRISIS

The crisis, as it pertains to securitisation, started in the 3rd quarter of 2007 with the issues relating to US sub-prime mortgage backed securities. As we now stand in the second quarter of 2013, we have the benefit of 22 quarters of data and information. In addition, the United States and Europe have experienced severe economic stress and market disruption during this time, including in certain cases (eg Spain and Greece) levels of GDP decline and unemployment greater than those suffered by the United States in the early nineteen thirties. Data and information on the performance of asset-backed securities since 2007 is therefore not only extensive but also highly relevant in working out capital requirements for various types of investors, including insurance companies.

During this time a number of securitisation classes performed extremely poorly, whilst others performed extremely well. At the outset of the crisis it was probably difficult to discern any pattern in these distinct outcomes. Also, it was not clear whether the better performance of some securitisations was merely the issue of time (in other words, they too would run into difficulties later on in the cycle), a purely random effect or indicative of more fundamental differences between securitisation types.

Time has allowed firmer lessons to be drawn from these differing outcomes and has led to a fairly general recognition that there are such things as "high quality securitisations" [5]and that SME loan securitisations, in which insurance companies may invest, are part of that sub-category.

[5] For example, in a recent report, IOSCO stated that: "Securitisation, when functioning properly, is a valuable financing technique contributing to economic growth and an efficient means of diversifying risk". See "Global Developments in Securitisation Regulation", IOSCO, November 2012 (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf).

PCS wishes to draw attention to the fact that all securisation types that ran into difficulties contained one of four distinct elements (or, in some cases, more than one of those elements). Conversely, senior tranches of securitisations that did not contain any of these four elements (including European SME loan securitisations) performed very well, even when their underlying assets suffered high financial stresses.

*Four elements*

The four elements that led to difficulties in securitisations since 2007 are not, in the view of PCS, particularly controversial.

(i) Originate to distribute: many securitisations whose underlying assets were originated by financial institutions that ran an "originate to distribute" model performed badly. This has now been recognised as the consequence of the dramatic decline in underwriting criteria that can be generated by this model. Such declines resulted from the replacement by some financial institutions of a long term funding credit analysis by a short term VaR analysis. This does not mean that all securitisations produced under an "originate to distribute" model failed or are vulnerable to failure. Nor does it seek to imply that a collapse of underwriting criteria is the inevitable consequence of any "originate to distribute" model. It is perfectly possible to devise internal rules or regulatory schemes that can prevent such a collapse within the context of an "originate to distribute" model.

    However, one of the lessons of the crisis is that securitisations produced under an "originate to distribute" model are, all other things being equal, vulnerable.

(ii) Leverage: many securitisations containing high levels of leverage failed (CDOs of ABS, CDO squared, CPDOs, etc…). Leverage in this context means the creation through credit tranching of allegedly higher credit quality obligations through the pooling of many lower credit quality obligations, themselves the product of credit tranching.

    Leverage implies that very small changes in the credit performance of the underlying assets have substantial impacts on the credit performance of the securitisation. As such, these securitisations relied on a purported degree of accuracy in the measurement of the credit risk (including issues of correlation) that proved highly illusory. Put differently, highly leveraged securitisations are very vulnerable to model risk and the CRAs, as well as the market, placed unwarranted faith in the capacity of models based on limited data sets to gauge credit outcomes.

(iii) Embedded maturity transformations: securitisations are, in the great majority, "pass throughs". The obligation to pay the holders of the securitisation bonds only arises when the debtors in respect of the underlying assets pay interest and/or principal. As such, they do not rely on a capital market refinancing to meet their obligations. A limited sub-set of securitisations did have embedded maturity transformations: structured investment vehicles and, to a substantial extent, commercial mortgage backed securities (CMBS).

Securitisations relying on refinancing within a narrow window of time are vulnerable to market liquidity risks that are extremely difficult to model – if such modeling is even theoretically possible. As such they present specific and very difficult to quantify credit risks. They also did very badly during the crisis.[6]

(iv) Transparency: During the crisis it became clear that many investors did not have at their disposal sufficient information on the credit risks of their asset-backed holdings to perform a reasonable assessment. This led to massive and uncontrolled disposals (or attempted disposals) of these poorly understood holdings generating substantial mark-to-market losses for financial institutions.

Lack of transparency can come either in the form of an absence of necessary data or in the form of complexity. When related to complexity, the data is available but either its quantity or the underlying complexity of the securitisation structure is such that even a sophisticated investor cannot derive a reasonable assessment of the risks of the instrument.

Usually, during the crisis, complexity has been associated with leverage (e.g. CDO squared products based on CDO's of ABS).

Securitisations (a) where the originator retains a meaningful share of the risk ("skin in the game"), (b) which are unlevered, (c) which have "pass-through" structures and (d) where appropriate information is provided to investors, for PCS define, "high quality securitisation". The assessment of quality is completed when combined with some credit component.

Securitisations that met the criteria for "high quality", because of their simplicity and transparency, have proved during the crisis to be resilient and considerably less vulnerable to model risk. These are also the qualities that are encapsulated in the criteria used to determine whether a securitisation is eligible for a PCS label. (This fact is relevant for the table set out below which is based on PCS eligibility).

We note that these elements were not derived from a pure quantitative analysis but from a qualitative analysis involving an actual examination of the securitisations that failed and those that did not. However, this qualitative analysis can be quantitatively verified. We also believe that, in view of the complexity of the events that preceded, precipitated and followed the crisis, a

[6] Asset backed commercial paper conduits also embed maturity transformations but the risks of these are usually taken out by bank liquidity lines. In the context of capital adequacy rules, the key issue is the treatment of these lines. Issues regarding ABCP conduits fall outside the remit of PCS and are therefore not broached in our response.

"purely quantitative" approach, which sought only to interrogate the data, cannot yield any meaningful results. This is not just for practical but also for solid theoretical reasons. Accordingly, any quantitative approach must be overlaid with a qualitative framework, if only to be able to organise the available data in a meaningful nomenclature. What PCS is setting out in this response is such a qualitative framework, crafted from an examination of the ways in which the securitisations that failed did so.

**SME LOAN SECURITISATIONS AND REGULATORY CHANGES**

In Europe, the "originate to distribute" model (as understood in the United States) was never applied (with the possible exception of Northern Rock in the United Kingdom). With the new regulatory regime designed to maintain "skin in the game"[7], this feature can no longer realistically be introduced in European securitisations. In addition, any revision of Solvency II should mirror the provisions of CRD4 in making it a condition of any favourable capital treatment that the "skin in the game" rules be complied with.

SME loan securitisations were never "leveraged" in the meaning given to that expression in this paper. Again, PCS would be in favour of any provision of Solvency II that made favourable capital requirement treatment dependent on no leveraged re-tranching.

SME loan securitisations never embedded maturity transformation but were, like traditional residential mortgage backed securities or asset backed securities, "pass throughs".

Finally, in the view of PCS, the transparency issue is in the process of becoming of mainly historical interest. Market conventions and regulatory initiatives, such as the loan-by-loan data requirements of central banks for repo collateral purposes, as well as the disappearance of complex products, are resolving this issue. Still it would be advisable that regulatory rules encompass this aspect, to make the improvement permanent.

**SME LOAN SECURITISATION AS A TYPE OF "HIGH QUALITY SECURITISATION"**

Historically, European SME loan securitisations were part of those types of securitisations that can be defined as "high quality securitisations" based on the absence of any of the four elements that generate fragile securitisation structures. Their performance during this crisis testifies to this fact (see table below). Continued inclusion of future SME loan securitisations within that category should be enforced by simple rules in the Solvency II framework.

As a sub-category of high quality securitisations the calibration of SME loan securitisations should be calculated using the data that is relevant to this

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[7] Originally, Article 122a of the Banking Consolidation Directive - Directive 2006/48/EC (http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF (as amended))

asset class and not to the no-longer accurate or relevant generic designation of “securitisation”.

In fulfilling the Commission’s request and designing a capital requirement regime for SME loan securitisations that is both prudent and anchored in solid data and analysis, we invite EIOPA not to seek to differentiate SME loan securitisations per se from all other securitisations but (i) to recognize the now almost universally acknowledged distinction between “high quality securitisation” and other securitisation[8], (ii) recognize that SME loan securitisations belong to the former and (iii) use the historical data (for both credit performance and secondary market price volatility) to adjust the proposed Solvency II rules to a more realistic basis.

In this respect, we therefore fully agree with EIOPA’s statement in the Paper (in paragraphs 131 and132) that “it is not a priori clear why a SME loan securitisation with a certain rating should be more or less risky than a securitisation of other assets with the same rating.” But PCS believes that the logical consequence of the suggested approach and of the lessons of the crisis is not to retain the existing proposals. On the contrary, it is to reconsider the proposals for all securitisations that (like SME loan securitisations) fall in the extremely well performing category of “high quality securitisations”. Only by doing so will it be possible to produce a conservative, prudent, fair and level playing field for capital in the insurance sector.

**HISTORICAL DATA**

PCS is aware that a number of market participants and trade bodies have provided EIOPA with a substantial amount of data as to the credit performance and market price volatility of high quality securitisations. PCS believes that an objective analysis of these data does not support in any way the very large differences in proposed capital requirements between such securitisations and other asset classes, such as covered bonds and corporate bonds. Nor does it support the proposed calibrations.

To possibly complement that data already at the disposal of EIOPA, the cumulative default data for what PCS would define as high quality securitisations on the one hand and other securitisations on the other hand is provided below:

[8] When asked a question on the subject, Mario Draghi, President of the EBC had the following to say: “Regarding the ABS, you are absolutely right, ABS have a very bad name, but one should say that there were very different kinds of ABSs. One was the so-called plain vanilla ABS box. You open the box, and you know exactly what is inside. So, if you for example put some mortgages there, it would be like a covered bond. A different thing was the squared ABS, etc., that are infamously known to have been one of the causes of disruption in the financial markets over the last few years.” See http://www.ecb.europa.eu/press/pressconf/2013/html/is130502.en.html

## Default Rates: Mid-2007 To End-2012

| | Original Issuance (EUR billion) | Default Rate (%) |
|---|---|---|
| **Europe** | | |
| **Total PCS eligible asset classes** | **959.9** | **0.10** |
| Credit Cards | 33.2 | 0.00 |
| RMBS | 755.7 | 0.08 |
| Other consumer ABS | 68.0 | 0.13 |
| SMEs | 103.0 | 0.23 |
| *Only senior tranches to be PCS labelled, the default rate for which is zero, like Covered Bonds* | | |
| | | |
| **Total Non-PCS eligible asset classes** | **734.2** | **5.07** |
| Leveraged loan CLOs | 71.3 | 0.10 |
| Other ABS | 71.0 | 0.16 |
| Corporate Securitisations | 67.7 | 0.33 |
| Synthetic Corporate CDOs | 254.3 | 2.47 |
| CMBS | 163.2 | 8.67 |
| Other CDOs | 77.8 | 6.33 |
| CDOs of ABS | 28.9 | 39.64 |
| | | |
| **Total European securitisation issuances** | **1,694.1** | **2.25** |
| **Covered Bonds** | **1,085.0** | **0.00** |
| **Total European issuances** | **2,779.0** | **1.37** |
| | | |
| **Select US asset classes** | | |
| Credit cards | 295.4 | 0.04 |
| Autos | 215.1 | 0.04 |
| Student loans | 266.8 | 0.28 |
| RMBS | 3,254.9 | 18.79 |

Source: Standard & Poor's

Please note that the default rates for the senior, highly rated tranches (the only ones eligible for a PCS label and which include the senior tranches of European SME loan securitisations), notwithstanding five years of the worse economic crisis since the Second World War remain zero. Yet, under the current proposals, investing in such a securitisation with a five year maturity would require capital equal to 35% of the face value of the investment.

Calibrating this asset class against the results of US RMBS, or other non-high quality securitisations such as the leveraged CDO's of ABS, could only be justifiable if it were not possible to design simple rules to differentiate, in an insurance company's holdings, "high quality securitisation" from others. As we have seen, this is not the case.

## ADDITIONAL RELEVANT FACTS

Pricing Data

PCS understands that market participants have provided pricing information regarding the comparative volatility in the historical secondary market prices of various types of assets including securitisations, covered bonds and sovereign bonds. We understand that this information, in respect of high quality securitisations such as European RMBS, demonstrates that securitisations have shown more stability in pricing than some other asset classes whose capital requirements are fractions of those currently proposed for securitisations.

PCS would like to draw EIOPA's attention to the fact that there are good grounds to believe that even those historical volatility numbers overstate the likely future price volatility of high quality securitisations. This is because these numbers were generated in an environment where:

- the very different credit behavior of high quality securitisations versus products such as US sub-prime was not established or understood as it is today. This resulted in a contagion effect that is not likely to repeat itself as the lessons of the past are incorporated in investor behavior.

- the situation in the early years of the crisis was marked by a degree of lack of transparency or perceived lack of transparency that encouraged hasty disposals by some investors of all their securitisation holdings, unable as they were to accurately assess the risk of any given bond. Initiatives such as the European Data Warehouse and the collateral rules of European central banks have resulted in a substantially more transparent market. Such a market is much less likely to turn to "panic" selling.

PCS is not suggesting that EIOPA disregard the pricing data that it has been provided with but merely that these additional facts are reasons to treat this data with due caution as it is likely to have been generated by extreme developments.

Data availability

PCS is aware that a number of regulators have queried whether the data to compare high quality securitisations with other types is available and how complex a task it would be to separate data relating to one set from data relating to the other.

PCS wishes however to draw EIOPA's attention to the fact that within geographical and asset class combinations, high quality securitisations and other securitisations are not mixed up. Therefore there is no requirement for a time consuming process of extracting the data relevant to the former from the data relevant to the latter. Basically, in every market, the vast bulk (and, in fact, often the totality) of securitisation transactions migrated to the format that was most efficient for the originator whilst at the same time being acceptable to investors. In other words, for any geographical/asset class combination almost all the data refers to the prevailing type of structure: either high quality securitisation or other securitisation.

As a result, it is a fairly simple task to test the proposition that high quality securitisations performed very well and others did not by using the data already available to EIOPA and requiring almost no additional work. It requires only to allocate geography/asset class combinations to the appropriate category. For example, all CDO's of ABS were leveraged. This was in their very definition. Similarly, no European credit card transactions from banks were done with no "skin in the game". A fairly swift combing through each geography/asset class combination can be done to ensure no "outliers" are accidentally caught in the wrong category.

**CONCLUSION**

PCS believes that the request of the European Commission does not require EIOPA to modify the fundamentals of its approach to the capital weighting of securitisations or other asset classes. However, when considering the new data that has become available and the lessons to be drawn from this crisis regarding the distinguishing characteristics of high quality securitisations and when further considering the regulatory changes that have already occurred to prevent the recurrence of some of the dangerous practices of the past, PCS believes that EIOPA should apply its existing approach but taking these new developments into account. Only then will an appropriate, prudent yet reasonable calibration of high quality securitisations including SME loan securitisations emerge.

## ANSWERS TO SPECIFIC EIOPA QUESTIONS

Q26: What is the volume of investments by insurers in these securitisations?

A26: PCS is not entirely sure why EIOPA is seeking this information to calibrate capital requirements for SME loan securitisations. However, if the question is posed to ascertain the impact of any proposed change to the current Solvency II proposals, PCS has extremely strong reservations regarding any proposition that the volume of current insurer investors in the few outstanding SME loan securitisation is a guide to the importance to the European economy of the final Solvency II outcome on this subject.

First, insurers who invest in securitisations have already, to a large extent, factored in their buying decisions the proposals on the table. Therefore, any process which sought to show the limited impact of changing the present proposals based on the small size of current insurer holdings of SME loan securitisations (or, for that matter, all high quality securitisations) would be entirely circular. The present proposals are a key reason for that small size.

Secondly, as our response has sought to indicate, an appropriate yet prudent calibration for high quality loan securitisation (including SME loan securitisations) is the best hope to see the European capital markets begin to fill in the €4 trillion funding gap which bank deleveraging will cause. Therefore, consistent with good prudential rules, we should wish to see a major increase in the insurer holdings of SME loan securitisation. The past is therefore not relevant to the desired future.

In other words, PCS suspects – although it does not possess strong data on the topic – that insurance holdings of SME loan securitisation today is low both as a percentage of the whole and in actual Euro numbers. What is hoped for by many in the industry, in the policy making community and by PCS, is that in the future, these holdings will rise substantially. To conclude that the main impediment to such a rise, namely the current Solvency II proposals, needs no correction because the current level is so small would be a mistake with potentially very damaging consequences to the European economy.

Q29: What are the characteristics of the securitisations considered with respect to their financial structure (tranching, credit enhancements etc.)?

A29: There are many characteristics to a securitisation of SME loans. It is not clear to us what characteristics EIOPA feels are relevant to a capital calibration under Solvency II.

However, as PCS has set out in its general comments, the key characteristics that define high quality securitisations are all present in SME loan securitisation. To the extent that it is theoretically possible to construct an SME loan securitisation with one of these characteristics missing (skin in the game, no leverage, pass-through structure and appropriate disclosure) it would be a simple matter to add these in the definition of those securitisations that could benefit from a lower capital charge.

Q34: How knowledgeable are investors about the securitisations considered (experience, internal capacities for risk assessment vs. reliance on ratings, etc.)?

A34: PCS is not clear about what EIOPA is seeking to determine with this question, in the context of capital requirements. The issue of the capacity of any investor, including an insurer, to properly assess the risks contained in its investment portfolio is, of course, very important. But it is also a matter for other parts of the legal and regulatory machinery and not the capital regulations. We would expect investor appropriateness rules to cover these matters, whilst the capital requirement rules deal with the risk to an insurer who is holding a particular investment.

PCS is not unaware that the lack of transparency and complexity that existed pre-2007 in the securitisation market did lead to some strong price volatility, as investors feared they had bought products they did not fully understand. However, many of these issues have now been remedied by regulations. If EIOPA feels additional regulations are needed to ensure that complex products are not sold to insufficiently sophisticated insurers, we would expect these regulations to be introduced in the context of investor appropriateness rules. To use the potential lack of sophistication of a putative investor as a reason to increase a given asset class' capital requirement – presumably on the grounds of potential future price volatility – would be to punish sophisticated investors whilst doing nothing to prevent unsophisticated ones from buying inappropriate investments.

In addition, PCS is not aware that such considerations are taken into account in the case of other complex investments covered by Solvency II. If this is a matter that needs to be taken into consideration in the setting of capital requirements (which, for reasons we have indicated, PCS does not believe to be the case) then, for reasons of intellectual consistency, it should be taken into consideration for all asset classes, including sovereign debt, corporate debt and covered bonds.

Q37: What is the economic rationale, if any, for a higher or lower risk of the securitisations considered compared with other securitisations?

A37: PCS is not sure what EIOPA has in mind when it refers to "economic rationale".

If by this expression, EIOPA means a "macro economic" reason that would be so compelling that it would justify providing a capital requirement for SME loan securitisations that was lower than that which a rational analysis of the data would demand, PCS cannot answer this question. However, we would say two things:

First, PCS does not believe, as a matter of principle, that the prudential capital requirement rules for any type of institution should be modified so that they no longer reflect the proper conclusions of a prudential analysis. It is our belief that achieving “macro economic” effects is an important and legitimate aim of policy makers. But we also believe this should be achieved outside of the prudential capital requirement framework. To do otherwise creates a very real risk of misalignment between risk and capital and a consequential regulatory arbitrage that can swiftly lead to the type of imbalances from which crises arise.

Secondly, in the case of high quality securisations (including SME loan securitisations), PCS is also confident that an appropriate analysis of the available data will produce substantially smaller capital requirements than those proposed currently. This will make such “macro economic” driven changes to the prudential capital regulations unnecessary.

If, though, EIOPA meant by the expression “economic rationale” some economic aspect of SME loan securitisations that made them unique compared to all other types of securitisation, then, as we have set out in our general comments, we do not believe there is any such economic rationale. There is, however, as we set out, a compelling economic rationale based on actual credit and price performance for a lower capital requirement for high quality securitisations over other forms of securitisation.