PCS Response to the European Commission's Green Paper on Long-Term Funding

July 2013

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EXECUTIVE SUMMARY

Prime Collateralised Securities would like to thank the European Commission for the opportunity to respond to its Green Paper on "Long-Term Financing of the European Economy" dated 25th March 2013 (the "Green 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 of maintaining high standards of quality, transparency, simplicity and liquidity for ABS and thus improve market resilience in Europe and promote real growth.

The key findings from this response are summarized below.

The structure of Europe's economy is such that securitisation must form an important part of the future financing of long-term investment in Europe. The reasons underlying this are:

a) Banks play a fundamental role in financing Europe's economy today due to a combination of legal, cultural and technical inheritance. These drivers will not change in the foreseeable future and as a result banks will continue to play this key role in originating lending to those borrowers who cannot directly access capital markets. This is particularly the case of SMEs.

b) Banks will continue however to experience increasing capital constraints, certainly in the medium term.

c) Institutional investors are much more likely to fund SMEs through securitisations than other direct or indirect means.

However, the securitisation market in Europe is currently stalled by the depth of the recession and the availability of substantial central bank liquidity.

Were these factors to be reversed, however, two further necessary conditions will need to be addressed to ensure the availability of a strong but safe securitisation market in Europe:

a) Calibrating prudential regulation, particularly Basel 3 and Solvency II, to differentiate properly between qualities of securitisation. At present the undifferentiated calibration poses an existential threat to securitisation as a financing channel;

b) Restoring investor confidence.

Both these remaining issues can and should be dealt with by learning the lessons of the crisis. We have the benefit of sufficient distance to be able to analyse clearly what differentiates "high quality securitisation" from others. We also have data that shows how well high quality securitisation has performed. Our response provides an analysis of the qualities of high quality securitisations ("HQS").

Therefore, a prudent and strong regulatory framework can be based on introducing the same definition of HQS in all the diverse regulatory proposals and calibrating the rules for HQS against its actual performance.

Finally, regarding the role of the public sector in supporting long-term finance, securitisation has an important role to play in enabling the official sector to participate in a positive and co-ordinated manner, following principles that we set out in our response.

This is particularly true of SME finance where we set out a possible co-ordinated program of joint public sector and market purchases. Such a program would match European public entities' mandates to securitisation tranches and provide one element of a possible solution to the lack of bank SME funding. It would also help to bring back the open and competitive markets called for by the Commission. For such a program to be successful one must focus on the fact that the banks' SME funding issue is primarily one of capital not funding.

SUMMARY OF OUR RESPONSES TO SPECIFIC QUESTIONS

We have set out the summaries of our response to some of the key questions found in the Green Paper. In our full response you will also find responses to other questions not summarised here.

Summary of our response to Question 3 – The role of banks

In the short to medium term, bank deleveraging will substantially reduce the role of banks as financial intermediaries in the provision of long-term finance. However, if a strong yet prudent securitisation market in Europe can be revived, PCS believes that banks can continue to play the pre-dominant role in channeling long-term finance, through their origination and administration functions to borrowers without access to capital markets, such as SMEs. This is based on securitisation's capacity to separate the origination and administration functions of banks from their role as financial intermediary. This must never lead though to a complete separation which results in a pure "originate-to-distribute" model with its attendant misalignment of incentives.

Longer term, there are good reasons to believe that, although some role will be played by non-bank lenders, it is likely that banks will continue to play a very substantial origination and administration role in channeling long-term finance. Whether they re-acquire a similarly substantial role in financial intermediation depends, to a large extent, on the shape of future regulation. As to this, PCS strongly urges the European Commission to outline a project for the financial architecture of Europe.

Summary of our response to Question 4 – The role of public sector financial entities

National and multilateral development banks (and other public sector funds and entities) are best used to support markets rather than substitute for them. Securitisation can allow them to do so by:

a) maximizing their leverage;

b) allowing them to support markets by setting quality standards;

c) providing a counter-cyclical effect; and

d) by matching different securitisation tranches to different entities' and funds' mandates, through co-operative joint programs.

Summary of our response to Question 6 – The role of institutional investors

Europe is endowed with a high savings rate compared with some other regions. This provides the opportunity for institutional recycling of such savings into long-term investments. However, increased involvement of institutional investors in long-term financing for smaller borrowers such as SMEs would be maximised by investment opportunities that came in the form of liquid instruments benchmarked on internationally recognised standards of disclosure and analysis (minimizing the need for deep knowledge of local idiosyncratic risks). Such investments would also be more capable of drawing funds from outside Europe to fund European growth at a reasonable cost. This is already true of large corporations that can access the international capital markets but more difficult to achieve for mid-caps, SME's and any type of household lending. For such types of long-term investments, securitisation has, in our view, the greatest likelihood of increasing institutional investor involvement. This is especially true if backed by public sector programs such as those suggested in our response to Question 4, an example of which is contained in our response to Question 27.

Such involvement would still be dependent on a restored investor confidence in securitisation. This matter will be dealt with in our response to Question 14.

Summary of our response to Question 14 – The revival of the securitisation market

No revival of the European securitisation market will occur until central bank liquidity begins to ebb. Even when this occurs though, unless a strong revision occurs to the proposed regulatory framework, it is unlikely that any meaningful revival will occur. Such a revision can be done by inserting in all the regulatory proposals the same definition of "high quality securitisation" based on a solid analysis of the crisis and then calibrating the requirements for high quality securitisation on its actual performance rather than the performance of deeply flawed products.

The definition of "high quality securitisation" should be based on the absence of the four elements of weakness in securitisations:

a) pure originate-to-distribute model;

b) leverage;

c) embedded maturity transformation;

d) lack of transparency.

Summary of our response to Question 27 – SME securitisation instrument

PCS would recommend a joint program for purchasing all the tranches of SME securitisations. Each tranche could be purchased by a European institution whose mandate was consistent with the acquisition of this type of risk, leaving the riskiest capital tranches to be purchased (or guaranteed) by grant funds rather than investment funds.

The program would need to provide for:

- a proportion of market purchases to ensure the program assists the recovery of an open and competitive market; and
- some capital relief for originating banks to avoid providing a funding solution to a capital problem, consistent though with retention of "skin in the game".

OUR RESPONSE

The issues raised in the Green Paper are of great urgency for the European economy as it moves into its sixth year of low or negative growth and faces serious questions about the funding of it's return to growth in the coming years. In a recent White Paper published by PCS in February[1], PCS estimated a European funding gap over the next five years of €4 trillion. This gap will result from the deleveraging process that the European banking system will need to go through. At the heart of our White Paper lies the proposition that, given the limitations of bank lending, the funding gap will need to be bridged by the capital markets. Although large corporations can and do access the capital markets directly, neither SMEs nor consumers have this possibility.

In PCS' view, and for reasons set out in our White Paper, securitisation is the only financing channel that is immediately available and sufficiently scalable to provide a meaningful complement to bank funding for these two groups of borrowers. PCS also acknowledges that securitisation retains a mixed reputation because of its role in the onset of the crisis. Any return of a strong securitisation market in Europe must therefore be based on an honest and thorough understanding of what went wrong pre-2007. Armed with such an understanding, it becomes possible to define a concept of high quality securitisation, free of the problems of the past and to create an appropriate regulatory framework that can foster such securitisations whilst preventing a return of dangerous practices. Many of our responses to the Green Paper are based on points that are also articulated in our White Paper.

GENERAL COMMENTS

General comments on the Introduction

As a general matter, PCS wishes to commend the Commission for the analysis of the present state of things, as set out in the Introduction to the Green Paper. Not only do we agree with virtually every statement in the Introduction, but we believe that it captures almost all the salient points relevant to this debate.

In particular, we note the support for financing the European economy through open and competitive markets. This will be particularly pertinent in the PCS response to questions relating to the funding of European SMEs and the possible roles of national and European public sector entities (Questions 4 and 27).

We also would strongly agree with the statement that "it is appropriate to ensure that the detailed calibration of the new regulatory and supervisory framework most effectively enables the financial sector to support the real economy, without jeopardizing financial stability". PCS' approach to securitisation remains that the overwhelming imperative is to create a securitisation market that is systemically stable. We believe that there should be no special pleading for securitisation or any suggestion of a relaxation of appropriate prudential requirements in order to allow more funding to the economy. On the contrary, we believe that it is entirely feasible to create a new securitisation market that operates fully within a strong prudential environment and yet supports the needs of the real economy, and particularly those of the SME sector.

[1] http://pcsmarket.org/wp-content/uploads/2013/03/Europe-in-Transition-Bridging-the-Funding-Gap1.pdf

PCS agrees that for historical, cultural, legal and practical reasons, "banks will continue to be important players in channeling long-term investment". And yet, we also agree with what might appear, at first blush, to be the paradoxical statement that "the diminished role of banks in long-term lending opens up new needs and opportunities for other financial institutions and market-based intermediation channels financing long-term investments". We would contend that securitisation is an ideal financing channel both to leverage the existing role and skills of the banks *and* to bring new sources of investment into the long-term financing of the European economy.

General comments on timing

When looking at the future of long-term investment in Europe, we believe that it is important to separate issues of short to medium duration (those that face us for the next five to eight years) from issues of long duration (beyond the eight year horizon). Europe needs to have two strategies: the first to exit the present crisis and return to a growth path in the face of substantial bank deleveraging, the second to set up a new long-term financial architecture that can sustain growth over the next generation in the face of the structural issues confronting the continent, including an ageing population and the economic emergence of new economies.

Obviously, the two strategies need to be complementary. However, PCS believes that keeping in mind the duality of the strategic challenges is important. Without holding the time component in our minds at all times, we run the double risk of (a) seeking to rely on solutions designed get us out of our short term difficulties but which will actually take many years to put in place and/or (b) neglecting important steps in the creation of the financial architecture for long term prosperity, in our search for an immediate return to growth. By keeping in mind the two time frames, we can also check that the short/medium term strategy does not conflict with Europe's long-term strategy.

Limitations of our response

Finally, we agree with the Commission that the task facing Europe is complex and multi-dimensional. There are, in our view, no simple all-encompassing answers. In view of our mandate, PCS' response to the Green Paper focuses on the issues that surround securitisation. These alone are already complex and multi-dimensional. We have therefore elected only to answer those questions that we felt are relevant to this matter, leaving to more knowledgeable respondents the burden of responding to the other equally important questions. We do not wish, however, to suggest that securitisation alone can resolve the multiplicity of risks and opportunities presented by Europe's current situation. We do believe though, that even if securitisation is not the answer, it must be a part of the answer.

RESPONSE TO SPECIFIC QUESTIONS

Q3: Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channeling of financing to long-term investments?

Looking at the role of banks in the channeling of long-term finance, PCS believes it is most important to keep in mind two dichotomies:

- first, the distinction between the role of banks as originators and administrators of loans and banks as financial intermediaries;
- secondly, the distinction between the short to medium-term and the long-term, as outlined in our General Comments section above.

3.1 Banks as originator/administrator or financial intermediary

In a traditional banking model, banks perform a number of distinct roles. Although there are a number of ways to separate these roles into different categories, the categorisation that is most useful when looking at the possible future of long-term financing in Europe is the division of bank functions between financial intermediation and origination/administration.

The financial intermediation function of banks consists in borrowing funds from economic actors that do not presently need them and lending them to actors who have a current funding need. It is the practice of taking deposits from both retail and wholesale customers (including the raising of money through unsecured and covered bonds) and lending these funds to borrowers. As most depositors want immediate or quasi-immediate access to their cash but borrowers are not prepared only to borrow under "on-demand" facilities, the banks' financial intermediation role involves a substantial element of maturity transformation. The risks of losses from borrowers failing to pay require the banks to hold capital. The risks of depositors withdrawing their cash before borrowers are required to repay require the bank to have sound liquidity management.

The origination/administration function of banks involves the machinery through which:

a) potential borrowers are identified (front office functions, marketing, bank branches);

b) potential borrowers' credit worthiness is assessed (credit underwriting);

c) funds are advanced and interest and repayments collected (loan administration);

d) delinquent borrowers are pursued (loan recovery).

In PCS' view, the role of the banking sector in originating and administering long-term investments, especially for SMEs, will continue to be preponderant. There are a number of reasons for this:

a) *Costs*: Origination and administration requires a substantial infrastructure. It requires buildings, IT, systems, staff, etc… For the banking sector this infrastructure exists and is a sunk cost. For any non-bank entrant to build such infrastructure will take time and money. Some new entrants will do so, but we are uncertain that sufficient numbers will be willing to do so substantially to change the long-term finance landscape for borrowers that are not large corporations.

b) *Legal issues*: In some countries such as the United Kingdom, lending is not subject to bank regulation (only "deposit taking" is). But in many European countries such as France, only banks are allowed to advance money outside the capital markets. Therefore, without substantial changes in law in many European countries, it is difficult to envisage banks being replaced in the origination/administration function.

c) *Proximity:* Consumer and SME lending requires local knowledge, which banks (and to a large extent, banks only), with their branch network and long established credit cultures, possess. The existence of the internet has, of course, reduced the importance of being physically proximate to potential borrowers through branch networks. However, PCS would question the wisdom in encouraging a massive extension of "automated lending".

For these reasons PCS believes that, although large corporations with access to capital markets may well circumvent the banks altogether, for mortgage borrowers, consumers and SMEs, banks will remain, at least in the short to medium term, the preponderant providers of long-term finance.

In the long-term, it is possible that the factors mentioned above are overcome by new economic players making use of new loan origination channels such as the internet. One hears about B-2-B lending, supply chain finance, crowd funding and other developments. Without seeking to downplay the long-term potential for such channels, PCS remains skeptical of their likely impact for three reasons:

- PCS agrees with the Financial Stability Forum's approach, in its "shadow banking" work, that entities fulfilling the same functions as banks and subject to the same risks as banks should, for systemic stability reasons, be subject to similar regulatory and legal constraints as banks. Therefore, if new entrants are seeking to replace banks whose roles have shrunk because of such constraints, at what point do they become "banks" and become subject to the same constraints that led banks to scale down their presence in the relevant market in the first place?

- Most potential new lenders are likely to have constraints in their skill sets and approaches that will make it difficult for them to step into the role of banks – these constraints are set out more fully in our response to Question 6.

- Banks can also use household and SME deposits to fund household and SME loans and can further often cross-subsidise their household or SME lending from additional sources of income from the borrowers (eg account charges or F/X transactions). New entities will not have access to these sources of additional funds or revenue, making it more difficult for them to compete with existing bank lenders.

However, securitisation does allow the separation between a bank's origination and administration function and its financial intermediation function.[2] A bank that securitises its loans basically passes on the funding and (partly) capital aspect of its lending to market investors who will finance the loans originated by the bank. The bank continues, in most cases, to administer the loans. Because most of the credit risk passes to the securitisation investor, securitisation can legitimately ease a bank's capital requirements. Because, in high quality securitisation, the maturity transformation element of banking is eliminated, securitisation also extinguishes the liquidity risk in

[2] PCS acknowledges that, because of the dangers inherent in a pure originate-to-distribute model, such separation cannot be absolute. A securitising bank must retain some financial intermediation risk.

respect of the securitised loans.

3.2 Short/Medium Term vs Long Term Perspectives

3.2.1 Short Term - Bank deleveraging

In the next five years, the process of bank deleveraging will mean that the role of banks in financing long-term investments from their balance sheet in the traditional way will shrink substantially.

According to the IMF, deleveraging of European banks will be around 7% of their balance sheet – namely, US$2.6 trillion (as a base case with a top range of US$3.8 trillion)[3]. This number is confirmed by the banks surveyed by Deloitte[4], which estimated a decrease of just under 7.5% - equivalent to €2 trillion. Considering the very substantial increase in the size of banks' balance sheet since 2001 and the depth of the crisis, a 7% deleveraging appears to be very optimistic. As losses eat into existing bank capital, the final deleveraging could be meaningfully greater.

Another aspect of this process that is worth paying attention to is timing. Almost three quarters of the banks in the Deloittes' survey (71%) anticipated that the deleveraging would take five years or more from 2012.

In addition to the shrinking of their balance sheet, further amounts will be withdrawn by the banks from their financing of long-term investment through the operation of the new liquidity cover ratios (LCRs) introduced in the Basel 3 capital accord. In their 2012 report, the EBA calculated that the amount of high quality assets that would have to be set aside by European banks to meet the liquidity requirements of the LCR stood at €1.17 trillion[5]. This was not the total amount of LCR buffers mandated by Basel III but the *additional* amounts that still needed to be set aside[6]. Under the Basel III LCR rules, 60% of the LCR buffers need to be composed of what are known as "Level 1 assets" – namely, cash with the central bank or public sector, sovereign or quasi-sovereign debt. In other words, even on a conservative estimate, the LCR's will require banks to freeze another €600 billion. In the words of the EBA's Bank Stakeholder's Group, "the LCR would have the effect of crowding out productive investments and sterilize [sic] €1 trillion of liquidity out of the real European economy"[7].

Even using conservative figures, the addition of a €2 trillion deleveraging and €600 billion LCR "strerilisation" leaves Europe with over €2.5 trillion less in bank funding.

Furthermore, we must bear in mind that the longer the European economic crisis endures, the more losses will erode bank capital and profit contractions will reduce the amounts available to rebuild this capital from internal sources. This could easily widen further the finance gap by putting additional pressure on banks to deleverage, creating a dangerous negative feedback loop.

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[3] See "Global Financial Stability Report", International Monetary Fund, October 2012 (http://www.imf.org/external/pubs/ft/gfsr/2012/02/pdf/text.pdf)

[4] See "Capital gain, asset loss –European bank deleveraging", Deloitte Bank Survey 2012 (www.deloitte.com)

[5] See "Results of the Basel III monitoring exercise based on data as of 31.12.2011", EBA, September 2012 (http://eba.europa.eu/cebs/media/publications/other%20publications/qis/eba-bs-2012-xxx--public-isg-report-basel-iii-monitoring-.pdf). .

[6] In the new rules regarding the LCR and published in January 2013, some technical changes were introduced to certain assumptions, such as run off rates. These changes will result in a smaller number for the missing LCR requirements, but are not likely dramatically to alter the outcome.

[7] See "New Bank Liquidity Rules: Dangers Ahead", a position paper by EBA's Banking Stakeholder Group, October 2012 (http://www.eba.europa.eu/Aboutus/Organisation/Banking-Stakeholder-Group.aspx).

The suggested alternative to such deleveraging, namely that banks raise capital to repair their balance sheets so as to maintain funding levels to the European economy, does not appear realistic. Not only do the banks need to replace capital lost to the crisis, but they also need to add additional capital required by the new rules contained in CRD 4.

Clearly, European banks will (and have begun) to raise additional capital. Some of this will be in the form of profit retention and some will need to be in the form of new equity issuance (including potentially the new forms of contingent equity). However, such potential issuance is running into considerable head-winds. There are good reasons to believe that traditional equity raising by banks could be diminished for a generation:

a) *dilution:* since the amounts of capital that would be required to be raised are highly dilutive, it is going to meet with strong existing shareholder resistance.

b) *uncertainty:* the markets remain uncertain as to the future health of banks and the state of the economy. Are all the banking problems really behind us? Realistically, banks' problems will not be over until the European economy exits recession and the banks *recapitalize*. But the economy will not improve and the banks will not be able to recapitalize until their problems are surmounted. This is a "chicken and egg" situation.

c) *business model:* In 2007, global average ROE for banks was 13.6 per cent. In 2011, it had fallen to 7.6 per cent. The European situation is even more dramatic. Whereas US banks had an average ROE of 7 per cent in 2011, the ROE of European banks was zero. Even if one attributes much of that fall to the serious banking and economic crisis of some peripheral countries, ROE in 2011 for European banks excluding the peripherals (Greece, Italy, Ireland, Portugal and Spain) only averaged 5 per cent. [8] This is substantially below the present cost of capital for banking institutions. But even after the present crisis has abated, we know that bank returns are extremely unlikely to return to their pre-crisis levels. This is the result of the requirements for more capital (and liquidity buffers), the prohibition for banks to undertake some of the riskier trading activities in which they indulged before 2008, the possible separation of retail banks from investment banks and a likely very low interest environment. The latter is particularly meaningful if banks' profits need to shift from fee generation and trading profits to a more traditional banking model of borrowing and lending. Yet, although a significant decline in ROE is inevitable, it remains very unclear how steep such decline will be in the medium to long term. This makes buying bank stock a very uncertain proposition.

d) *no more "too big to fail":* following the crisis, one of the clearly expressed desires of policy makers the world over is the need to move away from the "too big to fail" trap where bank profits in good times are privatised but bank losses are socialised. Of course, it can be argued that bank equity is always at risk even in a rescued financial institution. Nevertheless, in the "too big to fail" era, banks benefited from many forms of support from governments and regulators who knew that, if a difficult situation was not brought under control soon, a costly rescue would be the ultimate outcome. In the new era of greater willingness to see banks fail, how much less governmental and institutional support can even equity holders expect? Again, uncertainty makes buying new bank capital issues a difficult proposition today and for the next few years.

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8 See "The Triple Transformation – achieving a sustainable business model", 2nd McKinsey Annual Review on the Banking Industry, October 2012 (www.mckinsey.com)

So the short to medium-term prospect is for a substantial reduction of the role of banks in channeling long-term finance in their financial intermediary capacity.

3.2.2 Long Term – Lack of Project and Uncertainty

In the long-term, the role of banks in channeling long-term funding will be determined by the future shape of the banking industry once Europe emerges from both the present crisis and the present round of regulatory changes.

Whether European banks return to the role of predominant provider of finance both in an origination and financial intermediary sense or whether other capital market investors carve out a more substantial role in this areas , will turn not just on the constraints that regulations and regulators place on banks but those they place on other potential capital market participants (such as insurance companies).

The primary reason we find it difficult to speculate usefully on this matter is that PCS believes that, although policy makers at a national, European and global level have indicated clearly their intention to take measures to prevent a repetition of the events of 2007-2008, it remains difficult to discern a long-term vision of the role that policy makers see for banks going forward. In the absence of a long-term project or blue print for a European financial architecture for the coming century, the future place of banks in the financial system remains obscure to us.

Therefore, PCS would urge the European Commission, upon completion of the work set out in the Green Paper, to provide a clearer blue print of the desired future European financial architecture. We believe this would assist policy makers and regulators to design rules that provided for a prosperous and stable economic outcome. It would also lessen the risk, which we believe to be currently very high, that the rules being designed could work at cross-purposes and even cancel each other out. Finally, this would provide a benchmark for assessing the various aspects of regulatory proposals: to what extent do the proposals bring us closer to the realization of the European financial project?

Q4: How could the role of national and multilateral development banks best support the financing of long-term investment? Is there scope for greater coordination between these banks in the pursuit of EU policy goals? How could financial instruments under the EU budget better support the financing of long-term investment in sustainable growth?

In our response to Question 27, dealing with securitisation for SMEs, we set out a proposal that PCS believes provides the way in which a coordinated approach by national and multilateral development banks and other public sector entities could work to push forward the Commission's agenda on generating robust long-term finance for growth.

In this section, we would like to deal with certain key principles we believe could guide the activities of such entities; principles which then find illustration in our SME securitisation proposal.

4.1 Limitations and risks

In our White Paper, we indicate that Europe faces a €4 trillion finance gap in the coming five years. Clearly, not all this gap relates to long-term finance. Nevertheless, even in the long-term finance area, and subtracting that part of the finance gap that can be financed relatively easily by capital market participants within existing structures (basically, large corporate funding), it is clear that the amounts that are required to replace missing bank funding are extremely large.

At the same time, most European national budgets and the European Union's budget are facing fiscal consolidation and will do so for a number of years.

Therefore, it is clear that the Commission and other European public sector entities (including the national and multinational development banks) should not primarily seek to focus on solutions that replace the markets, euro for euro. Although, in certain specific and cases, such market substitution solutions can play a role, globally it is clear that they cannot deliver sufficient resources to the European economy. We note that the formulation of the Commission's question refers to national and multilateral institutions "supporting" the financing of long-term investment and fully agree with this view.

The traditional tools of public sector entities in the financing sphere are guarantees, direct funding (of SMEs or infrastructure projects) or indirect funding (through the purchase of securitisations or project bonds issued by the original funders). In each case, issues of skill sets and moral hazards must be balanced. On the one hand, does the public sector entity have the skill set to underwrite the credit risk it is taking? As we have mentioned in the context of institutional investors some forms of lending (such as SMEs) require a large amount of direct local knowledge. On the other hand, if the public sector entity "delegates" the credit underwriting to a third party such as a bank, how does it deal with the moral hazard such delegation entails? This was the problem that emerged in US securitisation in the context of pure "originate-to-distribute" models.

This is also where the use of high quality securitisations that, amongst other aspects, do not proceed from "originate-to-distribute" business models and have appropriate retention rules allows for a bridging of the local knowledge/moral hazard gap.

4.2 Possible guiding principles

4.2.1 Supporting markets

For the capacity reasons set out above, we believe that solutions should be sought that support existing markets or create new markets for investors, rather than rely entirely on public funding or public guarantees. Reliance on the later, especially in respect of senior securitisation issues, can also create problems of "cannibalisation" in that the guaranteed obligations tend to provide market investors with a debt instrument that represents public sector risk but with a slightly higher interest rate to reflect the added complexity of the guarantee. As such, these guaranteed obligations can crowd out the relevant public entity's traditional funding. This, in turn, can result in an increase in that entity's cost of funds.

In the context of securitisations, a market supporting solution can mean purchases of, or repo facilities for, securitisation issues but with the relevant public sector entities also engaging in some trading. This means that national or multilateral bank can assist in the creation and sustenance of a market, rather than becoming the sole, buy-and-hold investor. It can also mean, alternatively, the creation of a new market for high quality public sector backed or guaranteed bonds purchased by private sector institutional investors. (However, such solutions need to be aware of the cannibalisation risk).

4.2.2 Creating leverage

Since the available resources from the public sector will not be sufficient to substitute for the market for long-term financing, we believe that solutions that create a leverage effect should be favoured. By this we mean solutions where the financing of a euro by a public sector entity is the pre-condition but also the enabler for the financing of multiple euros by the markets.

In the context of securitisation, this can take place through the purchase of the more difficult to place riskier junior tranches. As we will set out below, in our response to Question 6, many institutional investors are very risk averse. As we have set out above in our response to Question 3, lack of financing by banks is, in large part, because of capital concerns. If institutional investors are ready to lend to the least risky part of long-term finance (for either SMEs or infrastructure) but banks are not ready to originate such financing because they are worried about absorbing the most risky part, public sector entities can step in to invest in that risky part. This will then enable the larger but more risk averse institutional investors to step in and invest in the less risky but much larger part. This creates leverage and multiplies the effect of available public sector funds.

4.2.3 Setting standards

One of the effects of the crisis, particularly in securitisation, is that some institutional investors are concerned about the robustness of some fixed income markets and have become even more risk averse, turning away entirely from whole types of financing.

One role that national and multilateral development banks can play is in providing solutions that support markets but are also explicitly based on clear and transparent standards. Compliance by market participants, such as banks, with these clear standards would be a precondition for the involvement of the public sector entity or entities. By such actions, the public sector entities would substantially increase the likelihood of a return by institutional investors to a market with a strong and clear framework. This would additionally provide greater systemic stability for the future long-term finance architecture in Europe.

In the context of securitisation, these standards could be set by providing solutions based on various not-for-profit industry initiatives such as the PCS quality label or the European Data Warehouse's disclosure standards, as well as the development of European wide standardized information sets such as are being investigated at the behest of the European Investment Bank.

4.2.4 Providing counter-cyclical balance

As witnessed by the present large scale bank deleveraging, finance markets are pro-cyclical. Ways of dampening such pro-cyclicality are clearly positive. Therefore, we believe that solutions that achieve this are to be favoured. Solutions should involve national and multilateral banks acting within and in parallel to capital markets and being able to increase or decrease their participation in line with the economic cycle. This could help maintain a more level quantity of long-term finance flowing to borrowers throughout the cycle.

In the context of securitisation, the solutions mentioned above and, in the case of SMEs, elaborated in our response to Question 27, can provide for such counter-cyclicality. Effectively, the suggested program (and similar types of programs for other asset classes) works by sharing the purchase of securitisations with institutional investors. In good times the public sector role can be small as private sector players are happy to absorb most of the high quality securitisations. When the economic cycle suffers a downturn, the public sector's proportion of purchases can ramp up to replace some (or all) of the withdrawn private sector funding. This could smooth out the peaks and thoughs of SME (or infrastructure) lending volumes and dampen cyclicality.

4.2.5 Co-operation through "credit tranching"

One of the fundamental aspects of securitisation is the notion of "credit tranching" where a pool of loans is horizontally divided into senior, mezzanine and junior tranches and where losses suffered on the loans in the pool are first suffered by the junior tranche investors, then the mezzanine tranche investors and, only in cases of catastrophic losses, by the senior note investors[9].

This tranching allows for a pool of loans to be financed by investors with different risk/return appetites (since the lower tranches obviously pay higher interest). However, this tranching can also reflect the different institutional roles of various public sector entities in Europe. This is why securitisation is an ideal financing technique to promote co-operation between European institutions.

Within the European Union there exist various public sector financial entities as well as various publicly funded financial programs. These have a diversity of mandates that determine the amount of risk that they are entitled to absorb. For example, the European Central Bank and, to a large extent, the European Investment Bank are financing entities that should invest in very safe assets. They are not set up as "risk takers". At the other end of the spectrum you have European Structural and Investment Funds (ESIFs) that are grants. In other words cash that is designed to be spent to achieve a positive overall economic or societal result rather than invested to achieve a financial return.

Securitisation, by credit tranching, can finance long-term investments through separate tranches reflecting the mandate and purposes of the various European public sector entities or a blend of public sector and private sector entities.

Securitisation can therefore allow for a "matching" of a public sector entity's or fund's credit mandate with a given tranche (senior, mezzanine or junior). As such it allows the setting up of joint programs where the totality of an investment (in SMEs or infrastructure) can be funded by co-operating public sector entities. Each entity can fund that part of the securitisation that reflects its particular mandate. Such joint programs allow non-risk taking entities to become involved in the finance of long-term investments where the bulk of the risk is taken by other risk taking entities. It also allows risk taking entities to maximize the leverage effect of making such long-term investment since they only need to invest in the smaller higher risk tranches. This, in turn, allows them to invest in more projects.

[9] Although the terms senior/mezzanine/junior are traditional, there are no *a priori* requirements for how many tranches are in a securitisation. You can have securitisations with only two tranches, others with a dozen. There is a lexicographical debate over whether it is possible to have a single tranche (or "untranched") securitisation. In PCS' view, such a product is a "repackaging" and not a "securitisation". In truth though nothing meaningful turns on this debate.

Q6: To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?

6.1 Limited institutional investor involvement in Europe

Traditionally, Europe has had a much greater reliance on banks to fund its economy. For example, the ratios of securitised loans and corporate bonds to total financing volumes in Europe in 2011 was 19 per cent, compared to 64 per cent in the United States[10]. This has led many commentators to suggest that, in the face of clear bank deleveraging in Europe, institutional investors could be expected to step into the breach and fill the looming finance gap. PCS agrees that institutional investors can and should play a greater role in long-term financing.

6.2 Some characteristics of institutional investors

However, in order to assist institutional investors to play this greater role and, to some extent, substitute for the banks it is important to understand some key aspects of most institutional financing and how it differs from banking practices.

6.2.1 Risk appetite

Most capital market participants have a high risk aversion. Of course, all lending involves an element of risk, however minute. But there is a strong difference between a "zero loss tolerance" mindset which is typical of the majority of debt capital market investors and a "base case loss" mindset which is found in banks that lend to smaller, granular borrower groups. Most capital market players such as insurance companies, pension funds and most retail funds have credit departments whose jobs it is to select investments that will not suffer default. Obviously, they are not always successful. But crucially, it is not their task to calculate how much they expect to lose on any given portfolio under various stress scenarios[11]. This is precisely what bank credit and underwriting departments do. Of course, no bank lends to any particular SME believing it will default and every credit officer underwrites each loan in the earnest belief that this particular individual borrower - whether borrowing for a car loan, a house purchase or SME working capital - will repay in full. But each bank knows that, even in a very benign economic environment, statistically, some loans will go bad. For some asset classes, such as credit cards, the whole science of lending is accurately to calculate the overall loss on the book.

For capital market investors to lend directly to SME's or other types of long-term projects would require them to accept losses in unpredictable quanta as a normal part of their business. This is equally true of the purchase of pools of SME loans from banks. This would represent a very substantial cultural shift. It remains unclear that investors have, globally as a class, either the incentive, capability or the inclination to make such a shift.

It is often said that, in the markets, everything is merely a matter of price and that there is always a price at which you can sell anything. Even in theory, this is not always correct. But in the case we are examining, we are looking at a deep

[10] See McKinsey Annual Review – already cited

[11] There are, of course, some capital market participants who do not operate on this "zero loss tolerance" mindset, such as private equity firms, venture capital firms and a number of hedge funds. However, they represent a very small part of the overall available investment potential in the global debt capital markets.

cultural shift that, if it occurred, would take many debt capital market participants into areas and ways of thinking where they have so far felt very uncomfortable. The additional price that would have to be offered to trigger this cultural shift in a large number of investors is very likely to be much greater than would be suggested by simply looking at the spread that debt capital market investors, who are already culturally comfortable with this type of risk, are willing to accept. In other words, just because a hedge fund is willing to invest in a pool of SME loans at X per cent over LIBOR does not mean that one can induce conservative insurance companies and pension funds to invest at anywhere near the same return. It is not at all clear that a price could be set at any vaguely reasonable level that would both bring meaningful numbers of traditional debt capital market investors to direct lending and be acceptable to mid-caps, SMEs and projects seeking to borrow.

Even if a large base of capital market investors could be found who were willing to make this cultural leap, they would have to invest in a new credit infrastructure. They would have to hire new teams of analysts. They would also have to re-calibrate a large part of their business model to account for the new environment of inevitable yet fluctuating losses. Experiences over the years with such transitions, such as industrial corporations owning "in-house" banks, suggest that these cultural shifts are difficult and not always successful. Also, being new ventures by otherwise long established players, when the economic cycle reverses itself and lending made in good times turn into unexpected losses, there is a substantial risk that the venture is seen as a failure and the player withdraws from the activity.

Although the direct lending by established capital market investors to SMEs should not be discouraged and may yet come to play an important role, nevertheless such a development is culturally difficult, its size highly uncertain and its resilience in the face of the economic cycle unproven.

Financial channels that allowed debt capital market investors to invest whilst maintaining their existing culture of "zero loss tolerance" would have the best chances of mobilizing substantial funds for the real economy in the shortest time.

6.2.2 Infrastructural costs

As mentioned above in the context of banks' origination and administration role, lending in small amounts to a larger number of borrowers requires a technological and human infrastructure to identify borrowers, filter them, receive their applications, do the credit underwriting and advance the funds. It requires a further infrastructure to collect data on borrower performance, identify delinquencies and recover unpaid amounts.

On the credit underwriting front, the internet has lowered the cost of this infrastructure to some extent. But we would also query, bearing in mind the poor results of some model driven lending practices, whether we should be encouraging even more distance - geographical and economic - between borrowers and lenders. Also, especially in SME lending, model driven lending needs to be very conservative in its assumptions as it is easily "gamed" once the model parameters are known. A conservative model could well limit access to funding for otherwise good SME credits.

Such a lending and collection infrastructure (with its attendant information gathering processes) is costly and is only likely to pay dividends if there are economies of scale.

Most capital market investors willing to lend to SME's and consumers will therefore most likely seek to delegate the lending and collecting infrastructure to other specialist institutions. However there already are such institutions available: banks. This type of delegation is precisely what already occurs with securitisation and was referred to earlier in our response, in the context of the separation that securitisation allows between the origination/administration role of banks and their financial intermediation role.

6.2.3 Liquidity

Most established capital market investors value liquidity: the capacity to sell easily their assets if their views or strategy change. For some capital market investors such as fund managers who provide their investors the capacity to withdraw their investment at relatively short notice, liquidity is essential. In bad or uncertain times, for these managers to invest in non-liquid assets is courting insolvency. This desire for liquid assets is not in contradiction with being a long-term investor. An insurance company may well wish and intend to be a long-term investor. But it will still want the option to sell its position. The longer term the investment, the greater the need to know you can sell it since, as the time horizon stretches out, the more uncertain the outcome. To lend directly long-term to mortgage borrowers or mid-caps and SMEs without a relatively easy exit is, of course, possible. This is true even for the longer term lending that mid-caps and SMEs have indicated they wish to have. But again, it would require a very substantial cultural change for which it is not clear we can see the incentive or the inclination in most existing capital market players.

Undoubtedly, a price could be set at which such change would become a compelling proposition for even the most culturally conservative capital market investor. However, the rise in interest rates charged to the ultimate borrower is likely to be very substantial. It is doubtful that such "liquidity premium" could even be met by most SMEs.
Again, financial channels that used tradable and traded instruments would have an advantage over those that did not in mobilizing institutional investor funds for long-term finance.

6.2.4 Global reach

The last few decades have seen substantial imbalances in global financial flows, resulting in large part from current account imbalances between the developed economies and the emerging economies. In addition, as we have seen, the United States has a substantial pool of capital outside the banking system that seeks capital market opportunities. When funding long-term growth, Europe should seek to the greatest extent possible, consistent with long term strategic safety, to have access to these extra-European sources of funds.

Cross-border lending by risk averse capital market participants operates through global and recognised benchmarking tools: global scale CRA ratings, internationally recognised accounting standards, internationally understood disclosure standards (whether for debt or equity). Such internationally recognised benchmarks help capital market investors to compare potential investments across markets. They also lessen (or are meant to lessen) the need for specific, idiosyncratic and local knowledge. If you invest in a senior AAA rated publicly quoted securitisation bond backed by SME loans from a European nation, you need to understand the relevant CRA's criteria for SME securitisations and focus on “tail risk”. You should be able to rely on the international nature of those criteria to compare them to other opportunities for investment and rely on the recognised disclosure standards to do your own credit analysis. But if you are investing directly in the same pool of SME loans – either through direct lending or through loan purchases – you need to have a much greater understanding of the specific local situation so as to calculate your base case loss, your downside loss and any idiosyncratic risks created by the underwriting process. Without this you cannot assess the value of your investment. To obtain such understanding you need to have extensive local knowledge that must be obtained - as a non-European investor - from the kind of investment in skills that can only be justified if you are thinking of committing funds in the billions of Euros.

6.3 Conclusion

To conclude, much greater involvement of institutional investors in long-term finance for sectors that do not already have direct access to them is possible and to be encouraged. But it is more likely to be successful if the means to provide such greater involvement take into account the characteristics of the majority of institutional investors including risk aversion, a desire for liquidity and a desire for global benchmarks of quality and disclosure.

This does not suggest that greater direct involvement by institutional investors cannot be achieved outside of the medium of securitisation. Indeed PCS is well aware that some direct lending schemes to SMEs (often as joint-ventures with banks) have already been set up by institutional investors.

However, on a large enough scale, such involvement would require deep changes that will likely play out over the longer horizons. This is where PCS believes that it is most crucial to bear in mind the distinction between the short to medium term solutions and the longer term aspirations. PCS would certainly encourage longer term changes to institutional investor behaviour and the creation of tools that could assist with this change but is also aware that, in our view, these are not solutions to pull Europe out of its present predicament.

Q7: How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?

PCS, as stated in our introduction, strongly believes that prudential objectives must be paramount in the design and implementation of rules for insurers, reinsurers and pension funds. However, prudential rules must also be grounded in an objective measurement of the facts. We set out in our response to Question 14 how we believe strong prudential rules for insurers, re-insurers and pension funds are compatible with a strong securitisation market.

Q10: Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?

PCS is grateful that the Commission has asked this question, as we believe the cumulative impact of planned and proposed prudential reforms of the treatment of securitisation poses an existential threat to the continuation of the market. Since we have put forward in our White Paper the view that, without a revived securitisation market in Europe, we cannot see any meaningful hope of a substantial bridging of the funding gap that is yawning for SMEs and consumers (including mortgage borrowers who contribute to long-term capital creation), a threat to the survival of the securitisation market is extremely significant for the level of aggregate long-term investment.

Securitisation can provide a funding source for banks that provides capital relief. As such it potentially can allow banks to continue lending even if they have capital constraints of the type that usually accompany an economic downturn. Therefore PCS views a strong secutisation market as having the capability to contribute to counter-cyclicality. It follows that a threat to the continued existence of the securitisation market is also significant for the cyclicality of aggregate long-term investment. (We would not want to overstate the impact of securitisation on cyclicality as institutional investors who purchase securitisations also partake of a pro-cyclical mindset and so securitisation can ameliorate cyclical swings but should not be treated as a remedy for them).

The possible private sector investors in European securitisations are as follows:

a) European banks;

b) European insurance companies;

c) European pension funds;

d) European asset management funds;

e) Non-European investors (banks, sovereign wealth funds, funds…).

The current Basel 3 proposals for capital requirements for banks holding securitisations and the current definition of “highly liquid assets” that can be part of the new Liquidity Cover Ratio would make it extremely unattractive for any European bank to purchase a securitisation.

The current Solvency II proposal for capital requirements for insurance companies holding securitisations would make it near impossible for any European insurer to buy a securitisation on economic grounds.

The current proposal under the Shadow Banking work that would prohibit money market funds from investing in securitisations closes yet another source of investment in securitisations backing European long-term finance.

There is talk of extending the insurance capital requirement to European pension funds and the banking requirements to European hedge funds.

Additional proposals, in rule making nominally tangential to securitisation would further substantially constrain the hope of a market revival. Examples would include the proposals regarding swap collateral postings under EMIR, the new proposals from the EBA on the treatment on securitisations under the large exposure regime or the uncertainties around the due diligence requirements flowing out of the AIFMD.

We are aware that advocacy groups such as the Association of Financial Markets in Europe (AFME) have produced long and comprehensive lists of these regulatory proposals and we have no desire to duplicate their work in this respect. The length of the list though is compelling.

The cumulative impact of these measures is to leave only non-European investors as possible providers of funding for securitisations. This would most likely result not only in a much smaller securitisation market than that which could exist otherwise but in a dangerous reliance on non-European funding for some key finance sectors. Although PCS welcomes non-European funding, it does not believe that a position should develop where large segments of finance are effectively reliant solely on such non-European funds. We know that, without local knowledge and implantation, non-resident funds can be withdrawn very suddenly as sentiment changes. This creates systemic instability.

It is also worth addressing the issue of banks as investors in securitisations funding long-term finance. We have heard some commentators put forward the proposition that Europe should be seeking ways to circumvent the effect of bank deleveraging and permanently increase the part of its long-term funding that is derived from the capital markets. In that optic, it is questioned whether restrictions on banks' purchases of securitisations should not be welcomed. The argument that securitisation allows for diversification of funding away from the banking system is not harmed, goes the argument, by limiting bank purchases. PCS does not agree with this argument for two reasons:

a) First, the argument ignores the way markets operate and the importance non-bank investors give to liquidity. If banks, through the operation of regulatory restrictions, cannot purchase securitisations, then potential liquidity is removed from the market. Bank participation in the securitisation market is like oil that smooths that market's operation. Anecdotally, when PCS enquired of a large European pension fund whether it cared at all about the proposed regulations since none so far were directed at pension funds, we received the clear reply that if banks and insurance companies could no longer be in the market, the draining of liquidity that this would produce would lead this very large pension fund to withdraw altogether from holding securitisations.

b) Secondly, securitisation is not only able to move risk away from the banking system as a whole and find funding from non-bank capital market sources, but it can also channel funding from banks across borders from where there are surplus funds or bank capital to where the banking system is deleveraging more severely and bank capital is disappearing. When we consider the current breakdown of cross-border banking flows in Europe, securitisations, if they can be purchased by banks, can powerfully assist in re-establishing these flows.

For these reasons, PCS believes that European bank participation in the securitisation of long-term financial assets is a positive component of the European financial system.

PCS' response as to how this cumulative impact can be addressed is set out in our response to Question 14.

Q14: How could the securitisation market in the EU be revived in order to achieve the right balance between financial stability and the need to improve maturity transformation by the financial system?

14.1 What is preventing the revival of the securitisation market in Europe?

Whereas the securitisation market in the United States is showing robust growth – with the possible exception of the residential mortgage market where the federally backed housing agencies have crowded out the traditional market – the market in Europe is anemic to the point of being comatose (see Appendix 1). So far in 2013, issuance placed with real investors (rather than used by the originating bank as collateral for central bank repo operations) stands at €20 billion.

When looking at the lack of securitisation in Europe though, it is important to distinguish between the proximate current causes of its weakness and the factors that will prevent its future growth should those proximate causes cease.

14.1.1 Central bank liquidity, capital constraints and economic recession

The proximate causes of the lack of securitisation in Europe are the depth of the recession and the availability of cheap funding from central banks.

Because of the depth of the recession many potential borrowers are reluctant to borrow because of fears about the future. Amongst those who wish to borrow, banks find few borrowers to which they are prepared to lend as they are concerned about the creditworthiness of these potential borrowers.

Also, as banks are concerned about their capital ratios, they are inclined to shrink their balance sheet. If they are prepared to increase it a little, they are also inclined to lend only to the least risky borrowers as they are particularly sensitive to the possibility of a future erosion of capital resulting from borrower defaults.

So, with few new assets to securitise, funding requirements of banks are low.

Then, to the extent that banks do need funding, this funding is presently provided at very low cost and in seemingly infinite quantities by central banks. PCS has heard many times of advocates of securitisation within banks across Europe being told by the bank's treasury that it was not prepared to fund the bank through a comparatively expensive finance channel such as securitisation when it can get much cheaper funds from the central bank facilities.

PCS entirely accepts that the liquidity measures of the central banks were absolutely necessary to rescue the banking system and the European economy. The examples of the fiscal retrenchment in the United States in 1929-1930 or under Brüning in Germany in 1932 are warnings enough. We must all be grateful for the decisive actions of the European central banks in this regard. However, at some stage, Europe must return to some form of normal funding mechanism for banks. Until this occurs, the securitisation market will not return. PCS understands that this is a very difficult decision for policy makers and would anticipate a gradual disengagement, which always retains the option of future re-engagement if necessary.

Once central bank liquidity recedes and conditions of economic growth re-appear though, the return of a strong yet safe securitisation market in Europe will still depend on two key factors being in place.

14.1.2 Regulatory framework and investor confidence

Once banks have reason again to securitise, they will only be able to do so if the regulatory framework allows investors to purchase securitisations. The issue of whether investors are willing to purchase – ie investor confidence – is an important but second order question since, without the appropriate regulatory framework, it is irrelevant.

14.2 Getting the regulations right to revive securitisation prudently

As we mentioned in our response to Question 10, a host of proposed regulatory changes, primarily but not exclusively, under CRD4 (through new Basel 3 proposals) and Solvency II, are threatening any chance of a return of a strong and safe securitisation market in Europe.

14.2.1 Overall approach

It is the view of PCS that, although partaking of very different technical designs, all the proposed regulations suffer from the same fundamental error when it comes to securitisation. We also believe that this error can be corrected in the same manner for almost all the proposed regulatory rules. We do not wish to underplay the subsequent complexities involved in working out the exact and numerical consequences of this correction. But there is a simple principled approach to reaching a strong yet reasonable securitisation prudential framework for securitisation.

Prudential regulators proceed by defining the asset class or activity they are required to regulate and then selecting the worse performing part of that asset class or activity, to calibrate their rules. This is normal and quite proper.

However, the regulatory proposals facing securitisation have their roots a number of years ago before we collectively had a clear picture of the true causes of the collapse of so many securitised products. As a result, each and every regulatory proposal is calibrated on the premise that "securitisation" is a single, unitary asset class. Therefore, all the rules are based (explicitly as in Solvency II or implicitly as in the recent Basel 3 proposals) on the worse performing securitisations – namely US sub-prime and CDOs of ABS.

Today – in 2013 and six 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; indeed 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 selection 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.

14.2.2 Defining "high quality securitisation"

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 third quarter of 2013, we have the benefit of 23 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 or 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 appropriateness and capital requirements for various types of investors.

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" [12]and that SME loan securitisations are part of that sub-category.

PCS wishes to draw attention to the fact that all securisation types that ran into difficulties contained one of fours 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.

1) 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.

2) 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 quality obligations through the pooling of many lower credit 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 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

[12] 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).

models based on limited data sets to gauge credit outcomes.

3) 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.[13]

4) 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) 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 where (a) the originator retains a meaningful share of the risk (“skin in the game”), (b) are unlevered, (c) 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 were free of any of these elements, 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 elements that are encapsulated in the criteria used to determine whether a securitisation is eligible for a PCS label. This fact is acutely demonstrated by the performance table based on PCS eligibility and set out in Appendix 2.

14.2.3 Proposed regulatory approach

In order to revive a strong yet safe European securitisation market once the macro-economic conditions make it possible, it is essential that throughout the various regulatory schemes (CRD4 including LCR asset definitions, AIFMD, Solvency II) there be inserted a definition of “high quality securitisation” based on the simple principles enunciated above and on the work of the various not-for-profit initiatives that have been

[13] 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 regulatory 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.

set up to set standards around this concept, such as PCS and the European Data Warehouse.

Once this definition is present, rules that set capital standards should be calibrated for high quality securitisations on the basis of the actual performance of this type of securitisation during the crisis. The same should be done for securitisations that do not meet the definition.

This will provide an appropriate and evidence based calibration for high quality securitisations that will achieve the right balance between financial stability and the need to improve maturity transformation by the financial system. In this respect, we refer you to Appendix 2. Based on these performance figures, and particularly the fact that, after six years of the worse economic crisis since the war, losses on the senior tranches of high quality securitisations remain nil, one would expect:

a) a capital calibration for high quality securitisation that reflected this exceptional performance and was in line with the calibration of other asset classes with similar records (such as covered bonds);

b) the inclusion of high quality securitisations in those categories of very safe debt instruments appropriate for conservative investment requirements (such as bank LCR requirements).

14.3 Restoring investor confidence

If an appropriate regulatory framework for securitisation is established, it will still be necessary to restore investor confidence in the product. A recognised definition of "high quality securitisation" together with support schemes such as those we describe in our response to Question 27 below, will go a long way towards restoring such confidence. Independent initiatives set up by the industry such as PCS and the European Data Warehouse also have a role to play. Ultimately though, if investors are allowed to invest in securitisations, it will be up to them to satisfy themselves that it is reasonable to do so. The analysis backs up the proposition that it is indeed so, as do the performance numbers.

Q27: How could securitisation instruments for SMEs be designed? What are the best ways to use securitisation in order to mobilise financial intermediaries' capital for additional lending/investments to SMEs?

27.1 Setting and requirements

To understand how securitisation can assist SMEs, it is useful to remind oneself of why so little bank funding is presently going to the SME sector.

Bank funding to SMEs is clogged because:

a) The transmission mechanism of monetary policy in the €-area is broken;

b) SME credits are risky and riskier in a recession;

c) Banks are concerned about their capital position:

- SME defaults could consume capital above expected losses;

- SME defaults could reduce profits needed for recapitalisation and and/or for successful capital raising in the markets.

The solutions put in place so far in Europe are not showing the hoped for effects because they use a funding solution to try and solve what is essentially a risk and bank capital problem (eg Funding for Lending Scheme of the Bank of England).

Any proposal for the use of securitisation to channel funds to SMEs also needs to take into account that:

a) By shifting the credit risk away from the banks, there is a “moral hazard” of pushing banks into an “originate to distribute” mindset with misaligned incentives – “skin in the game” rules must be respected;

b) But the “skin in the game” rules have to be applied in such a way as not to deprive the banks of any capital benefit, or else one is left with another purely funding solution;

c) The proposal needs to generate new lending to SMEs and therefore must be structured so as to avoid being just a method of recycling existing lending off the balance sheet of banks;

d) Any proposed solutions should bring the yields on lending down towards a fair level and thus be convenient for both lender and borrower.

27.2 Key components of a possible solution

27.2.1 General considerations

At the core of our proposed solution is a scheme that provides an incentive for banks to lend more to SMEs than they would otherwise do and at fair prices.

This solution, as outlined theoretically in our response to Question 4, envisages a funding facility jointly run by different European institutions where each institution purchases (or guarantees) a particular tranche of a high quality SME securitisation whose risk profile is consistent with that institution’s mandate and mission (the “Facility”). Together, though, the overall Facility allows for a sharing of risk with banks at the capital level. This way, it can generate some capital relief to banks engaged in new SME lending.

It also requires participation of private institutional investors, so that the Facility also assists in the rebuilding of an open and competitive SME securitisation market that can provide for the longer term financing needs of this economic segment.

One aspect of this Facility that may require some discussion is the issue of pricing. If the Facility is designed solely as a “market supporting” facility under which each securitisation bond is purchased at the current market price, then the Facility may not be able to immediately and directly impact any perceived market failure in the pricing of current SME lending across Europe. If one wishes, through the Facility, to reduce directly the cost at which European SMEs can borrow, then it is possible to design pricing mechanisms, within the Facility, that seek to correct identified market failures in this regard. The challenge, as with all such schemes, though is to ensure that pricing benefits provided by the public sector are indeed passed on to SMEs.

PCS also strongly encourages the setting up of the Facility as a single program with a co-ordination administration. An attempt to provide a purchasing facility through the disparate operation of different existing or new programs, each separately administered by the participating institutions, each operating under different rules and requirements, requiring separate negotiations with each European institution, would likely lead to massive administrative hurdles that would render the scheme inoperable. Also, as some European participating institutions will, in all likelihood, come from different European countries, the absence of a common set of rules for all program participants and a common central administration will mean that a truly pan-European approach capable of smoothing out the existing intra-European funding barriers will not be achievable.

The key components of the PCS proposal would be as follows:

27.2.2 A senior tranche purchase facility (the "Senior Facility")

A simple purchase facility can be provided by one or more European finance institution for the senior notes of high quality SME securitisations. Being a purchase facility only of the least risky, most senior tranches of SME securitisations, this facility can be provided by a variety of European institutions with very low risk tolerance mandates. They can provide it acting either singly or jointly.

The chief candidates for such senior tranche purchase facility would be:

a) The European Central Bank acting through the national central banks;

b) The European Investment Bank;

c) The European Investment Fund;

d) The European Stability Mechanism;

e) A newly created entity whose capital would be provided by member states and/or the Commission and would fund itself by issuing bonds in the capital markets.

We would call the entity or entities providing this facility the Senior Facility Provider ("SFP")

Under this facility, the SFP could offer to purchase, outright or on a non-recourse repo basis, the most senior tranche of high quality securitisations (HQSs). The offer would be on a shared basis with market investors and the SFP could not buy more than a specified percentage of a given ABS (say 50% or 75%). The shared basis is needed to provide comfort that the HQS was structured as a marketable security. It also ensures price transparency. As mentioned above, though, a variety of alternative pricing schemes may be included in the design of the Senior Facility (or any other part of the Facility) if the Facility were intended to directly impact the cost of borrowing for European SMEs.

Such facility would also help re-establish the securitisation market. A re-established securitisation market, in turn, would favour the exit strategy for the SFP from this scheme when the economy recovers.

The hope that the Senior Facility assists a return of a strong SME securitisation market suggests that, although PCS would anticipate it being a long-term facility, it may not be used substantially, or even at all, once financial recovery has occurred in Europe. As such, the setting up of a special entity capitalised by member states and/or the Commission (option (e)) may not be the most efficient solution as it could involve substantial set up costs and long lead times for what may end up being a shorter term facility. On the other hand, if the Senior Facility is provided by one or more existing entities and proves to be a long-term pillar of a strong SME securitisation market, it will always be possible to set up such a dedicated entity in the future. This has the added advantage that, at that future point, the exact requirements of such entity will be clearer since the Senior Facility will have operated for a while.

To qualify as HQS, the securitisations would need to meet a number of conditions:

a) meet quality, simplicity and transparency criteria (those defined by the European Data Warehouse and the PCS label could serve as a starting point);

b) be backed by SME loans, of which at least a specified percentage would be new loans (i.e. loans made from an agreed date). The specified percentage could be increased over an 18 month period to reach a set proportion (between 75% to100%) by the end. This would allow the facility to start immediately, using at first a proportion of existing loans and delivering some immediate impact. Quite quickly though, the percentage of new SME loans required by the scheme would be increased so that the facility can assist in channeling new money to the sector and not be used as a way for the banks to clean up their existing balance sheets;

c) any other standardisation requirements that are felt necessary or appropriate eg on the types of SME's funded, the length of the SME loans (in line with the desire to assist long term finance), etc…

The Senior Facility could be used to purchase HQSs either on the primary or the secondary market, even if the condition that the securitisations contain a growing percentage of new loans will quickly limit the possibility of purchases on the secondary market. Again this could help revive the general securitisation market in Europe by generating liquidity and thus lowering the liquidity premium.

Such a purchase facility would generate liquidity in the SME securitisation market, potentially reduce the cost of SME funding, particularly in the periphery and may also assist in the revival of the SME securitisation market.

However, a scheme limited to a Senior Facility would not provide, in and of itself, a capital relief to banks that made new SME loans. Many banks have argued that the market for highly rated senior SME ABS is already available to them and suffers few constraints. It is a moot point, considering the small number of investors still active in this market, exactly how much SME ABS this market could absorb at present prices, but it could certainly absorb more than is being issued.

Accordingly, the setting up of a senior HQS purchasing facility, although helpful, would not in our view, on its own, deliver a major impact on the volume of new SME funding in Europe.

27.2.2 Capital solutions and the junior notes (the "Mezzanine Facility" and the "Capital Facility")

We believe that a program that reduced the capital usage of banks lending to SMEs would, in terms of impact on SME lending, be truly meaningful. This would remove one of the chief disincentives to SME lending in the current "deleveraging" environment.

So, in addition to the Senior Facility, the Facility should also contain a purchasing facility for the junior notes of SME HQSs. Technically, the "junior notes" may be constituted by a single tranche. However, it is most likely that they will be divided between one or more higher credit "mezzanine tranches" and a "capital tranche". The "capital tranche" would represent the first loss capital relief element. In other words, the capital tranche would be a part of the capital that would otherwise have to be held by the bank against the SME loans had these not been securitised. A facility that provided for the purchase of the mezzanine tranches would be the "Mezzanine Facility". The capital tranche purchase facility would be the "Capital Facility".

As set out above, we also strongly believe though that any capital relief provided by the Capital Facility must be partial. If all the risk of default was removed from the lending bank, a major moral hazard would be created, importing into Europe the misalignment of incentives that played havoc in the US sub-prime market.

The banks should be required to comply with the old Art 122A of the Capital Requirement Directive[14], which mandates a 5% risk retention. However, Art 122A does allow such a retention to operate by having the bank retain 5% of the total pool risk and not just by having the bank retain the "first loss", bottom 5% risk of any securitised pool. By allowing the bank to retain less than 5% of the first loss position, some capital benefit can, in theory, be made available to a lending bank.

The exact amount of first loss risk that should be left with the bank, and therefore its minimum capital requirement, could be set out as part of the program design. We would envisage that the banks would be required to maintain an "L-shaped" retention[15], where the "vertical slice" could be relatively substantial (around 15% or more) but the junior "horizontal slice" could be quite small to generate maximum capital relief consistent with a good prudential approach. The large vertical slice retention being substantial is consistent with European actual banking practice prior to the crisis. It explains why there was never a pure "originate to distribute" business model in Europe and why, as a consequence, European securitisations in the plain vanilla asset classes performed so well.

Since the securitisation notes purchased under the Mezzanine Facility and the Capital Facility are junior to those purchased under the Senior Facility, it is self-evident that they have to share all the qualities of HQSs other than that of seniority.

27.2.3 Mezzanine Facility Providers

The notes purchased under the Mezzanine Facility will be riskier notes than the senior tranches and have ratings from single-A to BB. They are nonetheless traditional investment instruments for institutions with a higher risk/reward appetite.

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[14] Now Art 394 of the proposed CRD IV

[15] For an explanation of the different forms of retention and how they apply to the proposed program see the Appendix 3.

There are a number of European institutions that could provide the Mezzanine Facility:

a) the European Investment Bank;

b) the European Investment Fund;

c) national financial institutions such as KfW, CDC, OSEO, CDP, ICO and others.

Again, these institutions could provide the Mezzanine Facility singly or acting in concert. In the case of the EIB and EIF, the funds for these purchases would be from specific earmarked programs that could be already available under the new Multiannual Financial Framework (MFF) or made available in some other form.

27.2.4 Capital Facility Providers

The notes purchased under the Capital Facility will be very risky indeed. This is normal since they represent the capital element of SME lending. Therefore, European entities purchasing these most junior notes of SME HQSs should anticipate suffering some losses during economic downturns. If the economy declines sharply, the losses could represent a substantial part of the total. It is possible to provide a sufficiently high yield on these notes to seek to compensate entities investing in them. However, it is probably better that funds mobilized for the Capital Facility should be considered as subsidies or grants rather than investments.

It is therefore natural that the providers of the Capital Facility be European or national entities that are mandated to provide such subsidies or grants.

The Capital Facility should therefore be provided by the European Commission and/or national governments, as part of their subsidies and grants to the SME sector. Grants and subsidies provided in this manner have the advantage that they are more efficient in that they create a leverage effect, as described in the next section. Also, this opens the possibility that the suggested Capital Facility need not require new, additional public funding, but might, in part or in whole, be funded from existing, already budgeted sources.

27.2.3 Structure of the Mezzanine Facility and the Capital Facility

The Mezzanine Facility and the Capital Facility can be provided either by:

a) direct purchase of the junior notes of SME HQS; or

b) by providing guarantees to the junior notes of SME HQS. Once these benefited from such a guarantee, they could be acquired by the Senior Facility Provider under the Senior Facility and/or sold to market investors or the originators themselves.

In addition, the Capital Facility can also be provided by providing the banks with guarantees for that portion of its securitised SME loans.

If the Mezzanine Facility and the Capital Facility were provided by direct purchase, funds such as the European Structural and Investment Funds (ESIFs) could be mobilised.

27.3 Leverage effect

One aspect that is important is that the funds provided by the Mezzanine Facility and the Capital Facility, by being used to meet possible losses on junior tranches of HQSs, will provide leverage to the senior tranches. Under CRD IV, prudent bank capital for SME lending will stand at around 4%. Since the banks under any scheme will still need to retain some capital risk – let us say, by way of example, that this minimum is set at one third of the risk- this means that the "capital at risk" provided by European institutions under the Capital Facility only needs to represent 2.6% of the overall new SME lending made possible by any proposed scheme (ie 2/3rd of 4%).

In other words, keeping within the prudential requirements of CRD, every Euro of funding made available under the Capital Facility can produce 38 Euros of additional lending. Put differently, if the amount that one or more European institutions was prepared to put at risk in the Capital Facility equaled € 4 billion in aggregate, this could allow for around €150 billion of possible new SME lending. As some of the senior tranches will be placed in the market, this effect would be greater than any benefit deriving from the Senior Facility alone.

The exact amount of leverage would depend on how much funding was available for the Mezzanine Facility and Capital Facility and how much risk retention versus capital relief is appropriate and necessary to give incentives to bank lenders to maximize new SME lending consistent with appropriate risk retention. The leverage, in any case, is substantial.

Also, investment in the Senior Facility and the Mezzanine Facility would not be a subsidy or a grant, but should generate a return for the providing institution or institutions. Experience in Europe and the US shows that analogous facilities eventually netted large profits for the authorities providing them.[16] Even the Capital Facility, although carrying equity type risks, could produce a return or at least generate few if any losses.

27.4 Advantages of the Facility

The proposed Facility has a number of advantages:

a) By operating through a high quality securitisation issuance program, this proposal can help revive a market based securitisation in Europe, thus supporting the thrust of the Green Paper and would be an important contributor to a sustainable SME financing which Europe desperately needs to stop the fiber of its employment and growth providers from dwindling in an irreversible way;

b) By setting a benchmark set of criteria (such as those set out by the EDW and the PCS criteria) as a pre-condition of participating in the program, this would not only help revive the securitisation market in Europe but also do so on a sound and clearly defined basis;

c) By removing a hurdle to funding reaching SMEs, the program could favour both lenders and borrowers:

[16] Estimates of large marking to market profits for the ECB from its Securities Market Program and for the FED from its TALF program are meaningful precedents in this respect.

d) By modifying the tranching (ie changing the ratings/risk profile of the tranches purchased by the participating European institutions), one can change the structure of the incentives and the risks absorbed by the system. This allows for a finer tuning that would not be possible by the direct funding of whole loans;

e) Properly structured, this can provide a capital efficient solution to a capital problem.

CONCLUSION

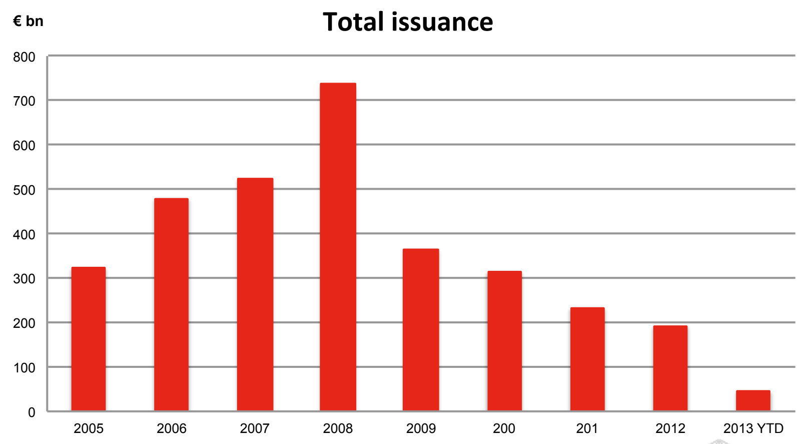
Again, PCS would like to thanks the European Commission for a timely paper. It is clear that the stakes for the Europe are very large and that the debate on how to channel long-term funding into the economy will be a key determinant of our future.

PCS believes that, although no panacea, securitisation will need to play an important role in the provision of long-term finance. We also believe that, learning the lessons of the crisis, we collectively have the opportunity to create a strong, substantial and safe securitisation market that can play a major positive role. However, we must also recognise that we stand at a crossroads. Unless measures are taken to create an appropriate regulatory framework in the coming years, that respects prudential considerations but is grounded on a clear analysis of facts, we genuinely risk closing down the possibility of a return of any secutisation market in Europe.

The opportunity exists to create such a framework as well as provide public sector support for schemes that help revive the securitisation market whilst channeling much needed funds to key economic sectors of the European economy.

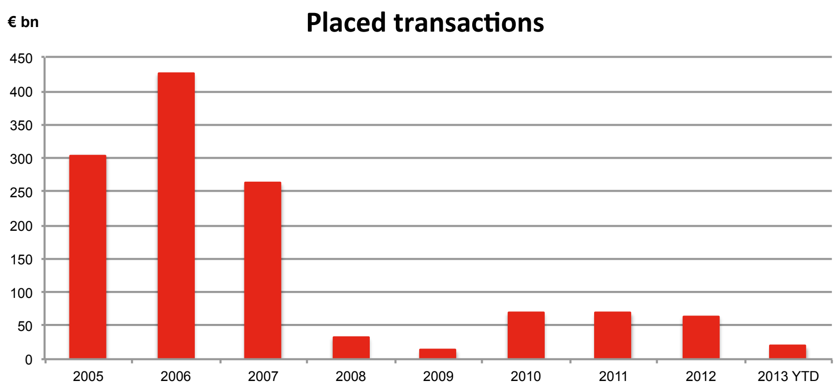
APPENDIX 1: HISTORICAL AND CURRENT SECURITISATION ISSUANCE

Total European Structured Finance issued transactions 2005 to date



Source: BAML

Total European Structured Finance placed transactions 2005 to date



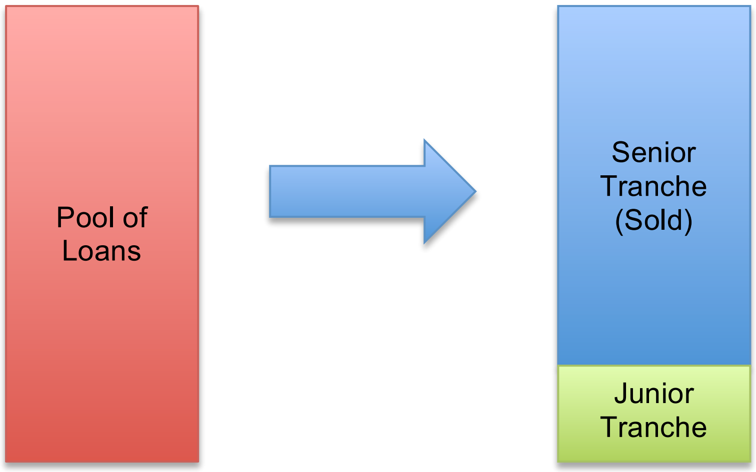
Source: BAML

APPENDIX 2: COMPARATIVE PERFORMANCE TABLE OF HIGH QUALITY SECURITISATION

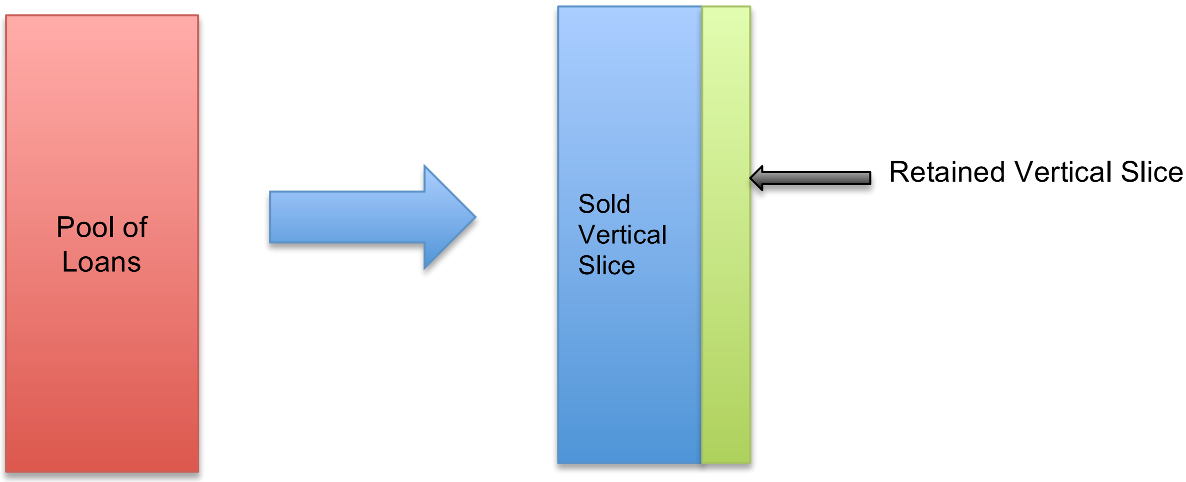
	Original Issuance (EUR billion)	Default Rate (%)
Europe		
Total PCS eligible asset classes	**959.9**	**0.10**
Credit Cards	33.2	0.00
RMBS	755.7	0.08
Other consumer ABS	68.0	0.13
SMEs	103.0	0.23
Only senior tranches to be PCS labelled, the default rate for which is zero, like Covered Bonds		
Total Non-PCS 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	**1694.1**	**2.25**
Covered Bonds	**1085.0**	**0.00**
Total European issuances	**2779.0**	**1.37**
Select US asset classes		
Credit cards	295.4	0.04
Autos	215.1	0.04
Student loans	266.8	0.28
RMBS	3254.9	18.79

Source: Standard & Poor's

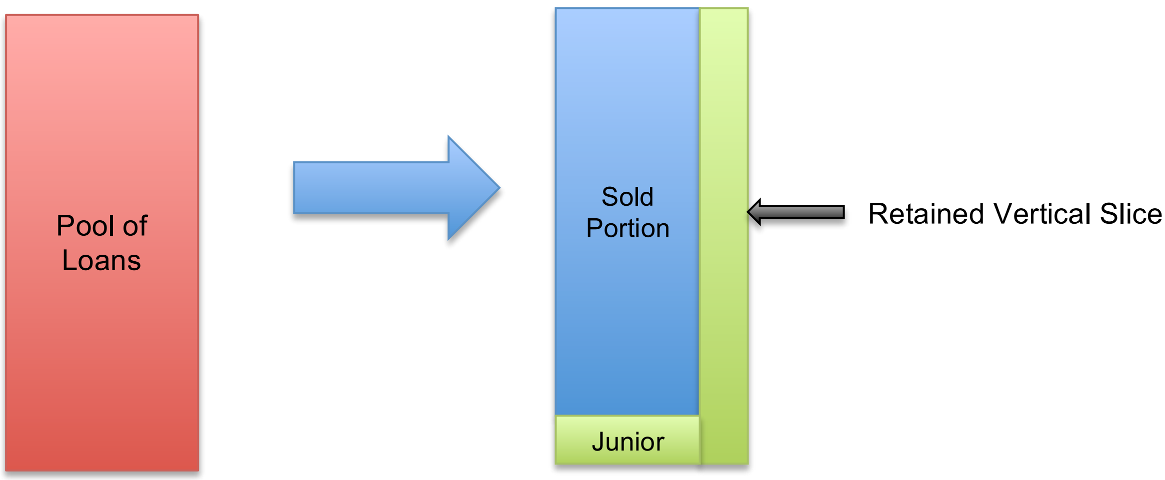
APPENDIX 3: SECURITISATION TRANCHING AND RETENTION



Horizontal Slice Retention



Vertical Slice Retention



“L” Shaped Retention

SME High Quality Securitisation Facility