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for securitisation

T: +44 (0)20 3866 5000
E: info@pcsmarket.org

Prime Collateralised Securities
(PCS) UK Limited
61 Queen Street
London EC4R 1EB

www.pcsmarket.org

Securitisation Policy team
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

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Dear Policy Team

Discussion Paper 3/23

We would like to thank the PRA for the opportunity to comment on its proposals and thinking around the output floor under Basel 3.1 as it impacts securitisation.

PCS is an initiative set up in 2012 by market participants with the support of policy makers and prudential regulators to assist in bringing back a strong, deep but safe securitisation market in Europe, including the United Kingdom. The initiative is a not-for-profit entity and funds itself through fees received as a third-party verification agent under the STS regime, authorised by the FCA in the United Kingdom. The initiative is also independent. Therefore, we do not represent in this paper the views of any market participant or group of market participants and our positions engage no-one but ourselves.

In this response, we will first set out some general considerations that, in our view, should provide the background against which proposals need to be weighed. We will then seek to address some of the policy considerations and comments made by the PRA in its discussion paper (DP3/23, the “Paper”). Finally, we will seek to respond to the questions set out in the Paper.

GENERAL CONSIDERATIONS

[A] ***The need for a broader reform***

In our response, we will deal almost exclusively with the impact of the proposals on the SRT market in the UK. The reason is simply that, with true sale funding securitisations or “traditional” securitisations as they are sometimes called, almost all transactions are structured so that the capital requirements for the senior tranche will hit the floor (15% for non-STS and 10% for STS). Consequently, since the senior tranche is usually the only tranche purchased by UK prudentially regulated entities, the output floor will have no meaningful, if any, impact. Since the consultation is limited to managing the impact of the output floor, we have therefore limited our comments to that segment of the market affected by the introduction of the Basel 3.1 output floor.

However, we and most, if not all, market stakeholders continue to believe that the existing capital calibrations for securitisations generally as they are set up in the onshored CRR are grossly excessive when measured against the actual risks embedded in the product. The crux of the matter, as the PRA is well aware, is the non-neutrality factor *p.* Originally designed to account for agency and complexity risk, it no longer adequately captures the actual risk profile of transactions issued under the Securitisation Regulation with its focus on the elimination of many of these agency risks (eg alignment of interest through mandatory retention, the banning of the truly complex products through the ban on resecuritisations, the elimination of weak disclosure through extensive mandatory disclosure requirements). This is even more starkly the case for STS transactions which are required to meet – for traditional securitisations – over 100 separate criteria, each one chosen to eliminate some form of agency and complexity risk[1].

The case has convincingly been made that pretty much none of these agency and complexity risks have ever obtained in the United Kingdom for securitisations in the traditional asset classes. These performed exceptionally well during and after the GFC. This point is somewhat moot since we have the Securitisation Regulation and the STS standard. It is however important when trying to ascertain the likely behaviour of STS transactions in a crisis, since pre-GFC traditional securitisations were, for all intents and purposes, STS transactions or just sub-STS transactions.

Therefore, even though we do not deal with this issue in what is a response to a discussion paper on the output floor we feel bound to point out that the problems with the output floor and securitisations flow primarily from the miscalibration of the current capital requirements and the excessive non-neutrality of those requirements. We acknowledge the PRA’s comments that it is aware of this issue and would support a wider review by the BCBS of the

[1] A very good argument can indeed be made that the purpose of the STS standard was the elimination of all agency risk. If that is the case, this would lead one to the inescapable logical conclusion that the correct level of non-neutrality for STS transactions should be zero. This zero level is, in our view, supported by the actual performance data of “STS equivalent” transactions during the GFC and since. This argument, in our view, is even more powerful for synthetic transactions. This though is a debate for another discussion paper.

Basel standards relating to Pillar 1 securitisation capital. We also agree with the PRA that their interaction with the Basel 3.1 output floor raises questions about their design and calibration.

Another aspect of the CRR which ought to be mentioned is this context is the treatment of securitisations within the liquidity coverage ratio pools. The low status of securitisations (category 2.b) is predicated on their supposed low level of liquidity. Academic work has seriously questioned this supposed limited liquidity. But nothing could have demonstrated more clearly the liquidity of securitisations than the real-world stress test of the LDI crisis. We would therefore also urge the PRA to re-examine the rules around the eligibility of STS securitisations for insertion in liquidity coverage ratio pools.

For reasons set out in more details below when we comment on paragraph 2.27 and the Basel rules, we would urge the PRA not to send this to the BCBS but to seize the bull by the horns and complete the necessary revisions for the UK on its own authority, lest UK financial institutions suffer serious competitive disadvantages.

[B] ***The value of SRT***

SRT securitisation is a bank capital management tool. Some have expressed a concern that securitisation is an invitation for UK banks to conduct banking business without adequate capital. This concern though is based on a narrow focus on the traditional definition of "bank capital". As such, we feel it is a misunderstanding of the nature of capital within the banking system.

When a bank reduces its RWAs (and attendant capital) by entering into an SRT transaction the protection seller providing protection under the securitisation is putting its money against the securitised risk. Invariably, in the case of synthetic transactions and almost invariably in the case of true sale SRT transactions, that protection seller is not a bank.

Before the synthetic securitisation, the risk in the banking system was met by funds/assets on that bank's balance sheet and designated to absorb possible losses (ie traditional bank capital).

After the securitisation the same risk is met by funds/assets provided by the non-bank securitisation investor. So, loss absorbing bank capital has been replaced by loss absorbing non-bank capital. This could have been done, with equivalent effect, by the non-bank providing the same amount of traditional capital to the bank in the form of share capital or deeply subordinated debt. However, current comparisons between UK banks' return on equity and implied cost of capital show that such traditional capital contributions are unattractive to most investors.

But the final result remains that, after an SRT transaction, the total amount of capital within the banking system remains the same.

In fact, because of the non-neutrality of Pillar 1 capital requirements for securitisation, the total amount of capital in the banking system for the same underlying risk is increased through SRT transactions.

Securitisation in SRT form brings capital to the UK banking system. This is why SRT poses no threat to the safety of the UK banking system.[2]

On the contrary, the availability of SRT securitisation increases the safety and stability of the UK banking system. It does this in three ways.

First as a capital tool

A look at the current price to book ratios of UK banks will show that these are invariably below 1. Also, an examination of their implied cost of capital will show this to be above the current return of equity for almost all UK banks. This sets high hurdles to raising additional traditional capital for most UK institutions. These hurdles will only get higher for banks facing financial stress and capital erosion due to unfavourable economic conditions. Without a robust SRT market that allows new bank capital to be injected in the system (via a reduction in RWAs), such capital stress could easily become a crisis. Even if it does not rise to the level of crisis, limitations on banks raising traditional capital at an economically rational price, in the absence of an SRT market allowing the raising on non-traditional capital, will constrain the amount of lending that can be made available to the British economy.

Secondly as a risk and price testing tool

By asking diverse market participants to price the risk of specific pools of assets via SRT securitisations, a UK bank can verify that the credit risk component of the price at which it is originating assets reflects the market's perception of risk of these same assets. A bank that securitises multiple portfolios (or a single portfolio with which it feels uncomfortable) can test its own assessment of risk and, potentially, identify assets which it is originating at too low a spread to capture actual expected loss.

The capacity provided by an SRT market-based assessment for UK banks to identify in this manner business lines with insufficient returns adequately to cover potential losses strengthens the UK banking system as a whole.

[2] PCS is aware of prudential regulators' legitimate concerns over "flow-back" risk. These, however, should be manageable in a fairly straightforward manner.

Thirdly as a liquidity tool

A stressed bank will find accessing liquidity difficult. During the GFC and the bank/sovereign crisis that followed, we saw a number of banks in peripheral countries unable to raise funds on their own covenant but able to do so in securitised form using their high-quality assets. True sale securitisation, whether in SRT, full stack or traditional funding format, allows banks in difficulty to access liquidity not otherwise available.

But to be available in times of stress, the securitisation market in SRT or funding format must exist and be robust. It cannot be created at speed, *ex nihilo*, during the crisis itself.

The conclusion is that, when analysing options that may severely damage or even extinguish the SRT market (such as Option 1), the PRA's challenge is not, as it is often framed, to (or only to) balance the prudentially conservative option of high capital requirements against the value to the UK economy of a functioning SRT market. It is about balancing the prudential benefit of higher capital against the prudential damage of making the UK banking system more brittle by a lack of a functioning SRT market.

This is why we strongly challenge the notion set out in paragraph 2.24 of the Paper that Option 1 "supports the PRA's primary objective of promoting the safety and soundness of PRA-authorised firms". At the very least, that is still to be demonstrated against strong arguments to the contrary, as the PRA recognises in paragraph 2.25.

There are also economic and global competitiveness aspects that militate in favour of a strong SRT market which we will broach later in our response.

[C] ***Non-neutrality in the context of SRT***

In paragraph 2.17 of the Paper, the PRA indicates that the sources of non-neutrality reside in complexity, misaligned interests and asymmetrical information as between originators and investors.

For reasons we have set out earlier, the present paper is only really relevant for originators holding senior positions in SRT securitisations.

Earlier in our response ("The need for a broader reform"), we outlined why the current levels of non-neutrality fail to acknowledge the regulatory reforms enacted in the Securitisation Regulation, especially for STS transactions.

But in the context of the retained senior tranches of SRT, two of the three identified sources of non-neutrality never existed in the first place. The investor whose capital requirements are the subject matter of this consultation is the originator. There can never be a misalignment of interest since the two parties are the same entity. For the same reason there can never be an asymmetry in information.

This only leave a non-neutrality flowing from complexity.

Here, based on the extensive experience PCS has acquired in analysing both synthetic and true sale transactions, we would aver that the synthetic transactions we see across Europe are considerably simpler in design than true sale transactions. This simplicity flows mostly from the absence of having to deal with the management and distribution of actual cash, the legal consequences of having ownership of the assets vested in a vehicle and knotty tax considerations attaching to both the assets, their transfer and the cashflows generated by them.

However, we would also propose that, if complexity remains a concern driving non-neutrality, the PRA can address that concern by adopting STS for synthetics (as it already is in place for true sale SRT transactions) as discussed in Chapter 4 of the Paper. This would be subject to considerations that we set out more fully when addressing Chapter 4.

With the adoption of STS for synthetics – possibly in a modified format - virtually all, if not all, reasons for non-neutrality for senior retained tranches of SRT transactions are eliminated. This is, self-evidently, true whether capital is calculated under SEC-IRBA or SEC-SA.

[D] **An artifact of regulatory construction**

Had the high capital requirements for senior retained tranches under the SEC-SA been the result of historical data and observed behaviour, a discussion would have to take place about the relevance of that data to current conditions. We look forward to that discussion in the context of a review of the Basel Pillar 1 securitisation approach.

However, the damage that will be visited on SRT transactions under the implementation of the Basel 3.1 output floor is not the result of data driven analysis of the performance of senior tranches. It is the accidental by-product of the structure of the capital rules set out in the CRR. Those rules create a doubling up of conservative capital requirements to cover the same single set of risks.

The exceedingly high capital requirements for retained senior tranches are an artifact of the regulatory architecture. They do not reflect a thought through desired outcome.

[E] **Consolidated basis only**

As set out in paragraph 2.5 of the Paper, the output floor will apply to UK firms on a consolidated basis only. We have therefore heard both in the UK and in the EU the argument that many apocalyptic predictions by banks on the impact of the output floor should be discounted since the true impact of the new rules on any future transactions – including SRT securitisations - could only be worked out *ex post facto* taking account of all consolidated RWA positions of the bank.

This does not reflect though how financial institutions manage their business and should manage their business. Every division of a bank must know how much lending capacity it possesses to calibrate its pricing, marketing and pre-contract negotiations. For this, it needs to know how much capital is internally allocated to its operations. This number, together with the cost of capital, is also essential to calculate the cost at which it can offer its products. Taken into consideration in this overall capital allocation are any RWAs that have been or will be removed from that division's books via SRT transactions together with the appropriate capital reduction, if any, generated by those transactions.

So, if the SME lending division of Megabank has been allocated capital of x, that division will know that it can advance y to small businesses. If that division also knows it can remove w RWAs via SRT reducing the capital consumption of those RWAs by 50%, then it can lend (y + 0.5 w). If the regulatory rules provide no capital relief via the output floor limit – effectively Option 1 – then 0.5 w of loans will never be made.

It does not matter in practice that Megabank could have, in retrospect, made more capital available to the SME division because of the lower capital consumption of other businesses not or less impacted by the output floor. The SME division has already implemented its annual business plan and is stuck at lending of y.

[F] **Grandfathering**

We strongly urge the PRA to discuss with UK bank originators the SRT transactions currently extant. Since the synthetic market is private, PCS does not possess the data on how many existing transactions would fail to provide capital relief (or commercially reasonable capital relief) once the output floor comes into force. However, since these transactions are optimised for the current regulation, it is reasonable to expect that the introduction of the output floor – even in the proposed graduated fashion – could result in a capital shock. Should that be the case, the PRA will wish to consider some form of grandfathering of these existing transactions to avoid placing unnecessary and damaging prudential stress on the UK banking sector.

CHAPTER 2 – BASEL 3.1 OUTPUT FLOOR

RESPONSES TO SPECIFIC CONSIDERATIONS

In this section we deal with specific considerations raised and/or discussed in the Paper.

[A] **Paragraph 2.18 – dual role of the *p* factor**

The PRA identifies the dual role of the *p* factor in generating non-neutrality but also in smoothing the capital curve and avoiding cliff effects.

We believe that this is a genuine issue and that a solution that reduces the non-neutrality effect to its correct level at the cost of generating cliff effects would be sub-optimal.

As with the high capital requirements for senior retained tranches, this dilemma is not a logical necessity but an artifact of the regulatory architectures. A regulation designed so that one cannot correct an obvious mis-calibration without creating a new one is clearly flawed and must be redrawn.

We therefore strongly support the suggested answer alluded to by the PRA and which PCS has already publicly advocated for in other fora: create two *p* factors each one dealing with one of the current functions of the existing dual purpose factor.

This is a complete solution and is conceptually extremely easy.[3]

[B] **Paragraph 2.24 – Safety and Soundness**

In the Paper, the PRA states that it believes that Option 1 would support its primary objective of promoting the safety and soundness of PRA-authorised firms.

First, as we set out above ("the value of SRT"), this is far from a given. Powerful and, in our view, convincing arguments can be marshalled to demonstrate that the safety and soundness of the UK financial system is weakened by the absence of a robust SRT market. This is, of course, acknowledged in paragraph 2.25 of the Paper.

Secondly, and at a more fundamental level it is universally recognised (and acknowledged in paragraph 2.28 of the Paper) that prudence must be calibrated to be reasonable and coherent. Absolute safety and soundness of any banking system can only, theoretically, be reached when that banking system engages in no activity or lending whatsoever. However, no-one

[3] PCS is aware, of course, that conceptual ease does not necessarily translate into legislative and/or regulatory ease depending on the sources of regulation and the available methods for their amendment.

believes that the primary objective of the PRA should be pursued at any cost. Even less at the cost of obliterating the UK financial system.

A reasonable balance is reached when capital calibrations are set to reflect their purpose. The purpose of capital is to be available to meet unexpected losses for a given level of financial stress.

Coherence is reached when the level of stress under which "unexpected losses" occur, once selected, is applied consistently across the capital requirement regime. (Or, at least, where consistency is not selected, a rational explanation is provided for why it was not selected).

We believe it can be shown fairly conclusively that the capital requirements generated by Option 1 for senior retained tranches of securitisations are not reasonable or coherent with the stress scenarios used for the rest of Pillar 1. This is unsurprising bearing in mind how these numbers are an artifact of the regulatory architecture rather than fundamentally derived figures.

[C] **Paragraph 2.26 – Helping smaller firms**

The PRA states that it is considering whether Option 1 could assist in improving the competitiveness of smaller and newer banks in that it punishes larger established institutions that are likely to use SEC-IRBA and brings them closer to the smaller players likely to use SEC-SA.

We are fairly certain though that when His Majesty's Treasury set the PRA as a secondary objective facilitating effective competition, it did not have in mind fostering competition by lowering the competitiveness of the most competitive and efficient players with the result that UK finance as a whole became less competitive. We believe it had in mind actions that would raise the competitiveness and efficiency of the currently less competitive and efficient players and thus raise the efficiency of UK finance as a whole.

This interpretation of HMT's intent is also consistent with the other secondary objective it gave the PRA of facilitating the international competitiveness of the economy of the UK.

We do believe though that the PRA has the capacity to fulfil its secondary competitiveness objective whilst at the same time raising the overall efficiency and competitiveness of UK finance. It can achieve this by allowing STS for synthetic transactions (Chapter 4 of the Paper). The experience of the EU is that once STS was made available for synthetics in January 2021, we saw a number of smaller institutions able to issue SRT synthetic securitisations. This allowed such smaller institutions to compete with the larger banks that had been using this SRT format for a number of years.

[D] **Paragraph 2.27 - Alignment with international standards**

The PRA also has the objective of facilitating the international competitiveness of the UK economy "subject to aligning with relevant international standards".

Clearly, the expression is to be understood as meaning "taking into account" rather than "without deviation from". Otherwise, there would be no point in any option but Option 1.

What is not clear to us is whether the international standards that must be aligned with are the *de jure* standards that governments have agreed to or the *de facto* standards that they apply. As noted by the PRA itself in paragraph 2.27, the Basel standards have not been implemented uniformly across jurisdictions. Even on some of the most basic lessons of the GFC and the US sub-prime debacle such as the need to align interests, we note that Japan does not require any retention and that the US has disabled retention both in "high-quality" mortgages and managed CLOs. Furthermore, the US still has not implemented the Basel agreed *p* factor.

The two most relevant blocks when it comes to measuring the competitiveness of UK banks, are the United States and the European Union. The European Union has implemented STS for synthetics although no such provision exists in Basel. It has also provided for a narrow but meaningful exemption from the output floor for retained senior pieces of securitisations as discussed by the PRA when addressing Option 3. As we have seen, the US still has not implemented the *p* factor or fully implemented retention. We are aware that the Basel Endgame process is designed to align more closely the US with Basel 3.1 but we also note that this has not been implemented, the US banks have reacted extremely negatively and vocally to the proposals and we are in an election year.

As PCS asked rhetorically in a public hearing: "How many parties have to stop complying with international standards before they cease to be "international standards"?". We would therefore advocate that the PRA, when considering alignment with international standards, take into account the *de facto* standards of the main competing jurisdictions.

When taking into account such standards – whether *de facto* or *de jure* – we would also advocate that the PRA determine whether these standards are consistent with prudence, the facilitation of competitiveness and proportionality.

As discussed above, we believe that Basel 3.1/Option 1 by extinguishing SRT transactions undermines safety and soundness and is therefore not prudent. By not being applied in the EU and, quite likely, in the US it undermines the competitiveness of UK finance. By requiring disproportionate amounts of capital to cover the actual risk, it is not proportionate.

[E] **Paragraph 2.36(a) – Risk sensitivity**

The PRA is reluctant to reduce the *p* factor under SEC-SA below that for SEC-IRBA to preserve the greater risk sensitivity of the latter.

We believe this is a mistake.

First, there is nothing conceptually necessary in the Basel framework or the CRR that dictates that the SEC-IRBA must generate lower capital than SEC-SA. It makes broad sense, of course, but the framework can operate perfectly satisfactorily without this feature.

Secondly, this approach amounts to saying that, in the attempt to reach the correctly calibrated number (for SEC-SA) we are bounded by what we acknowledge to be another incorrectly calibrated number (SEC-IRBA) and a desired relationship between the two. This will result in an incorrectly calibrated SEC-SA *p* factor with potentially serious real-world consequences for UK finance and the British economy in the name of preserving an artificial and unnecessary feature of Basel and notwithstanding that it produces what we know to be the wrong result.

A better approach would seem to PCS to determine the correct SEC-SA *p* factor. Then, depending on the approach the PRA wishes to adopt, to recalibrate the SEC-IRBA *p* factor to the correct SEC-SA *p* factor or accept an inverted relationship in the case of securitisations.

This problem would disappear though if the PRA were to revise the Pillar 1 calibrations for securitisation itself as we suggested earlier in our response ("The need for a broader reform"). Then the proper *p* factors for both SEC-IRBA and SEC-SA could be determined and the greater risk-sensitivity of the former preserved.

[F] **Paragraph 2.36(b) – Incentivising STS**

We agree that STS should be incentivised. See our response to Question 7.

[G] **Paragraph 2.36(c) – Avoiding cliff effects**

We agree that cliff effects should be avoided. See our comments on paragraph 2.18.

[H] **Paragraph 2.40 – Scope for *p* factor reduction**

We assume that the 0.7 reduction (from 1) is proposed in relation to non-STS transactions since for STS the *p* factor is already 0.5. We would welcome clarification as to the PRA's intentions for STS transactions. Would the *p* factor be maintained at 0.5 or reduced in line with the non-STS p factor to 0.35?

To the extent the proposal (0.7 for non-retail assets and nothing for retail) is derived from the consideration in paragraph 2.36(a) we would refer you to our response above. We do not believe this is the correct approach.

[I] **Paragraphs 2.41 and 2.42 – Formulas and tables**

On the proposals to have variable *p* factors determined by a formula or a table, PCS has no in principle opposition to the idea. That said, securitisation regulation is already extremely complex and so we would only be supportive of such an approach if it could be demonstrated to produce a better, more accurate and more risk-sensitive set of calibrations.

As to whether this would be the case, we defer to originators who have the tools to run those numbers and generate the results.

RESPONSE TO THE QUESTIONS

Q1: To what extent do firms expect to be able to mitigate the potential impact of the output floor on securitisation exposures, including retained tranches of SRT securitisations? Please provide estimates of costs and benefits and / or illustrative examples.

PCS is not an originator and so cannot answer this question directly.

We have read though with interest the paper produced by Risk Control.[4]

We have also had the benefit of reading some data produced by trade associations responding to this discussion paper.

From all those sources, it seems clear that Option 1 would likely extinguish the SRT market in the UK.

Q2: How do you consider that option 2 could be developed?

For all the reasons set out above, PCS believes Option 1 not only is very likely to do serious damage to the UK banking sector's resilience and competitiveness but also is technically incorrect. The current calibrations for

[4] A copy may be found here: https://pcsmarket.org/publication/impact-of-the-sa-output-floor-on-the-european-securitisation-market/

securitisation are excessive in view of the product's performance during the GFC[5] and thereafter, the changes that have been enacted in the regulations and the creation of the STS standard. The dual layering of conservative and mis-calibrated standards in CRR exacerbates the problem. The result are post-output floor calibrations for senior tranches of securitisations in which no-one truly believes.

A proper recalibration of all securitisation capital requirements and especially the non-neutrality aspects is the best course. Failing that, Option 2 is the (second) best course of action.

For the principles on which Option 2 could be developed, we refer you to our general and specific considerations above.

Q3: To what extent could the p-factor be reduced while meeting the constraints set out in paragraph 2.36? Please provide evidence that would support this assessment. Are there other constraints that the PRA should consider?

As set out above, we do not agree that the constraint set out in paragraph 2.36(a) is legitimate or helpful.

The constraint set out in paragraph 2.36(b) is sensible. But the correct approach remains, in our view, to determine the proper level of non-neutrality for non-STS securitisations meeting the Securitisation Regulation rules and for STS securitisations. In this respect, we would note that the original *p* factor providing for 100% additional non-neutrality weighting was not derived from data and represents an arbitrarily selected number. A decade and a half after the GFC we have all the data necessary to conduct a serious examination and determine a better, more accurate *p* factor both for non-STS and STS securitisations[6].

In this respect, PCS does not agree with the proposition that, since STS did not exist as a standard pre-2019, it is not possible to determine the correct non-neutrality number for this type of securitisation. STS was not created from nothing. It was devised to incorporate all the features of existing European securitisations which were felt to enhance simplicity and robustness. These

[5] By "the product" we are referring not to securitisations that performed extremely badly but have since been banned (e.g CLO squareds) or products generated in the US under much laxer regulatory oversight but the traditional products that continue to exist and always had the features (pre-and-post GFC) that are now enshrined in mandatory norms set out in the Securitisation Regulation and, even more so, in the STS standard.

[6] In this respect we draw attention to our footnote 1.

were features found in almost all traditional retail securitisations in Europe (including the UK) pre-GFC. If anything, out of the 100 plus criteria of STS, oneor two might have been missing form such transactions. So, arguably, these transactions might be seen as marginally “worse” than STS. So they can serve as powerful proxies for the likely performance of STS transactions through the GFC had the standard then existed.

As for the constraint set out in paragraph 2.36(c), although entirely legitimate, the solution remains two *p* factors. See above.

Q4: To what extent could option 2 address industry feedback about the interaction between the output floor and Pillar 1 capital requirements?

We would leave the answer to this question to the securitisation industry which is in a much better position to address it.

Q5: What are your views of the different policy options in relation to the interaction between the output floor and Pillar 1 framework for determining capital requirements for securitisation exposures?

Broadly, PCS agrees with the PRA that Option 3 is second best to a properly calibrated Option 2.

However, we cannot stress enough that it is *second* best, with Option 1 a very distant third best.

We believe Option 3 is second best though not because it generates unacceptable risks or results in the under-capitalisation of firms but because it does nothing to address the deep issues with Basel’s Pillar 1 approach. It is an artificial stop-gap measure. But such stop-gap measure remains preferable to the implementation of a fatally flawed Basel 3.1 output floor in respect of securitisations.

For the reasons we set out in paragraph [C] of our General Considerations (“Non-neutrality in the context of SRT”), we believe that the *p* factor in the context of the retained senior tranches of SRT transactions never made any sense. Therefore, to reduce it artificially pursuant to Option 3 would not result in banks being under- capitalised in respect of those senior tranches. Option 3 would be a prudentially neutral amendment to the current regulatory rules.

Q6: What would be the initial and ongoing impact on: (i) capital requirements; (ii) operational requirements; and (iii) securitisation structures of changing the UK securitisation hierarchy of methods to better align with Basel standards? Please provide any data on these impacts.

We would leave the answer to this question to the securitisation industry which is in a much better position to address it.

Q7: Do you have any feedback on the PRA's views on the scope of the UK STS framework? Please provide any supporting evidence.

The extension in the European Union of the STS standard to synthetic securitisations has resulted in a considerable boost to the synthetic SRT market, with 86 transactions notified as of 25th January. Also, notable has been the increase in the use of SRT synthetic transactions by smaller banks, especially from peripheral jurisdictions. Those banks are usually standardised banks.

To the extent that SRT securitisation is both a prudential and an economic good, measures that promote it are – all other things being equal – to be supported. We refer you to our comments in paragraph [B] of our General Considerations ("The value of SRT").

That the introduction of STS for synthetics has led to smaller, SEC-SA, institutions being able to utilise the product, suggests that it would allow new, smaller and challenger banks to bridge the gap with larger SEC-IRBA banks. As such it would assist the PRA's secondary objective of improving competitiveness in the UK banking sector.

STS for synthetics exists and is being used widely by EU banks. These banks, with the US banks, are the primary global competitors of the larger UK banks. By being able to effect more cost effective SRT transactions, these EU banks acquire a competitive advantage over UK banks. Therefore, the introduction of STS for synthetics would allow the PRA to meet another of its secondary objectives: the competitiveness of the UK economy as a whole.

We have discussed the issue of international standards and do not believe these should be an impediment for the introduction of STS for synthetic for all the reasons we outline. (See Chapter 2 [D] "Paragraph 2.27 – Alignment with international standards").

So the only reason we can see not to introduce STS for synthetics would be if to do so clashed with the PRA's primary objective of the safety and soundness of the financial system.

For the reasons we set out in our General Considerations – [C] "Non-neutrality in the context of SRT", of the three causes generative of non-neutrality, two are inapplicable to synthetic transactions from the standpoint of the senior tranche holder: misalignment of interest and asymmetry of information.

The only other non-neutrality generator is complexity. This can be controlled via the STS standards.

So by allowing STS for synthetics, the PRA can eliminate virtually all sources of non-neutrality which, in turn, entirely justifies the lower *p* factor afforded by the STS rules.

However, PCS would add a gloss to this conclusion. The current 135 plus criteria for EU synthetic STS were created in a somewhat haphazard manner and are not internally coherent. Most of the rules are drawn from true sale STS. These rules were designed to protect investors. But investors are not allowed any benefit from synthetic STS. Other rules are SRT rules designed to ensure the risk is effectively transferred. Arguably, these latter rules are conceptually at odds with the former.

Therefore, PCS would recommend that the STS criteria for synthetics should not be copied and pasted from the EU synthetic STS rules. Just as was done in the EU, the existing true sale STS criteria should be examined by the PRA, in collaboration with the FCA and the market. This would allow a better set of criteria than obtains in the European Union. In particular, it would allow the PRA to focus specifically on the simplification and standardisation aspects designed to further reduce any non-neutrality effects.

By allowing STS for synthetics, the PRA would also reinforce standardisation and simplification as well as the prudential robustness of the SRT market. This is because of two additional features of the STS market that do not exist in the same manner in the non-STS synthetic market.

First, STS transactions must be notified to the FCA. Incorrect notifications are liable to generate regulatory sanctions. As a result, STS transactions are very likely to generate a degree of internal oversight at the originator firms greater than non-STS synthetic transactions. Bluntly, legal and compliance will want to be involved. This means that the positive, neutrality enhancing features sought by the PRA are more likely genuinely to be present.

This feature is reinforced by the second unique feature of the STS market: the existence of third-party verification agents.[7] These are regulated and independent verification bodies, providing another layer of oversight. This second layer reinforces the confidence that those aspects required by the PRA to generate a lower non-neutrality are genuinely present in those transactions.

If nothing else, this should allow for a lightening and streamlining of the PRA's deal-by-deal oversight work.

Q8: What is the appetite of bank originators for buying funded or unfunded credit protection in synthetic SRT securitisation?

We would leave the answer to this question to the securitisation industry which is in a much better position to address it.

Q9: What is the appetite of credit protection providers for extending funded or unfunded credit protection in synthetic SRT securitisation?

We would leave the answer to this question to the securitisation industry which is in a much better position to address it.

We would, however, note that the current miscalibration of the capital requirements for securitisations not only for banking institutions but also insurance undertakings is evidenced by the unjustifiable asymmetry in the capital required to be set aside by insurance undertakings for the provision of protection depending on whether this is done in the form of a synthetic securitisation or an insurance product.

If the protection provider is an insurance company operating its capital requirement pursuant to Solvency 2 as onshored in the UK, the capital needed to be set aside when writing an insurance policy (therefore, on the liability side of its prudential balance-sheet) is considerably smaller than the capital requirements for entering into a synthetic SRT securitisation covering the identical risks (but therefore, on the asset side of its prudential balance-sheet). This difference cannot be attributed to the stronger features of insurance contracts being more protective of insurance undertakings (eg the duty of *uberrimae fidei*), These protective features are almost invariably removed from insurance policies designed to operate as SRT credit protection transactions,

[7] As set out at the outset, PCS does generate its income from its work as a third-party verification agent and so these comments are subject to some conflict of interest.

the intention being to make these transactions identical in all respects to standardised SRT synthetic securitisations.

The reason we mention this anomaly is response to Question 9 is that insurance companies do not collateralise insurance contracts. This regulatory capital asymmetry therefore generates a regulatory arbitrage pushing insurance companies away from funded credit protection. Since the capital cost of these unfunded insurance contracts is so much lower, PCS is aware that insurance companies in the European Union are offering to provide credit protection in insurance contract form at much lower cost than funded synthetic protection. As the STS rules require funding (either as collateral or as CLN issue proceeds), this regulatory arbitrage, in large part, explains the slowdown in STS synthetic issuance in 2023. We do not possess any data for the UK but the absence of STS for synthetics makes the current regulatory arbitrage starker than in the EU and therefore there is no reason to believe the push, when dealing with insurance protection providers, towards unfunded transactions will be less.

To summarise, the current miscalibration of capital requirements for securitisations in Solvency 2 is driving the market to provide less robust protection (as it is unfunded) with *less* capital in the system for the same risk.

Q10: How and to what extent might contractual arrangements mitigate any prudential risks posed by unfunded CRM in SRT securitisations?

PCS has no strong views or particular insight in this matter which we will therefore leave to better placed stakeholders for responses.

GENERAL CONCLUSIONS

Our first set of conclusions from our general considerations is that the SRT market is important for the safety and stability of the UK financial system and that steps that would extinguish it or dramatically reduce it – even if superficially conservative in approach – are undermining of that safety and stability.

We also believe that the continued miscalibration of capital requirements in the Basel Pillar 1 framework and especially the arbitrary and no longer defensible non-neutrality factor, distorts the entire landscape. As is well-known from formal logic, from a false proposition it is possible to prove literally any other false proposition. The miscalibration of securitisation in CRR (and Solvency 2) operates as this original false proposition. Unless and until it is fixed, the regulatory community will be pushed into temporary and ill-fitting stop gap measures designed to mitigate clearly incorrect and/or damaging results.

This is why we urge the PRA to address this issue as soon as possible on its own authority to avoid damage to the UK banking system.

In the meantime, Option 2 – if properly calibrated – may be a case of an effective stop gap.

The effectiveness of this option would be strongly reinforced by the extension of the STS regime to synthetic securitisation. The existence of sanctions and third-party verification agents adds to the robustness of such extension.

We remain at your disposal should you wish to discuss any of the points appearing in this paper.

Yours sincerely

Ian Bell
CEO
Prime Collateralised Securities (PCS) UK