Setting the standard
for securitisation

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Dear Sirs and Madams

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Public Consultation on Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation

Prime Collateralised Securities (PCS) is an independent, not for profit initiative set up to help revitalise the securitisation market in Europe. As such, the views expressed in this paper are PCS' own and do not necessarily represent the views of the members of the PCS Association. PCS also conducts a not-for-profit third party verification business under the European STS regime. PCS is grateful to the FSB for the consultation report of 2nd July 2024 (the "Report"), the considerable amount of data provided by it and the opportunity to comment on the subject matter.

General considerations

Looking at the Report, PCS is struck by both the vastness of its scope and, at the same time, the narrowness of its enquiry.

The scope is vast as it encompasses – as befits the FSB's mandate – the entirety of the G20 economies, the differing structures of their financial markets and their often substantially different approaches to regulation. In addition, even in the narrow field of securitisation regulation, as pointed out by the Report, actual rules differ considerably. Further, as clearly understood by the writers of the Report, measuring the impact of any set of financial regulatory reforms is fraught with issues of confounding factors such as the overall behaviour of the economy, macroeconomic policy making and the microeconomic incentives of market players.

At the same time, the Report limits itself to only two asset classes: CLOs and RMBS. It also limits itself to two specific regulatory reforms: retention and the BCBS capital requirements for banks holding securitisations.

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Although PCS recognises the challenges the FSB had to face in completing this Report, this also poses a challenge to respondents. It is difficult to come up with precise analysis and specific recommendations covering such a wide field but looking at only two of the constellation of regulatory measures which not only impact the outcome but interact with each other in complex ways. Put colloquially, it is a little like asking for a medical recommendation on the overall health of a diverse population but looking only at the liver and the femur of one individual.

The approach we hope to follow is therefore one that suggests directions of thoughts and raises conceptual issues rather than comments on individual paragraphs or conclusions. PCS, as a European institution, will focus almost entirely on the impact of the reforms in the context of Europe.

OVERALL

Preliminary findings: Does the report draw the appropriate inferences about the extent to which the securitisation reforms have achieved their objectives? Is there other evidence on the effects of the reforms to complement the preliminary findings of the report?

Global inconsistencies

PCS does not believe that this is a question that can be answered for the G20.

First, as the Report acknowledges, even limiting the enquiry to the two chosen topics (retention and Basel calibrations), one finds substantial differences in approach to the regulation. In the US, retention applies to almost no CLOs or private label RMBS. In Japan, retention is not required. China and the United States have yet to implement fully the BCBS capital rules. The EU has an STC category with BCBS advantages but the US, China and effectively Australia and Japan[1] have not. These are not matters of details or fine-tuning.

Secondly and equally if not more important, the reforms were introduced in very different financial markets. For example, the impact of capital requirements for banks holding securitisations will be likely very different in financial systems like the United States with vast pools on non-bank investors compared, for example, to Europe where such pools remain comparatively thin. The impact on the behaviour of both originators and investors in jurisdictions where the bank bid for the senior tranches is large and inescapable is likely to be different from that in jurisdictions where the bank bid is optional.

Another example would be the effect of the existence of state sponsored securitisation platforms such as Fanny Mae/Freddy Mac in the United States or the JHF in Japan. The impact of BCBS capital requirements on the behaviour

[1] Japan has introduced STC but lack of regulatory interpretation has substantially constricted its use. Australia has formally adopted it but provided no regulatory benefit so that the category is not used.

of originators in the RMBS space will likely be very different when that originator has the option of by-passing the market altogether by selling mortgages to a state sponsored entity if it does not like the consequences of those capital requirements on pricing.

It follows that the answers the FSB seeks, in the absence of greater harmonisation, can only be given jurisdiction by jurisdiction.

Europe

In Europe, looking for evidence of the positive impact of the reforms is conceptually problematic. This is because during the GFC, the European securitisation market, and especially the RMBS market, performed extremely well. In RMBS and all other traditional asset classes (save CMBS), senior tranches suffered zero credit losses, notwithstanding the extremely severe economic downturn precipitated by the GFC. The impact of the reforms on "non-traditional" asset classes by which we mean re-securitisations (CDO squared or cubed) and the issuance of structured investment vehicle ("SIVs") is not measurable since the former is now legally prohibited and the second has disappeared.

Losses in CMBS and SIVs resulted from timing mismatches between assets and liabilities (the "refinancing risk" issue) rather than issues of skin-in-the-game. So any future performance is *prima facie* unlikely to be much, if at all, impacted by retention rules. (The point remaining, for the latter, academic until any unlikely re-emergence of SIVs)

The extremely good performance of European RMBS (and other asset classes) is likely to be connected to the fact that retention was never an issue in pre-GFC issuance. There were virtually no non-bank issuers (in contradistinction with the United States or Australia). Banks (with the sole and possible exception of the United Kingdom's Northern Rock) never securitised but a minority of their mortgage book and often a small minority at that. So European originators always had very substantial skin-in-the-game.

This is not to say that the requirement for retention in the G20 reforms should not apply to Europe. Indeed, in 2007 as the crisis hit, a small number of mortgage platform lenders had been established or were in the process of establishment with the openly stated intent to copy US style sub-prime lenders. Counterfactual history is not a science and so it is impossible to say whether these types of lenders would have succeeded and grown in Europe. But it is not impossible. Therefore, minimum mandated retention continues, in PCS' view, to be a positive development. However, this view must be based on a conceptual analysis as it cannot in Europe be grounded in a factual analysis of actual pre-vs-post reform originator behaviour.

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Looking at the BCBS capital requirements, the actual performance of European RMBS during the GFC indicates that the non-neutrality surcharge imposed on securitisations is not warranted by the data. This is certainly the case for current securitisations have all the characteristics of those securitisations that performed so well historically. It so happens that those characteristics were enshrined by law in the STS standard. Therefore, there is a very convincing case that the BCBS capital requirements for STS transactions do not reflect the data and are overly punitive.

Achieving or overshooting

PCS would like to point out that the FSB's focus on whether the reforms have achieved their objectives should not obscure the possibility that they may have also overshot their objectives by being excessive. In other words, from the point of view of financial regulations as a whole, policies should be correctly calibrated. This is not just about the potential negative economic effects of reforms, such as constrained lending volumes, but also about the distorting effect mis-calibrated rules have on financial architectures. Such distortions will usually take the form of regulatory arbitrage. These in turn leads to concentrations of risk within finance, the misallocation of capital and can therefore seed future systemic crisis. Although the Report rightly seeks to address negative economic impacts such as possible reductions in available lending, we believe it may not sufficiently address such possible distortions to the overall financial ecosystem.

In practical terms, we believe the current BCBS calibrations for European STS securitisations do not reflect the actual low level of agency risk embedded in these instruments. This distorts their market price in favour of other forms of financing such as covered bonds and restricts banks' ability to bring non-bank capital into the financial system through SRT securitisations. Both these developments are negative for overall systemic stability.

We believe these possible overshoots and their effects should be part of the FSB's analysis of the impact of the G20 reforms beyond the availability of finance.

2. **Analytical approach**: **Are the descriptive analyses used to evaluate the effects of the securitisation reforms appropriate? Are there other such analyses to consider? What types of empirical analysis based on available data could inform the evaluation?**

Retained securitisations

PCS notes that retained securitisations are included in the Report's analysis as part of the securitisation market. PCS believes this is a mistake as it presents a distorted picture of the securitisation *market.* We believe that retained transactions should be removed from the analysis for the same reason that state sponsored agency securitisations are removed. Retained transactions

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are not market instruments. They are merely the transformation of assets on a bank's balance sheet from one format (loans) to another format (securities). Once the transformation is complete, the assets remain on the bank's balance sheet in their entirety and, in almost all cases, do so forever. They never leave the balance sheet save briefly and temporarily to serve as collateral for central bank facilities. Their characteristics are not dictated by market players but by central bank collateral departments. They have no real market price. Once they have served their purpose, they are dissolved and the assets return to their original state.

To include retained transactions in the "securitisation market" is therefore misleading. It makes it impossible to determine, for example, the impact of the reforms on issuance volumes or on the blend of asset classes selected by originators.

Securitisations as part of a complex ecosystem

The securitisation reforms do not only impact securitisation instruments but the financial ecosystem as a whole. It is not possible to measure the impact of those reforms without looking at that ecosystem in a holistic way. PCS understands that this is extremely complex but it is essential.

As mentioned above, the miscalibration of BCBS capital requirements have created an uneven playing field generating potentially problematic concentrations in certain financial instruments as well as limiting the room for manoeuvre of banks facing liquidity or capital challenges. This we address more fully in our response to question 15.

By focusing solely on the impact of two reforms on the securitisation instruments themselves, the Report will find it difficult to measure the impact of those reforms on finance and financial stability.

OVERVIEW OF SECURITISATION MARKETS

3. Trends: **Are the securitisation market trends presented in this report adequate given the scope of the evaluation? Are there other important trends that should be included and, if so, what additional data sources could be used for this purpose?**

Other than the comment on the incorporation of retained transactions in the analysis, the market trends' analysis is comprehensive.

One trend that might be important to consider is the possible impact of the reforms on the size and composition of the investor base for securitised products. The diminution in Europe of the investor base both in size and in the type of entities investing, in contrast with other jurisdictions, appears to be a limiting factor to the growth of the European market. Although some of the regulations most likely to be impacting this (e.g. insurance capital regulation)

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may be outside the remit of the FSB, an analysis of the impact of the G20 reform should also encompass the nature of the investor base.

SECURITISATION REFORMS

4. Relevant reforms: **Does the report appropriately describe the key aspects of the design and jurisdictional implementation of the BCBS and IOSCO reforms for analysing their impact on securitisation markets? Are there other important aspects of these reforms that should be considered for inclusion?**

No comments.

5. Other reforms: **Does the report accurately identify other G20 and domestic financial reforms that are most relevant for securitisation markets? Are there other reforms that should be considered in terms of their impact on market participants?**

The Report is comprehensive in its description. It should be noted, and the Report does point to this, that these reforms are extremely different from jurisdiction to jurisdiction, making any type of global analysis impossible.

6. **Conceptual framework**: **Does the report adequately explain the objectives, transmission channels and expected outcomes of the securitisation reforms? What other metrics to assess the impact of the reforms should be considered?**

No comments.

EFFECTIVENESS OF THE SECURITISATION REFORMS

7. **Resilience metrics for the CLO market**: **Does the report accurately describe the evolution of resilience indicators for the CLO market? To what extent can the evolution of these indicators be attributed to the reforms?**

PCS has little interaction with the CLO market and so will leave questions on this market to respondents better able to answer.

8. **Risk retention in CLOs**: **Does the report accurately describe risk retention practices in the CLO market before and after the reforms? What additional analysis could be included to assess the effectiveness of risk retention in CLOs across FSB jurisdictions, including on how financing of risk retention deals by third party investors impacts effectiveness?**

See our response to question 7.

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9. **Resilience metrics for the non-agency RMBS market**: **Does the report accurately describe the evolution of resilience indicators for the RMBS market? To what extent can the evolution of these indicators be attributed to the reforms?**

As mentioned above, the European RMBS market showed extraordinary resilience prior to and during the GFC and was plagued by none of the issues that caused such dislocations in the US market (specifically the sub-prime market). This resilience is attributable to the maintenance prior to the GFC of traditional and solid underwriting standards. It is hard to ascribe this maintenance to any specific cause. A number of factors may have played a role: cultural differences with the US, different political pressures, the absence of non-bank financial institutions competing with banks, a less developed securitisation market. One likely factor though would be that banks securitised only small proportions of their books and so there never developed a sense of an absence of skin-in-the-game.

Since the GFC, the European Union's Mortgage Directive imposed minima to underwriting standards. However, as with the STS criteria passed in the Securitisation Regulation, these primarily codified existing practices rather than set new higher standards.

We agree with the Report than any improvement post-GFC in performance of European RMBS junior tranches (as senior tranches have shown no defaults) is therefore unlikely to be the result of reforms as these reforms did not raise the existing standards but codified existing ones. They more likely reflect, as the Report suggests, changes in macroeconomic circumstances.

This does not mean that these reforms were not important and necessary. But their importance and necessity derive not from the improvement of a bad situation but from the creation of barriers to prevent deterioration from a good situation.

10. **Risk retention in RMBS**: **Does the report accurately describe risk retention practices in the RMBS market before and after the reforms? What additional analyses could be included to assess the effectiveness of risk retention in RMBS across FSB jurisdictions?**

We do not believe that the report accurately describes risk retention practices in the European RMBS market, especially before the reforms. because it focuses on a narrow definition of "retention": namely, the legislatively mandated retention of 5%.

Both prior to and after the GFC, most RMBS was issued (as it still is) by traditional universal banks (or institutions directly owned by such banks). These banks almost always securitised a minority of their residential mortgage

book. So, at origination, there was always a greater than 50% chance that the credit risk of any mortgage would remain fully with the bank. This is exactly the kind of skin-in-the-game that minimum retention requirements are designed to ensure. This skin-in-the-game well in excess of 5% was always and broadly remains a feature of European RMBS.

To understand retention as practiced in Europe therefore data should be gathered on (a) the proportion of mortgage books that were securitised and (b) the way the securitised books are selected to measure the impact of any possible cherry picking on effective skin-in-the-game.

11. **Effectiveness of BCBS securitisation reforms**: **Does the report accurately describe the changes in bank behaviour following the implementation of the BCBS securitisation framework reforms? To what extent can the effects of these reforms be disentangled from the broader Basel III framework, other reforms and confounding factors?**

See responses elsewhere.

12. **Simple, transparent and comparable (STC) securitisations**: **Does the report accurately describe the impact of the introduction of the STC framework on the securitisation market? To what extent has the reform met its objectives?**

As a general and as mentioned previously, the adoption of the STC standard in the G20 has been extremely uneven,. It should also be pointed out that the European STS standard which was developed prior to the STC standard (even if the legislation was passed later) has higher and considerably more detailed requirements than those of STC.

Our comments will only refer to the European situation.

The Report is correct when it refers to comments that the STS standard did not create a new and higher standard for European securitisations. It reflected the best practices that were already in place prior to the GFC. It is those practices that explain the extremely good credit performance of European traditional securitisations.

If the creation of a new higher standard was the objective of the reform, this has not been met in Europe. However, the performance of European securitisations during the GFC also underlines the fact that this was not a meaningful objective as such standard was not necessary.

There are other possible objectives though for the STS reform.

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First, to create a high quality label backed by enforcement and sanctions that would bring back investors to the securitisation market. This would be the result of reducing the stigma that fell on all securitisations following the woeful performance of US sub-prime RMBS and CDOs. If that was the objective, it has failed. The investor pool in Europe remains extremely small. However, there is plentiful anecdotal evidence that it is excessive prudential requirements which distort pricing and lower incentives are driving the dearth of investors rather than stigma.

Secondly, to create a type of securitisation from which all or almost all "agency risks" have been removed[2]. This would allow such STS securitisations to benefit from lower capital requirements under the Basel rules. Such lower capital requirements are available under the Basel regime – with a halved p factor. However, there is abundant data from the GFC to show that the capital requirements for STS securitisations remain far too high when measured against their performance. So the objective of creating a securitisation with minimal agency risk has been met. But the logical consequences of meeting this objective have not been followed through. This has resulted in subdued European issuance and a shrunken investor base.

BROADER EFFECTS OF THE REFORMS

13. **Effects on financing the economy**: **Does the report accurately describe the main effects of the reforms on financing the economy? Is there additional analysis that could be undertaken to estimate the benefits and costs of these reforms and to assess their impact on securitisation as a financing tool?**

The Report suggests that there is little evidence of the reforms reducing the volume of lending to the European economy. We broadly agree but would make two remarks.

First, the period examined covers a period of unprecedented accommodative monetary policy by central banks. During this period, effectively infinite amounts of liquidity were poured into the banking system for free or nearly free. It would be difficult to see how the cash available for lending to the economy could have fallen short of demand. This central bank liquidity makes it impossible to reach any meaningful conclusions about the potential long-term impact of the reforms on overall bank liquidity.

Secondly, there are two components to the size of the potential bank lending envelope: liquidity and capital. By making bank capital management via SRT securitisation more costly, the reforms may have either forced banks (a) to raise

[2] This is in addition to the agency risks that European regulation had sought to remove from *all* securitisations, such as model-on-model risk generated by re-securitisations (now banned) or skin-in-the-game issues (dealt with by retention)

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additional traditional capital and/or (b) to pay more for SRT securitisations. This will, in turn, have raised the cost of funds of banks – once the capital component is included. In turn this may have raised the cost of borrowing for both retail and corporate clients. Finally, this in turn may have depressed economic growth in Europe. This is an analysis that would be very difficult to conduct but would be necessary to ascertain the real cost of the securitisation reforms.

The Report also states that respondents in a previous consultation had indicated that they believed the reforms had depressed lending to the economy. But the Report also pointed out, no doubt accurately, that no empirical evidence had been provided by such respondent. This is probably because it is difficult to see how it could be, due to confounding factors. However, the Report also states that "on the other hand, some studies carried out recently conclude that other non-regulatory factors constrain the growth of the EU securitisation market". It then goes on to cite the Joint Committee advice. It is worth noting that this advice also merely asserts that position without any empirical evidence or, for that matter, explanatory mechanism.

14. **Effects on financial system structure and resilience**: **Does the report accurately describe the extent to which there has been a redistribution of risk from the banking to the non-bank financial intermediation sector? What role did the reforms play in this process and what are the main benefits and risks from a system-wide perspective? How have the reforms impacted the demand and supply of liquidity in securitisation markets?**

We have no comments on the description of the redistribution of risk from the banking to the non-banking sector. We are unclear to what extent any of this redistribution is enhanced or subdued by the reforms. Undoubtedly, in the retail lending space, a strong and growing NBFI sector is dependent on the existence of an efficient securitisation sector. Therefore, although this is difficult to evidence, the extent to which the reforms have helped or slowed this redistribution of risk is probably determined by the extent to which the reforms have helped or hindered the recovery of securitisation post-GFC.

The benefits and risks posed by the growth of NBFIs system-wide is a very difficult and complex issue which goes well beyond the issue of securitisation regulation. However, you cannot respond on the narrow securitisation question about those risks and benefits without taking a view of the risks and benefits of NBFI growth as a whole. We therefore have no comments on the narrow point.

ADDITIONAL CONSIDERATIONS

15. **Other issues**: **Are there any other issues or relevant factors that should be considered as part of the evaluation?**

Part of the difficulty in responding to the consultation lies in the fact that the reforms being examined are not simple and so not capable of being judged in

a binary fashion. This is particularly the case for BCBS capital requirements. Clearly, capital requirements for securitisations post-GFC had to be re-examined to account for agency risk. The creation of an STC category with much reduced agency risk was also, in PCS' estimation, a positive step. But we believe that (in the case of Europe's STS) the re-calibration of capital requirement substantially underestimates the reduction in agency risk. The data from the GFC and post-GFC supports those conclusions.

This miscalibration is impacting the European economy and undermining systemic financial stability in a number of ways.

First, it renders capital management by banks via SRT securitisations (either in traditional or synthetic format) too expensive. Although often thought of as reducing capital in the banking system, the non-neutrality of the capital treatment of securitisations means that SRT securitisation will almost invariably increase the capital in the banking system. This capital is also almost always coming from outside the banking system. It is provided by the buyers of the mezzanine risk bearing tranches. These are bought by NBFIs. Therefore, by reducing this capital management channel, the current miscalibration in capital requirements reduces the stability of the banking system by reducing the access by banks to non-bank capital available via SRT securitisation.

Secondly, securitisation is a form of liquidity available to banks when the market is uncertain about a bank's medium-term viability. The absence – as experienced in Europe – of a deep securitisation market reduces the availability of this alternative source of bank liquidity. This makes individual banks more fragile. This, in turn, reduces the resilience of the banking system as a whole.

Thirdly, in Europe, the miscalibration of capital requirements for senior tranches of STS securitisations means that bank investors will require from originators a higher return to cover the additional cost of capital. This makes securitisations often uneconomic when compared to other financing tools. This has resulted in the last decade in banks relying for ever larger parts of their funding on covered bonds. This reduces diversification. Reduced diversification is always a systemic fragility indicator as shocks to the dominant product quickly become systemic threats in the absence of alternatives.

Conclusion

The reforms were necessary and positive but took place over time. This has resulted in their implementation in phases, where each phase did not amend fully and as required elements of earlier phases. This is why PCS views the G20 reforms, as implemented in Europe as completed. One of the results of this incomplete sequencing is the miscalibration of the BCBS capital requirements for European STS both for RMBS and other asset classes.

This is having a negative impact on systemic stability as well as most likely on Europe's economy.

We hope this response is found to be useful and are happy to discuss in further details any aspect of the comments.

Your faithfully

Ian Bell
Prime Collateralised Securities