Setting the standard
for securitisation

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The Secretariat
Financial Stability Board
c/o Bank for International Settlements
Basel
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Dear Sir

Prime Collateralised Securities welcomes the opportunity to respond to the consultation paper issued by the Financial Stability Board last November and entitled “Strengthening Oversight and Regulation of Shadow Banking”.

Prime Collateralised Securities (PCS) is a 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 improve market resilience in Europe, promote growth in the real economy and at all times maintain high standards of quality, transparency, simplicity and liquidity. The key way in which PCS performs its task is by the award of a label to structured finance securities that meet strict criteria addressing quality, simplicity, transparency and liquidity.

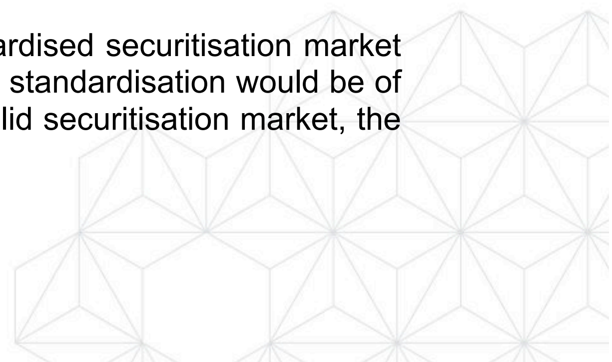
PCS is supportive of the work of the FSB to define the systemic risks in non-bank financial activities and agrees with the approach that identifies excessive leverage and maturity/liquidity transformations, as well as imperfect risk transfers as the greatest risks of the non-bank financial sector.

In view of its remit, PCS limits its comments to those aspects of the consultation paper that deal with securitisation.

[A] ***IOSCO – WS4 Report***

PCS welcomes the final report issued by IOSCO in conclusion to Work Stream 4 on “securitisation”. In particular, PCS endorses IOSCO’s support for the return of a sound securitisation market.

PCS strongly supports IOSCO’s call for a more standardised securitisation market and also agrees with its conclusion that, although such standardisation would be of great benefit to investors and thus to the return of a solid securitisation market, the



complexities involved make a "bottom up" standardisation preferable to one mandated from "the top down" by regulators.

The promotion of standardisation in the securitisation market is an explicit goal of the PCS initiative. We hope to be able to work with other market participants and the regulatory community to encourage and build such standardisation in Europe.

[B] ***General Comments on the proposed approach***

Economic functions

PCS acknowledges the probably insuperable obstacles in capturing the complex risks of non-bank finance by focusing on legal names and forms and agrees that a different approach is necessary. PCS also sees the logic in defining "funding financial entities through securitisation" as an economic function, but would suggest that this formulation may be more appropriate than the one that appears in the consultation ("securitisation and funding of financial entities"). This may appear to be a highly technical point, but we feel nomenclature is important. "Securitisation" is a financing technology that supports an economic function; it is not an economic function in and of itself. To describe it as an "economic function" runs the risk of generalised rule making for all securitisations, irrespective of the function they perform and/or the risks they pose.

Inherent risks

PCS feels the risk that we allude to in the previous paragraph arises again in the sentence: "A set of policy tools are proposed to mitigate shadow banking risks *inherent in each of the economic functions*" (italics are our own). Having identified the key risks of non-bank finance as excessive leverage, maturity/liquidity transformation and imperfect risk transfers, we are strongly of the view that none of these risks are "inherent" in securitisation.

Some forms of securitisation do indeed create such risks: structured investment vehicles and most commercial mortgage backed securities (CMBS) did involve maturity transformations, which accounted for the bulk of the problems encountered by those financings. Synthetic CDO's (and, even more so, CDO squared products) contained very high levels of leverage. Again, this accounted for most of their difficulties. Finally, it could be argued that the implicit support of sponsoring banks for some SIV's and ABCP conduits raises questions of imperfect risk transfers.

However, the bulk of European term securitisations do not run (nor have ever run) such risks. To our knowledge, all European RMBS and ABS are match funded. Term securitised bonds do not redeem earlier than the underlying assets. In this respect, it is important to recognize that the apparently short duration of these bonds (compared to the longer apparent duration of the underlying assets) is not the result of a refinancing "cliff" but is due to (i) early redemptions of some long dated assets (ie people move house and repay their 25 year mortgage early) (ii) a "clean up" call where the originators buy back *performing* assets if the pool falls to a very small size so that investors are not left with a tiny long dated remnant of the

original bond and (iii) non mandatory call options for the originators. Legally, though, almost all securitisations are match funded.

Equally, most securitisations have virtually no leverage.

Finally, outside of well understood areas (ABCP, SIV's and, arguably, master trusts), the crisis has not revealed any inherent imperfect risk transfer in securitisations. In other words, when securitisations ran into difficulties, the bond holders were not entitled put them back to the originators.

An alternative approach to systemic risk in shadow banking

We should therefore avoid an approach that identifies "securitisation" as an economic function containing inherent risks, as this may create a regulatory framework that captures a market made up almost entirely of match funded, unleveraged risks that have been appropriately transferred from banking institutions. This could well penalise the "sound securitisation activities" the consultation paper wants regulations to encourage.

This does not mean that we do not acknowledge that certain uses of securitisation technology can create systemic risks in the future (as they did in the past). However, it does lead PCS to suggest that a regulatory approach that identifies securitisation per se as a subject of new rules does not appear the most appropriate.

We would suggest that a better approach to shadow banking may be a three step process:

(i) regulators should identify actual systemic risks (rather than broad categories from within which risks may arise);

(ii) regulators should explore whether these risks can be appropriately dealt with within existing regulatory schemes (eg bank supervisory functions);

(iii) if such risks cannot be dealt with within existing rules, regulators should design new regulations to prevent such systemic risks from arising.

SIVs as an example

Structured investment vehicles (SIVs) are usually mentioned as an example of how securitisation can create systemic risks. SIVs were special purpose vehicles purchasing longer dated bonds (often ABS) and funding them through short term financing. Their financing was considered to be securitisation because it was credit tranched, rated by the securitisation teams at the credit rating agencies and marketed by the securitisation sales forces at broker dealers. Some SIVs were sponsored by banks but others were private entities. At the heart of SIVs was massive maturity transformation.

The rationale behind the high ratings granted by the rating agencies to the senior notes issued by SIVs was that, if their assets deteriorated, they could be sold rapidly at a small quantifiable loss. This loss would be absorbed by the junior notes issued by the SIV. When liquidity drained entirely from the market, that premise was shown to be deeply flawed. The SIVs' assets could not be sold at all, their short term funding dried up and they became insolvent.

Our uncontroversial contention is that SIVs operated as unregulated banks subject to runs. This weakness, and its concomitant systemic risk, was unrelated to "securitisation" as an economic function. The risk embedded in SIVs is conceptually identical to the risks embedded in any other non-banking entity engaging in large scale maturity transformation and at risk from runs with no lender of last resort. Money market funds (the subject of FSB's WS1) and many hedge funds run identical risks and, in our opinion, generate identical systemic issues.

By designing a regulatory scheme based on "securitisation as an economic function" and seeking to deal with the risks of SIVs within such scheme, one can create a dual inefficiency: first, most existing securitisations that contain no maturity transformation will become subject to rules and limitations designed to neutralize the risks of entities (ie. SIVs) whose risks do not actually result from their use of "securitisation" but rather from maturity transformation; secondly, identical risks (MMF's and hedge funds) may be monitored and regulated under separate regimes being classified as separate "economic functions". This could lead to regulatory redundancies and duplication, on the one hand, and, on the other hand, differing regulatory approaches to the same problem (eg if different regulatory agencies are tasked with overseeing different incarnations of the same problem). This invites regulatory arbitrage.

The three step approach we suggest would lead to the identification of any actual systemic risk from non-bank maturity transforming entities of sufficient size. The question of whether existing regulations could deal with this problem would probably have to be answered, presently, in the negative. So new regulations would need to be crafted. Such regulations would deal with the actual problem of such entities irrespective of form or economic function.

[C] ***Proposed regulatory tools***

Section 3.2.5 of the consultation paper sets out the proposed tools that may be used to deal with potential risks posed by securitisation.

Tool 1: Restriction on maturity/liquidity transformation

The identification of maturity/liquidity transformation as a source of systemic risk seems to us entirely appropriate. We would note though two points, which already appear in our response.

First, most traditional securitisations – and all those that can be awarded a PCS label – are match funded. They to not partake of any maturity/liquidity transformation.

Secondly, as set out in the previous section, we believe this issue is better seen as a general issue that requires an appropriate regulatory oversight and a response that is unified and treats all such identical risks identically (eg MMF's, hedge funds, etc…).

Tool 2: Restriction on eligible collateral

PCS has no comment on this paragraph as we feel it falls outside our remit.

Tool 3: Restrictions on exposures to, or funding from, banks/other financial entities

This section appears to contain three related concepts:

- concern over the negative impact of "originate to distribute";
- concern over potential regulatory arbitrages;
- concern over over-reliance of banking institutions on securitisation.

(i) originate to distribute

PCS agrees that there are deep problems that can arise from the "originate to distribute" model both in the generation of excessive credit creation and in the dilution of underwriting standards.

PCS also notes that the "originate to distribute" model never took hold in any European bank (with the possible exception of Northern Rock in the United Kingdom). We believe this had a very important role in the maintenance across the European continent of high underwriting standards for the classic asset classes for which the PCS label is available (residential mortgages, consumer lending and SME's). This is strongly reflected in the performance of European securitisations backed by these assets. To date, originally AAA rated securitisations in those asset classes have suffered no credit losses whatsoever, five years into the worst economic crisis since the war. Across all tranches of securitisations in those categories, total losses in Europe are running at only 7 basis points.

We believe that the corrosive effect of the "originate to distribute" model is in the way it affects the values and incentives of those tasked by banks with defining and enforcing underwriting criteria. This is why PCS believes the best way to prevent such corrosion is to ensure that banks make a substantial yet limited use securitisation. Securitisation should be one of a number of funding sources for a bank- not only generally but in any of its business lines. If all business lines receive funding from a variety of sources, then no bank officer should be able to identify ex-ante those assets to be securitised and those that remain on the bank's books. When this occurs, lending standards are most likely to be upheld.

This point reflects the considerations that underpin the various “skin in the game”/retention rules that have been enacted or are being discussed. Although PCS is not unsupportive of such specific rules, it also believes that a genuine portfolio approach by banks – rather than a specific retention number- is the most effective approach to overcome the problems of the originate to distribute model.

PCS’ view therefore is that, however powerful a tool securitisation may be, it should always form part of a portfolio of funding techniques for any banking institution. This has the added advantage of generating diversification of funding and making the bank less vulnerable to funding shocks.

However, we also believe that the monitoring of such diversity of funding falls within the existing remit of bank supervisory authorities. We are uncertain that any additional “shadow banking” rules are needed or appropriate.

(ii) regulatory arbitrage

Although no one can support “regulatory arbitrage”, we feel it is important that legitimate risk distribution should not be inadvertently swept up in that definition.

Securitisation, properly conducted, allows risk to be borne directly by capital market investors. To the extent that a bank is able genuinely to remove risk from its balance sheet and yet derives a profit from the activity (the “excess spread”), this can indeed be defined as a type of “arbitrage”. But it is a legitimate activity and should not be stigmatized by the regulations as a negative “regulatory arbitrage”.

PCS is not suggesting that the FSB is seeking in its consultation paper to close down legitimate activities, but we feel the point is worth making as this is a matter that is often prone to confusion.

(iii) over reliance on securitisation

PCS agrees that over-reliance on securitisation should be monitored and discouraged (see our response “originate to distribute”). We are slightly confused, though, by the prescription that over-reliance by banks could be dealt with by restricting the exposure of banks to vehicles. We are not clear whether the FSB is referring to the risk of imperfect credit transfer through devices such as swaps and liquidity facilities, or whether the focus is synthetic CDSs and CDOs.

The example also mentions limits on vehicles’ exposures to banking counterparties (rather than the exposure of the latter to the former which is mentioned earlier). Is the concern for the solvency of vehicles, and the systemic risks which result from their default, in the case of the failure of such banking counterparty? If it is, we would be concerned that such limits should only apply to either systemically important vehicles (eg very large SIVs) or to

systemically important asset classes (eg if 80% of all European RMBS had swaps from the same counterparty). Individual limits on single non-systemically important vehicles (eg an SPV issuing a single securitisation issue) would impose substantial costs on such a vehicle with no concomitant systemic benefit.

As a result, limits at the level of individual vehicles would risk severely constraining any chance of a return of the "sound securitisation activities" welcomed both by the FSB consultation paper and the IOSCO WS4 report. Since the systemic risks can be addressed at the level of asset classes, a vehicle specific limit would not, in our opinion, be consistent with the proportionality principle enunciated in your paragraph 3 ("The framework of policy toolkits").

We are at your disposal, should you have any queries regarding our submission.

Best regards

Yours faithfully

Ian Bell
Head of the PCS Secretariat