Setting the standard
for securitisation

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Dear Sirs and Madams

We are responding to the consultation paper on the advice on the review of the securitisation prudential framework in Solvency II dated 7th June 2022 (the "Paper").

PCS is an independent not-for-profit organisation dedicated to revitalising a safe securitisation market in Europe for the benefit of the economy, as well as a third-party verification agent under the Securitisation Regulation.

PCS would wish to apologise if its response does not contain as much data as we would like to demonstrate our arguments, but the extremely short period allowed by EIOPA to respond to the Paper precluded the possibility of PCS and most responding entities conducting, or engaging specialists to conduct, detailed historical data analysis.

Background

When considering the minuscule size of insurance company holdings in securitisations, it is easy to dismiss the reforms of the regulatory framework as a minor, almost irrelevant, exercise. This would be a profound mistake.

Securitisation is the only tool (outside asset sales) that allows banks to free up capital. With the final implementation of the Basel 3 reforms, it has been estimated that European banks will need to raise between €170bn and €230bn[1] of additional capital. Without a strong securitisation investor base outside the banking sector, the likely result will that they will fall short. This, in turn, would lead to a contraction of lending volumes from the banking sector. Bank lending represents over 80% of lending in the European Union.

[1] "EU implementation of the final Basel iii standard" (June 2021) https://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/7/567/1623766208/copenhagen-economics_eu-implementation-of-the-final-basel-iii.pdf

On top of "business as usual", Europe is looking at an extremely ambitious yet essential transition to a sustainable economy. The European Commission estimates, in its Sustainable Finance Action Plan, that, in addition to public money, there is a yearly €180bn investment gap to achieve EU climate and energy targets by 2030[2]. The Commission also cites the EIB's estimate of an overall yearly investment gap in transport, energy, and resource management infrastructure of €270 bn.

This additional lending will require either the mobilisation of bank lending – which will place further pressure on capital needs – and/or new capital market instruments such as securitisation.

This is without mentioning the key role of a securitisation market with a large non-bank investor base in the creation of the Capital Markets Union, the reduction of the size of banks in the landscape of European finance with the aim of breaking the co-dependence of banks and sovereigns and the promotion of fintechs to ensure that Europe is not left behind in the digital revolution. (Securitisation is a key funding channel for fintech lenders).

Therefore, far from a minor tweak of little import, the subject matter of the Commission's call for advice to EIOPA involves some of the most important challenges facing European finance and the economy.

General Considerations

Before responding to the specific questions, PCS would like to make a number of comments that address some of the general approach we see emerging from the Paper

[A] "Fit for purpose"

In the Paper, EIOPA states that it "considers that the current framework is fit for purpose".

PCS wishes to draw attention to two issues with that assessment.

1. <u>Mortgages vs RMBS</u>

Under the current rules, if an insurer purchases a pool of residential mortgages, it is required to allocate to those mortgages an amount of capital equal to 3% of their value.

If the same insurer purchases a five-year AAA senior tranche of an STS securitisation backed by exactly the same mortgages, it is required to allocate an amount of capital to that RMBS equal to 6% of its value.

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[2] "Action Plan: Financing Sustainable Growth" (March 2018) https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN

The RMBS has credit enhancement likely to be close to or greater than 15 times the worst loss suffered in that jurisdiction ever. The RMBS is a negotiable instrument that can be traded easily.

In the Paper, EIOPA mentions the existence of additional risks due to the act of securitising, known as "agency risk". PCS will address such risks in detail later but we would point out that the agency risks identified by EIOPA are either specifically prohibited by the STS rules or apply equally to the mortgages and the RMBS.

For example, STS prohibits an originator from adversely selecting the worst assets in its book to securitise. There is no such prohibition when a bank selects the mortgages it sells to an insurance company.

Yet, the RMBS capital requirements are ***double*** those for the same mortgages without the protection of either credit enhancement or a sanctions backed regulatory regime.

In addition, this doubled capital requirement applies to instruments that suffered no loss whatsoever in the crisis, compared to residential mortgages of which the same cannot be said.

This absurd result alone, in PCS' opinion, demonstrates that the current framework in not fit for purpose.

PCS is, of course, aware of the technical reasons to do with credit risk modules and spread risk modules why this result arises. But that is not a counterargument. It is only an explanation of why the framework is not fit for purpose.

2. <u>Burden of proof</u>

Before the introduction of Solvency II, European insurance companies were substantial investors in securitisations. Today US and Australian insurance companies are still substantial investors in securitisations. Clearly there is nothing in the nature of securitisations that make them inappropriate as an investment for the insurance sector.

Since the crisis, we have had two developments.

First, European insurers have witnessed the extremely good performance of traditional European securitisations. Just as a headline fact, during the depth of the GFC and the sovereign crisis that followed, losses in traditional European securitisations senior tranches were ***zero***. Literally none.

Secondly, securitisation became the most regulated capital market instrument in Europe with rules that provide more disclosure by far than for any other form of debt and prohibits all the structural features that were associated with the difficulties of securitisations that came from the United States (e.g. originate to distribute and re-securitisations).

Since the Solvency II regime was introduced, notwithstanding the two positive developments, insurance company investments in securitisations have collapsed. Yet they did not collapse in other jurisdictions such as the US where capital requirements are lower.

Prima facie, it would therefore seem that Solvency II calibrations are the prime suspect for the current state of insurance company involvement in the market.

PCS accept that it is not impossible that, as EIOPA avers, the refusal of European investors, contrary to the behaviour of their peers elsewhere in the world has nothing to do with capital requirements. But we would argue that the evidence suggests otherwise and that, at the very least, a meaningful burden of proof would fall on EIOPA to demonstrate that it is not the result of capital calibration.

Reading the Paper, we are at a loss to discern strong quantitative or qualitative arguments that would overcome this burden of proof.

EIOPA mention that some other assets with higher capital requirements are bought by insurers and therefore capital considerations cannot be what drives purchases. PCS, for reasons we will go into later, does not think this is very convincing.

EIOPA mentions other reasons why insurers may not wish to purchase securitisations. But no evidence is brought forth to confirm that these are key or even relevant to insurance companies' investment decisions.

On data for calibrations, EIOPA's main argument seems to be that there is not sufficient data so no conclusions can be reached.

To summarise, the assertion that the current framework is "fit for purpose" emerges from the Paper more as an act of faith than a demonstrated proposition and is at odds with the prima facie evidence.

[B] Capital Requirements are not responsible for the state of affairs

1. <u>Comparison to other capital requirements</u>

As evidence that high capital charges are not the reason for the disinterest of insurer's investment in securitisation, the Paper notes that insurance companies invest in equities where the capital requirements are considerably higher.[3]

At a theoretical level, this appears unconvincing. No one would suggest that capital allocation is the sole or even main driver of any investor's choice. But one cannot also ignore that the balance between capital consumption and returns (whether absolute or risk adjusted) must be a threshold consideration.

Put in the form of an idealised example, Product A is an extremely safe investment. Therefore, it has a very small return of 3%. So, an investment of 100 in Product A returns 3 per annum. The regulatory capital is miscalibrated at 25% so the investor needs hold 25 of capital for 100 of Product A. The cost of capital is 12% so it costs 3% per annum or 3 to buy 100 of Product A generating revenue of 3. It is impossible for an investor in Product A to ever make a return under this capital regime.

Product B is a risky investment but can yield 25% returns. The capital requirement is 39% so 100 of Product B requires 39 of capital at 12% or 4.68 against a possible return of 25.

To argue that an investor's purchase of Product B despite the 39% capital requirement indicates that the 25% capital requirement of Product A is not the reason investors are not purchasing the latter is unconvincing.

Maybe a better analysis would be to focus on a risk adjusted return on equity (RAROC) analysis for different products under Solvency II. The very short timeframe provided to respond to the Paper has made it impossible for PCS to gather that data. However, we have seen privately the data provided by a research house. We hope we can make that data available soon and that EIOPA will be willing to consider it as it drafts its response to the Commission's call for evidence.

The RAROC data we have seen confirms that, under Solvency II capital constraints, investments in covered bonds and corporate bonds have a much better RAROC than securitisations (and this is definitionally after taking into consideration their respective credit risks).

2. Complexity

Another possible culprit to explain the lack of insurance company investment is securitisations is the supposed complexity of the product.

Actual complexity

PCS would suggest that this is a view possibly anchored in an out-of-date understanding of European securitisation. Prior and during the GFC, there were very complex securitisation products such as CDO squareds and 32 tranche CLOs.

[3] Page 15 of the Paper

Since that time, the Securitisation Regulation was passed. Products like CDO squared's were simply banned and the STS standard was designed by the co-legislators as a gold standard in simplicity.

References therefore to the complexity of securitisations (and especially STS securitisations) we think are misleading.

We would point out, for example, that a traditional plain vanilla Dutch RMBS transaction backed by traditional prime Dutch mortgages for which extensive data is provided, has a very straightforward senior/junior tranching and a simple waterfall; for which investors can look up decades of data on mortgage performance in the Netherlands is not a complex product.

It is certainly considerably simpler than a corporate bond from a large hydrocarbon company with 50,000 employees across 20 countries, difficult to calculate reserves and facing the challenges of geo-political turmoil (including war, invasion and rebellions) at the time the world is facing a climate crisis and seeking to transition away from its core product.

Another suggestion that EIOPA may be analysing the market on an out-of-date model of securitisation is the statement that "transactions may be structured so as to lack a sufficient degree of transparency towards investors and other market participants". Since the Securitisation Regulation came into force, securitisation disclosures are mandatory, standardised in form and content, extensive and filed with special regulated entities (the data repositories). This disclosure is required to be refreshed quarterly. No capital market instrument in Europe (and probably the world) is required to provide such deep and constant disclosure.

Regulatory complexity

The Paper does also mention another source of complexity that may be holding back insurance companies' securitisation investments: the heavy regulatory rules imposed on potential investors in this product – and this product alone.

PCS acknowledges, and has indeed long argued, that the heavy rules under which investors in securitisations (and uniquely in securitisations) must operate makes it difficult for the market to recover. PCS has long advocated for a level-playing field amongst asset-based financings.

However, PCS is not aware of any evidence that this additional burden is the only, or even main, burden preventing insurance companies from investing in securitisations. Anecdotal evidence and discussions strongly suggest that it is the capital rules that drove insurance companies out of this market and the extremely heavy due diligence burdens that have raised the costs of going back in.

The Paper does not disclose any evidence that this is not the case.

Obviously, EIOPA is not suggesting that because miscalibration of capital requirements are not the only issue facing insurance company investors one should not fix that miscalibration. We note that, in the call for evidence, the Commission asked EIOPA to investigate possible other reasons for the small amount of insurer investment in securitisation and that EIOPA was merely responding to that request. However, unless convincing evidence arises that regulatory complexity is the only or main issue driving insurers away from securitisation, the balance of the facts still points to capital calibration as playing the key role in the current state of affairs.

3. RAROC

This is not a dispositive argument, but PCS would also like to draw EIOPA's attention to another reason why there is strong evidence that the regulatory framework is not fit for purpose and could be causing some systemic distortions.

It is a basic principle of financial theory that market pricing should lead investors to be somewhat indifferent to the form of their investment from a risk/reward perspective[4]. The risk adjusted return as determined by the market should somewhat equalise. There are elements that complicate this, such as issues of information asymmetry. Another issue that is well known to disrupts this analysis is regulation that modifies market pricing (eg taxes).

If Solvency II was correctly calibrated for various asset classes, absent other overwhelming issues, insurance companies should be relatively indifferent as to what assets they purchased. There could be other extraneous reasons why this was not so (complexity, maturity matching, systemic market mispricing….) but we have not yet identified any and the fact that non-European insurance companies invest in securitisations similar to European securitisations (if less safe) suggests strongly that there are none.

Put simply, if the RAROC produced by applying the regulatory formula equalised across asset classes, one would expect insurance companies to purchase naturally a lot more securitisations. Of course, financial theory does not exactly map to real life. But the almost total disappearance of securitisation in European insurance companies' portfolios, if not determinative, is very strongly suggestive that there is a miscalibration of the regulations.

For PCS, this is another piece of evidence to suggest that the statement that the framework is fit for purpose is likely incorrect. If it were fit for purpose, absent a yet to be identified confounding factor, European insurers would have some non-trivial investment in securitisation whereas in practice they have none.

[4] See for example Modigliani-Miller

[C] Agency Risks

The Commission also asked EIOPA to advise on agency and modelling risk.

PCS is concerned that in its response[5], EIOPA may have failed correctly to account for the reforms introduced by the Securitisation Regulation. It may also have attributed as special to securitisations risks that exist in all asset classes but are taken into account only in the regulation of the former.

1. Accounting for the new regulatory regime

One of the challenges PCS has encountered in dialogue with regulators around securitisation and the lack of a level playing field is their reference to "agency risks". This reference is almost invariably vague with a few examples thrown in. It is our contention that "agency risks" although an entirely legitimate concept, is a category. It is therefore equally legitimate that if regulations are to take into account "agency risks" these must be capable of description and enumeration. Only then is it possible to measure objectively whether the regulation appropriately accounts for the specific risks rather than for a vague and inchoate set.

It is PCS' analysis that "agency risks" in securitisations fall into two categories:

(a) Those that were identified during the crafting of the Securitisation Regulation and specifically and explicitly removed from either all European securitisation or from only STS;

(b) Those that are risks that remain after the introduction of the new regime but are risks that are in no way securitisation risks but risks present in a great many, if not all. financial instruments.

For example, the risk called "originate to distribute" leading to a divergence of interest between the party creating the assets and the investor taking the risk of the assets was removed for all securitisations by the requirement of a 5% risk retention by the originator.

In addition to these agency risks that have been removed from the European securitisation market in its entirety, the STS standard was intentionally crafted to eliminate any remaining agency risks from those transactions meeting the standard. There are 103 separate criteria that need to be met for a securitisation to be STS. Arguably, the vast majority are designed with the explicit aim to remove, one by one, individually identified agency risks. For example, the risk that the originator selects its worse assets to securitise is explicitly the subject matter of an STS criteria prohibiting such behaviour under severe sanctions.

[5] Pages 40 and 41. Paragraph 3.5

(We note that no such prohibition exists in mortgage portfolio sales which have no additional capital allocated to account for this conflict. We also note that no such prohibition exists for covered bond where a bank may choose its worst assets to go into a cover pool to retain the option of selling its better assets later if it gets into trouble. Again, this agency risk appears to be ignored and unacknowledged in regulations such as Solvency II).

Considering the STS standard was designed to eliminate agency risk, an analysis of any agency risk allegedly still remaining in STS securitisations requires this risk to be identified. We suspect (and would advocate) that if any such risk was identified, the better course would be to add an additional STS criterion to the existing 103. This would eliminate the agency risks from STS, the original intention and would free the regulatory framework from adding modifiers to the capital calibrations without any solid data to back them up. If the risk for which the modifier is introduced cannot be identified, the modification to the calibrations can never be logically determined.

2. Non-securitisation risks

Turning to the specific examples provided by EIOPA on pages 41 and 42, we note that none appear to be risks specific to securitisation and mainly appear to be instances of fraud or quasi-fraud.

- Disregard for the defined criteria is a fraud. This is no different than disregard for the selection criteria in a portfolio sale or in the selection criteria over a cover pool for a covered bond.

- Failure to report losses. Again, this is fraud or quasi fraud. But we fail to see how this is a *securitisation* agency risk. Failure to report losses is at the root of almost all corporate bond fraud or asset management fraud (e.g. Wirecard or Madoff).

- Lack of motivation to collect receivables. This is breach of contract and makes the servicer liable for damages. It is also a risk that exists in every mortgage portfolio purchased by insurance companies and serviced by the originator.

- Insufficient monitoring and violation of the payout rules. The latter is literally fraud and fraud is not a securitisation specific issue. Every secured corporate bond has the same issue of insufficient monitoring and possible violation of cash management rules.

- Maximisation of fee income – is not allowed in STS securitisations. In CLOs where it is allowed it is not “agency risk” but an attribute contracted for and desired by investors as the incentive for the CLO manager to do a good job.

When dealing with “agency risk” that is not securitisation specific, we note that , both in CRR and in Solvency II, the approach appears to be that such risks are considered to be reflected in the historical data and therefore need no specific adjustments ***unless*** they appear in the context of a securitisation where they are used to justify an additional amount of capital on top of what the data requires.

In conclusion, unless one or more specific agency risks can be identified which are not either (a) eliminated by the new securitisation regulatory regime or (b) common to many other categories of assets, then a reference to unidentified and undefined “agency risks” cannot be the basis for a reasonable and commensurate regulatory treatment.

[D] Lack of data

One of the main arguments put forward by EIOPA for not proposing any changes to the current calibration regime is that the new securitisation regime, and particularly the STS category, has only been in existence since 2019. This short period provides too small a data set on which to base changes.

PCS respectfully must disagree for three reasons.

First, data exists. Secondly, very good and conservative proxies exist. Thirdly, as a conceptual matter, this is not how one calibrates newly introduced regulatory regimes.

1. <u>Data is already available</u>

It is correct that data for the new regime and especially for STS only exists for the last three years.

However, EIOPA refers to an analytical piece produced by Risk Control and that can be found on the website of AFME.

This piece of research is based on post and pre-2019 data.

The pre-2019 data is not the data that covers the current regime.

However, it is clearly data that covers a market that cannot be less risky and volatile than the 2019 market.

Unless EIOPA wishes to argue that the introduction of the Securitisation Regulation, including mandatory reporting, mandatory skin-in-the-game, the prohibition of re-securitisations, the imposition of a savage sanctions regime, the appointment of regulatory supervisors and the creation of the STS regime made the European securitisation ***less*** safe, then the pre-2019 data in the Risk Control covers a market that was, at worst, equally safe.

From the point of view of volatility, the same applies: the highly regulated post-2019 market must be more stable than its unregulated version.

Therefore, using the pre-2019 data as if it related to the post-2019 market is extremely conservative an approach.

Despite this being an extremely conservative approach, it yields the conclusion if PCS has correctly read the Risk Control paper that capital for non-senior STS tranches and non-STS tranches is ***two times higher*** than the data justifies.

2. Proxies exist

PCS regrets that the very short time available to respond to this consultation did not allow it to commission work on proxy data.

However, PCS draws attention to the fact that the STS criteria were not designed to set a new higher standard than the standard that existed heretofore in Europe. The genesis of the STS standard was the recognition by the Commission and the EBA that traditional plain vanilla securitisations in Europe had performed extremely well during the GFC. The STS standard was therefore an exercise in analysing what were the features of those safe securitisations issued in Europe and codifying them.[6]

There are no criteria in STS that were not common in plain vanilla pre-2019 and, in fact, pre-2008 European securitisations.

Therefore, an analysis of the price and credit performance of those plain vanilla securitisations would be an ideal proxy for the performance of STS securitisations. This work could be done with a little time.

Based on the results of the Risk Control analysis which did not extract those plain vanilla securitisations from the pre-2019 data, it is extremely likely that the miscalibration already identified for securitisations in that paper would only be magnified for STS transactions.

3. Traditional regulatory approach

As we have set out, data already exists that justifies modifications to the Solvency II capital calibrations. Further data will be gathered that is very likely to justify additional adjustments.

However, even in the absence of such data, the traditional approach of the European Union seems to us to be that regulatory regimes are crafted and

[6] The first version of the STS standards was the private PCS Labels whose criteria were based on the analysis in the 2013 PCS White Paper which the EBA kindly endorsed in its own report on "High Quality Securitisation".

provided benefits and burdens commensurate with the intended aim of the legislation. Thereafter, at regular intervals, data is examined to determine whether those benefits or burdens should be adjusted.

It seems to us that many parts of Solvency II have been the subject of rules and requirements, formulae and adjustments from the moment the law was passed.

It therefore appears to us to be an unusual approach, not matched in other parts of European regulation, to say that a regulatory regime will be introduced but no adjustments to formulae can be made until at least ten years of data has been collected. We are not aware of other parts of Solvency II were EIOPA has taken such an approach and are aware of many where it was not.

Specific Questions

Question 1: Do you have any comment on the comparison of the securitisation capital charges with other asset classes with similar characteristics?

Based on the work of Risk Control and the general considerations outlined above we believe that the capital charges for securitisations are excessive compared to other assets classes.
Subject to the additional work using proxies as mentioned in our comments above (“Lack of data – Proxies exist”), we would propose the following more appropriate numbers

current	STS senior tranche (x Duration) *****	1.00%	1.20%	1.60%	2.80%	5.60%	9.40%	9.40%
	STS non-senior tranches (x Duration)	2.80%	3.40%	4.60%	7.90%	15.80%	26.70%	26.70%
	Non-STS tranche (x Duration)	12.50%	13.40%	16.60%	19.70%	82.00%	100.00%	100.00%
proposed	STS senior tranche (x Duration)*	0.90%	1.10%	1.40%	2.50%	4.50%	7.50%	7.50%
	STS non-senior tranches (x Duration) **	1.40%	1.75%	2.50%	4.50%	8.50%	9.50%	8.50%
	Non-STS (senior) tranche (x Duration)***	2.50%	3.50%	4.50%	7.50%	12.50%	14.50%	100.00%
	Non-STS (non-senior) tranche (x Duration)***	4.00%	5.75%	7.50%	12.50%	19.50%	23.50%	100.00%

PCS does not propose any changes to the modified maturity shocks or the credit quality step shocks.

Question 2: Do you see practical or legal difficulties in investing in securitisation with the STS label? Are you aware of any other factors, including regulatory rules other than capital requirements that could have a major impact on securitisation investment levels?

We do not invest in securitisation.

Question 3: Do you have evidence that the current calculation for capital requirements for securitisation (senior STS, non-senior STS and Non-STS) is not proportionate or commensurate with their risk?

The work of Risk Control, together with the points we made above in "*[B] Capital Requirements are not responsible for the state of affairs – RAROC"*

Question 4: Do you agree with the calibration method used in this paper? Do you have any evidence that an alternative method could have been used?

See above

Question 5: Do you agree with the conclusions obtained in this section? Do you have any evidence which suggests that the conclusions could be different?

See above

Question 6: What is your view on the proposed segmentation of the STS category: should the calibration of the Non-Senior STS Securitisation be differentiated between mezzanine and junior? Please explain your view. If Option 2 is your preference, do you think it would encourage you to invest more into securitisation with the STS label?

PCS has no objection to such segmentation. We believe that the existing regime is of such complexity already that this relatively minor change is unlikely to be material to investor behaviour.

However, this remains a small change compared to the more relevant and necessary changes to capital calibrations we discuss in our submission.

We also support Option 2 but with the same reservations as above.

We are not investors so cannot respond to the last question.

Question 7: What is your view on the preliminary conclusion not to implement the underlying exposure risk as a basis for the securitisation risk charges in Solvency II?

We believe that an approach focusing on underlying exposure risk without imaginary agency risks could be a positive approach. But we recognise the added complexity. Should the existing capital requirements be correctly calibrated, this would be unnecessary.

However, a cap at the capital requirement for the underlying assets for all the tranches of an STS securitisation would correctly reflect the absence of securitisation specific agency risks for STS. (See our comments in "Agency

Risks" above). As such it could be a positive aspect of a re-calibrated capital requirement regime, introducing a form of "sanity check".

Question 8: What is your view on the preliminary conclusion not to implement the considerations for the thickness of non-senior tranches in Solvency II?

We have no views on this issue.

Question 9: What is your view on the proposed segmentation of the non STS category: should the calibration of the non STS securitisation be differentiated between senior and non-senior? Please explain you view. If Option 4 is your preference, do you do you think it would encourage you to invest more into Non-STS securitisation?

See our response to Question 6. On balance we are favourable and have provided proposed numbers on that basis (see our response to Question 1).

We are not investors so cannot answer the final part of the question.

Question 10: What is your view on the preliminary conclusion not to implement the hierarchy of approaches in Solvency II? Do you have any evidence which suggests that this conclusion could be different?

We do not have strong views on the topic.

Question 11: Do you consider that agency and modelling risks are reflected in an appropriate manner in Solvency II? If the answer is "No", please elaborate on the changes that you deem necessary

We refer you back to our response in "[C] Agency Risks".

To summarise, we believe that there are no identified agency risks in STS securitisations what are not either (a) fully remedied by the general rules set out in the Securitisation Regulation or in specific STS criteria or (b) are general "agency risks" applicable to all or many capital market instruments but are folded in the general regulatory framework through the assumption that such risks are contained in the data.

As for modelling risks, for STS plain vanilla securitisations we invite EIOPA to engage with market participants. Whereas PCS (and many other stakeholders and the EBA) identified specific modelling risks generated by the use of models on models in the cases of re-securitisations[7], these modelling risks were derived solely from the structure of re-securitisations. These are now banned.

[7] See PCS' White Paper – the issue of "leverage" (page 19 et seq.) at https://pcsmarket.org/draft//wp-content/uploads/2013/03/Europe-in-Transition-Bridging-the-Funding-Gap1.pdf

For traditional securitisations and even more so for STS securitisations, the so-called “modelling risks” are very small and certainly no worse that modelling risks in corporate bonds or equities.

As with “agency risk”, we invite those concerned about these to explain in greater detail what risks exactly they are focusing on and not merely speak of loose undefined and undetermined “modelling risks”. PCS would contend that it cannot identify any securitisation specific modelling risks outside of the genuine but now banned risks of re-securitisations.

Question 12: What is your view on the preliminary conclusion not to use the maturity (as in CRR) for the Solvency II framework?

The modified maturity stress factor is not, in our view, a driver of the miscalibration we have identified in the current Solvency II framework. In our own proposals, we have not suggested any changes to this aspect of the rules.

Question 13: Do you consider that other technical amendments may be appropriate or desirable to improve that treatment of securitisation in Solvency II? If the answer is “Yes”, please elaborate on the changes that you deem necessary.

We believe that fixing the current miscalibrations is the primary task required here. Within the context of Solvency II as a whole, we would question the dichotomy between the credit risk modules and the spread modules. As we have stated above, they produce irrational outcomes and are not, in PCS’ view, reflective of the business and risks of European insurance undertakings.

PCS also believes that modifications should be made to the operation of the dynamic volatility adjustment. But we recognise that this is a matter that goes well beyond securitisation.

Conclusion

PCS believes that what is at stake in the subject matter of the Commission’s call for evidence is not a mere technical adjustment of a small forgotten section of the European capital market but a crucial component of the continent’s future financial architecture.

PCS is unconvinced by EIOPA’s arguments that the current framework is fit for purpose. We feel this assertion is more an act of faith in the face of considerable quantitative and qualitative evidence to the contrary.

We urge EIOPA to consider these weighty matters with great seriousness and engage with the market and stakeholders to extract additional data to ground a more credible and appropriate capital framework for European insurance companies.

For and on behalf of PCS

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