Setting the standard
for securitisation

Prime Collateralised Securities
(PCS) EU SAS
4 place de l'Opera
Paris 75002

www.pcsmarket.org

Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs/Madams

22nd September 2023

Securitisation Evaluation

PCS welcomes the FSB's request for comments on its future report on the implementation of the global regulatory framework on securitisation. We note the FSB's intention to publish a draft report at a later date and consult stakeholders at that time. We look forward to participating in this future consultation. It is with this anticipation, bearing in mind the very short period for which this consultation was open, that we have elected to provide a high-level view rather than a detailed analysis of specific regulatory proposals with accompanying data sets.

PCS is an independent not-for-profit initiative set up by the finance industry with the support of key policy-making bodies to help revitalise the European securitisation market as a safe channel for funding the real economy. As such, our comments will only address the success or otherwise and the impact of the G20 reforms in Europe – both within and without the European Union.

The FSB has stated that the purpose of its evaluation is twofold:

1. To assess the extent to which the G20 reforms on securitisation implemented to date have achieved their financial stability objectives. Specifically, the evaluation will assess whether the reforms have addressed misaligned incentives that weakened lending standards in the credit origination process, as well as opaque and complex structures that prevented proper due diligence and led to the mispricing of risks by investors.

2. To examine broader effects (positive or negative) of the reforms on the functioning and structure of the securitisation markets and the implications for financing to the real economy. This type of analysis will help identify any

material unintended consequences that may have to be addressed, without compromising on the objectives of the reforms.

This paper will address both these aspects.

Success of the reforms in achieving financial stability

A quick look back at pre-GFC securitisations

PCS would like to preface this part of our response by drawing attention to the fact that the securitisations that had such a devastating impact on global financial stability did not originate in Europe.

Specifically, we would take issue with the sentence:

"The complex structuring and multi-step distribution chains involved in much securitisation prevalent in the run-up to the crisis generated misaligned incentives among the originator of a securitisation and its investors while encouraging a rapid and largely undetected build-up of leverage and maturity mismatches."

This was undoubtedly true of the US market. It was not true of the European market.

A single statistic, drawn from Standard and Poor's, illustrates the point. Defaults in US RMBS, all tranches, from the GFC through to 2015 amounted to 22.97%. The equivalent number for European RMBS issuance is 0.14%. Senior tranches of European RMBS down to AA- (original issue rating) did not suffer ***a single Euro of loss*** during the GFC crisis. This is an extraordinary credit performance when one remembers the severe economic conditions prevailing in most of the jurisdictions from which these RMBS issues emanated.

We do not mention this as a piece of vain-glorious posturing on behalf of Europe. In our opinion, this fact is key to understanding how we conclude that current rules, following the reforms introduced in 2019[1], dramatically mis-calibrate capital requirements and impose unwarranted and burdensome restrictions on European securitisations. This is particularly true of securitisations meeting the "simple, transparent and standardised (STS)" requirements.

That the European securitisation market (and those of other countries such as Japan or Australia) did not suffer from the problems that beset the United States does not, of course, mean that US lessons need not be learned and applied to those markets. Just because it did not happen here does not mean it could not.

---

[1] The coming into force of the EU Securitisation Regulation – Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.

But, as we will discuss more fully in the second part of our response, it does provide guidance as to how one should handle the data used to calibrate capital and assess the other rules.

Did the reforms achieve the financial stability objectives?

In its 2013 White Paper[2], PCS analysed the reasons for the failures of securitisations during the GFC. The EBA, in its 2014 discussion paper, was kind enough to cite our analysis and endorse its conclusions.[3] The conclusions were not particularly controversial. They reflect the FSB's own analysis.

- The misalignment of incentives driven by the "originate to distribute" model.
- The existence of excessive leverage within transactions generated by re-securitisations (CDO cubes, etc…),
- The existence of embedded maturity transformation *within* transactions (maturity mismatches),
- The lack of transparency

Looking at these, we conclude that the G20 reforms, as embedded in European legislation, have successfully addressed these issues.

Retention requirements at 5% appear to deal with the originate to distribute model. We counsel a high degree of vigilance be exercised by regulators to avoid the requirements being gamed. We have also queried whether a 5% vertical slice retention is quite substantial enough. But, broadly, the rules are fit for purpose.

The excessive leverage generated by re-securitisations in Europe has simply been banned by law.[4]

The existence of embedded maturity transformation still exists in commercial mortgage-backed securitisations (CMBS). But this is a small non-systemic part of the market and the potential losses in any given transactions are usually limited. The vectors, during the GFC, of catastrophic losses driven by maturity mismatches, namely the structured investment vehicles (SIVs) have totally disappeared.

[2] Europe in Transition (2013) - https://pcsmarket.org/wp-content/uploads/Europe-in-Transition-Bridging-the-Funding-Gap1-2.pdf

[3] EBA Discussion Paper on Simple, Standard and Transparent Securitisations (2014) https://www.eba.europa.eu/sites/default/documents/files/documents/10180/846157/ceefdf3f-58ea-452f-a924-2563410d1705/EBA-DP-2014-02%20Discussion%20Paper%20on%20simple%20standard%20and%20transparent%20securitisations.pdf

[4] Technically, some extremely limited exceptions exist in both EU and UK rules but they are not systemically impactful and can safely be ignored

Transparency, in Europe, has now been mandated to an extremely high degree of specificity and no-one can argue that it is insufficient. In fact, pre-crisis the opacity of certain transactions was not usually the result of originators not providing information on simple transactions. The opacity, in our view, was almost always the result of the amount of information being too large for any investor to conduct a sensible analysis. This was a direct result of the structuring of re-securitisations with multiple layers. Most of the opacity issues disappeared with the banning of re-securitisations.

Broader effects

State of the European securitisation market

Whereas the US, Japanese, Australian and Canadian securitisation markets volumes (inter alia) have recovered, the European securitisation market has not. The failure of the European market to revive is widely recognised, by both private and public sector actors, as a major problem for European finance and the European economy.[5]

There are many ways to count securitisation (including retained or excluding retained, including agency paper or excluding agency paper, including ABCP or excluding ABCP). However, PCS' data shows that when looking at non-retained securitisations excluding ABCP as a percentage of GDP, Japanese issuance was almost twice that of Europe, Australian almost 4 times and US ***excluding the GSEs*** almost 7 times that of Europe.[6]

The absence of a strong European securitisation market substantially reduces the capacity of banks safely to recycle capital. As raising capital at reasonable rates becomes more difficult, this will likely constrain the available amount of finance to fund the economy. This is a particularly acute situation at a time when, in addition to the economy's usual needs, Europe is seeking to fund a very ambitious transition to a green sustainable economy.

The absence of a strong European securitisation market impedes the creation of a capital markets union. The creation of a unified capital market is a key aim of European policy makers. It would reduce Europe's dependence on bank funding (currently assessed at being between 75% to 80% of all financings, compared, for example, to 25% in the US). This would, in turn, reduce the systemic risks of bank failure. It would also provide a channel for European savings to fund the European economy as well as, potentially, attract foreign investors. Securitisation is ideally suited for this as it can generate substantial amounts of AAA/AA investments whose strong credit characteristics match the generally risk-averse approach of European savers. It would also assist in reducing systemic bank risk by providing an ongoing financing platform for new

[5] For a recent example, see the joint statement by Bruno Lemaire and Christian Lindner in the Financial Times (https://www.ft.com/content/88067cb1-4a3e-4824-9973-bc37864ecb52)
[6] Number are for 2021 and Europe is defined as including the United Kingdom

non-bank financial institutions. In this respect, we note that the largest part of securitisation issuance in the US (ex-GSEs) and Australia are NBFIs.

What has that to do with regulation?

The FSB has requested comments on the G20 regulatory reforms rather than on the health of the markets. It could be argued that the low level of issuance in Europe is not the result of these reforms as implemented in the European Union but of other factors (such as accommodative monetary policy by central banks). Indeed, the EBA made this point explicitly.[7] It could even be argued that the success of the recovery of securitisation markets in other countries also subject to the G20 reforms is powerful evidence for this proposition.

There are two reasons why this is not, in our opinion, correct.

First, it is well-known that it is not possible to “prove” a counterfactual history. What would have happened to the European securitisation market had the G20 reforms not been applied is, in a strict philosophical or scientific view, unknowable. However, in its over ten years of operation, PCS has engaged with virtually all market participants in Europe. This includes originators, arrangers, investors, lawyers, trustees, and regulators in all countries where securitisation is done. Not once have we heard anyone, save regulators and some policy makers, state that the low level of issuance was not wholly or substantially due to regulations. This does not mean that monetary policy was not seen as playing a role. But a similar monetary policy was in place in the other jurisdictions where the securitisation market did recover. It also does not mean that all the regulations emerging from the G20 work have been responsible for the low level of issuance in Europe. Indeed, many have helped the partial recovery from the GFC and many were clearly both essential and welcomed. But some regulations, as applied in Europe, continue, in the view of PCS and almost everyone else, to depress unjustifiably securitisation issuance.

Secondly, it does not follow from the recovery of other securitisation markets despite the applicability of the G20 reforms that part of these did not play a damaging role in Europe.

First, Europe chose to gold-plate a number of the internationally agreed reforms. A striking and consequential example is the stark difference in the capital treatment of securitisations held by insurance undertakings in Europe and the United States. The decision of Europe to apply a *p* factor double that applied in the US, is another example[8] as is, conversely, the US’ decision to disable retention requirements for certain types of RMBS. Other jurisdictions

[7] See the Joint-Committee Advice on the Review of the Securitisation Prudential Framework (Banking) – December 2022

[8] PCS is, of course, aware of the proposals to modify the *p* factor going forward and set out in the recent Notice of Proposed Rulemaking also known as the Basel III– Endgame. Should the proposal survive, though, its effects will be felt in the future.

have also adopted a less conservative approach on some aspects. For example, Japan does not require retention for all securitisations.

Secondly, the same policies will have substantially different effects when deployed in substantially different market environments. The United States has a deep and liquid capital market outside of banking. So, banks are not as crucial an investor for securitisations as they are in Europe. It follows that stringent regulations of banks *qua* investors will not impact the one as they do the other. (This is doubly true if, as in the US, regulations allow insurance undertakings easily to take the place of any lost bank treasury investors. This is precluded in Europe by the disproportionate capital requirements required of insurers under Solvency II). Another important difference is the density of NBFIs in the lending space and their use of securitisation. Although NBFIs are becoming more common in Europe, in the US and Australia they represent a major part of securitisation issuance. NBFI, of course, are not subject to the G20 reforms.

This argument does not seek to diminish the value of harmonised rulemaking of the type that the Basel Committee has crafted. But it does counter the argument that a proposed negative impact of regulations in one market can be dismissed by pointing out that no such impact was suffered in another market.

Possible approaches

PCS believes that the reforms made since the GFC need to evolve to be fit for purpose, at least in the European context.

First, we wish to make clear that we are not seeking a trade-off between growth and prudential standards. Our argumentation does not turn on the idea that if safe and stable financial markets are hindering the financing of growth, one should accept less safety to purchase growth.

As a corollary of this point, we are also therefore not suggesting any kind of roll-back of the changes made so far. Indeed, as we have written, many of the rules passed in Europe and elsewhere were both necessary and helpful. As set out in the first part of our answer, these rules did achieve the stability objectives set out in the original G20 reform plan. On the contrary, we are suggesting, rather than a roll-back, the completion of those reforms. It is our contention that many positive regulatory steps have been taken but the logical and necessary consequences of these steps have not followed. This leaves the G20 reform package, in Europe at least, unfinished.

The unfinished reforms

The reforms consisted of two intertwined steps. First, both in time and in importance, was a re-calibration of capital requirements and rules to reflect the catastrophic performance of “securitisation”. The quotations marks, of course, reflect the fact that not all securitisations suffered catastrophic collapses. But the general view at the time was that all securitisations were potentially problematic because of what became labelled as “agency risk”.

The second step was conducted slightly differently in different jurisdictions. This step consisted in passing a series of rules to learn the lessons of the crisis and reduce or ban agency risk. The imposition of retention requirements to control the risks inherent in the “originate to distribute” model was a key such reform. The difference was that Europe went further by the creation of the “simple, transparent and standardised” (STS) standard. This STS standard, with 103 separate criteria for true sale securitisations and up to 160 for synthetic securitisations is extremely demanding and encapsulates all the aspects that were found in those European securitisations we mentioned in the first part of our response and whose credit performance was exceptional during the GFC and its painful aftermath. The Basel Committee also followed suit with the lighter STC standard.

We believe though that the reforms are unfinished. Having created a regulatory and supervised standard such as STS, the recalibrations of capital requirements (both for banks and insurers) and the adaptation of other rules (disclosure, due diligence, liquidity coverage ratio…) does not appear to have been done by a scientific and rigorous analysis of the performance of these types of securitisations. On the contrary, the recalibrations appear to have been done on the basis of some arbitrary rule of thumb, applying a sort of “discount” to the existing requirements. The basis for this “discount”, to our knowledge, has never been justified, nor the mode of its calculation explicited. We are aware that some regulators have put forward the proposition that, since STS did not exist pre-GFC, there is no rigorous data set that can be used thus leaving little choice but to pursue a “rule of thumb” approach. PCS has published elsewhere why it believes this is simply incorrect. STS encapsulated pre-GFC European best practices. As such it did not set a new standard but codified the existing standard embedded in those European transactions whose performance has already been mentioned. Therefore, although somewhat laborious, it is more than possible to derive proper calibrations and rules from those pre-GFC transactions. This will complete, not roll-back, the reforms examined by the FSB. It will also provide data based calibrations that will more accurately reflect risk.

Another way of stating the argument is that almost all the regulatory burden imposed post-GFC was designed to account for the inherent agency risks present in securitisations. Europeans policy makers, advised by the regulatory community, subsequently crafted the STS standard whose sole and explicit purpose was to remove agency risk from transactions that met its onerous tests. But having removed the agency risks for which the original burdens were imposed, policy makers and regulators have not felt able to regulate securitisations that meet the STS standards as what they are. Current rules still assume a not unsubstantial level of agency risk for STS transactions as illustrated by the continued steep non-neutrality of capital requirements. Yet, it appears to PCS that, when asked what specific agency risks still supposedly present in an STS securitisation meeting the 100 plus criteria justifies this approach, none has been identified by the regulatory community[9].

Uneven playing field

Another aspect we would invite the FSB to look into is the way the reforms have created, in Europe at least, an unlevel playing field.

Money is fungible and moves. In finance one cannot focus on the regulatory framework for a single product (securitisation, commodities, equities….) without taking into account how this framework affects other markets. Such a siloed approach leads frequently to regulatory arbitrage and misallocation of risk capital.

In their desire to prevent a recurrence of the crisis, regulators and policy makers focused on "securitisation" as the source of the problem. As is now generally agreed, "securitisation" was not the source of the problem. Misaligned interests, opacity, embedded maturity transformation, leverage and informational asymmetry were the problems. These existed certainly in pre-GFC securitisations (especially out of the United States). But they also exist, potentially and in our view in actuality, in other financial instruments.

By imposing extremely high and precise mandatory disclosure requirements, as well as heavy prescriptive due diligence requirements only on legally defined securitisations, the European legislation has raised the cost, in time and money, of issuing and investing in securitisation compared to any other financial instruments. This includes many instruments whose credit is backed or underpinned by assets. So, securitisation issuance has diminished and other asset backed instruments, unburdened by those costs, have increased. This does not mean that the risks identified as having triggered the collapse of many securitisations in the GFC are not to be found in those instruments. In a way, the lack of disclosure means no-one, including the regulatory community, really knows.

This is not merely a problem for the size of the securitisation market. It is a problem of regulatory arbitrage where finance flows to the lesser regulated activities. Historically, this is where risk likes to hide.

PCS is agnostic as to whether this imbalance is resolved by lowering the standards on securitisations (which are, in some cases, excessive) or raising those on other similar instruments or, probably more sensibly, a little of both. We realise that the FSB may wish to argue that this is not the remit of this

[9] Technically, this is not a complete picture in that some agency risks such as informational asymmetry are sometime mentioned. But we would point out that all the risks so identified are not risks specific to securitisations. Informational asymmetry is universally present in all capital market issuance – both fixed income and equity.

exercise. But, if the remit is to look only at the securitisation silo, we fear that a sensible balance in achieving the overall stability of the financial system may be missed.

Conclusion

PCS believes that the G20 reforms, as implemented in the United Kingdom and the European Union, have achieved their goals.

PCS believes that, in Europe, some aspects of their implementation has dramatically reduced securitisation issuance.

PCS believes, in agreement with many European policy makers and most finance stakeholders, that a stronger and deeper yet safe European securitisation market is essential to finance the growth of the economy and the transition to a sustainable economy.

To achieve that market, PCS does not advocate a roll-back of prudential standards but the completion of the already achieved reforms. Specifically, completing the reforms in relation to the STS regulatory standard created by policy makers, supervised by regulators and adopted by the market.

We would be happy to answer any questions you may have on this response.

Yours faithfully

Ian Bell
CEO
Prime Collateralised Securities