afme/
Finance for Europe

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By electronic submission to cp11_23@fsa.gov.uk

Mr. James Hopegood
CBU Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Response of AFME to FSA CP 11/23 – Solvency II and linked long term insurance business

Dear Sir,

The Association for Financial Markets in Europe ("AFME")[1] welcomes the opportunity to provide comments on the FSA Consultation Paper 11/23 ("CP11/23" or the "Paper") entitled "Solvency II and linked long term insurance business".

We are particularly concerned by your stated views in the Paper regarding the treatment of residential mortgage backed securities ("RMBS") in linked funds under the current Handbook and COBS rules and guidance, the proposed amendments to the Handbook in SOLPRU and COBS and the content, factual accuracy and tone of the remarks made.

We refer to the separate submission prepared by Institutional Investment Advisors ("IIA Submission") the detailed contents of which we echo and fully support.

This letter uses acronyms defined in CP11/23 with the same meanings. Unless otherwise specified, each reference to a numbered paragraph refers to a paragraph of CP11/23.

Unless otherwise stated, this response should be read as answering Question 6: "Do you agree with our proposal on loans, deposits and cash and money-market instruments?". The primary focus of our response is regarding "loans" or, more correctly, securities and specifically residential mortgage-backed securities - "RMBS". We do not agree with your proposal, for the reasons set out below.

1 See Annex 1

Key points

Confusion and lack of clarity in the FSA's view of RMBS

There is confusion and lack of clarity in the two statements made in the Paper under the heading "Loans", specifically between 2.52 and 2.54. Could you please clarify whether it is some or all RMBS that you view as unacceptable? A reasonable interpretation of your Paper implies that you view all RMBS as unacceptable, and it is on this worst-case assumption that we have been obliged to base this response.

Further, in 2.52 you say "We do not accept that the performance of RMBS during the crisis renders them eligible to be used in linked funds. We note that the Bank of England has similar concerns relating to complex financial instruments". We would like to remind you that the main source of collateral for the Special Liquidity Scheme was high quality, AAA-rated prime UK RMBS. It seems to us that this was more of an endorsement than a condemnation of RMBS.

"Toxic" characterisation of RMBS is inaccurate and unhelpful

The statement in 2.50 referring to "… RMBS … which proved to be so toxic" is both inaccurate as a general observation and unhelpful in the extreme in the efforts of the securitisation industry to rebuild the confidence of investors and regulators in the securitisation market, an objective supported by many UK and European regulators and policymakers including, we believe, the FSA.

The G20's November 2010 report that noted that "re-establishing securitisation on a sound basis remains a priority in order to support provision of credit to the real economy and improve banks' access to funding in many jurisdictions."

On November 25th 2011, Mr. Emil Paulis, Director DG-Markt, European Commission, speaking at AFME's Securitisation and Covered Bonds Conference in Madrid, said that "The Commission considers it desirable to revive the market for securitised products provided that it can serve its function to raise capital and disperse risk in a safe way."

On February 8th 2012, Steven Maijoor, Chairman, ESMA, speaking at AFME's European Market Liquidity Conference, said "[The Securitisation market is] … a very important market that deserves to repair its damaged reputation and restore investor confidence …".

The Paper treats all RMBS as being the same; this is incorrect

The paper treats the RMBS market as a single, homogeneous whole. This is not a correct approach: there is a world of difference between badly underwritten sub-prime mortgages originated by (predominantly) unregulated non-bank originators in the United States which have since performed poorly, and the regulated, bank-originated prime-quality mortgages originated in the UK and elsewhere in the EU which have performed very well through the crisis in terms of both credit and, more recently, price performance.

For example, cumulative defaults to date incurred by European mortgage backed securities originated in mid-2007 – at the height of the "boom" – amount to only 0.07 per cent.

Also, during the recent sovereign crisis, the secondary market pricing performance of senior tranches of European real economy securitisations has been better than many other sectors such as sovereigns, senior unsecured bank debt and many covered bonds.

See further Annex II, Section III.

Many steps have already been taken to remedy past shortcomings

The paper fails to take into account steps taken by regulators and policy-makers to remedy the perceived shortcomings of the past. One good example is the requirement for an originator to keep "skin in the game" through retention of a tranche of the risk of a RMBS portfolio. For investors which are insurance companies, this is imposed by Article 135 of Solvency II (equivalent, broadly, to Article 122a of the Capital Requirements Directive for bank investors). Article 135 of Solvency II prevents insurance companies from investing in the kinds of poor quality US RMBS structures that contributed to the financial crisis, even if (which seems unlikely) such assets and structures were to re-emerge in the future.

Mistrust towards securitisation has led to potentially very damaging regulations; the Paper unfortunately seems to continue this trend

While risk retention has been accommodated by the industry, unfortunately some other regulatory initiatives have marginalised the role and potential benefits of securitisation investment. It is disappointing, to say the least, that the Paper seems to continue this mistaken approach rather than acknowledge the benefits of best practices for UK and European securitisations, which would contribute to the expansion of the investor base, encourage greater issuance and liquidity and contribute to economic growth.

See further Annex II, Section V.

The industry, on its own initiative, has also taken steps to build a stronger, more transparent market

The paper fails to take into account steps taken by the industry itself to strengthen and reinforce good market practice and in particular to distinguish higher quality securitisations, such as (for example) the Prime Collateralised Securities Initiative ("PCS").

The industry appreciates that in order to reassure regulators and encourage new investors, a clear reference point is needed. This should set out best practices around which to build investment guidelines and regulations to encourage issuance and investment, with the ultimate goal of supporting the real economy. AFME / ESF and the European Financial Services Round Table, working together, have for some time been leading the process to deliver such a scheme in the form of "Prime Collateralised Securities" ("PCS"). This is a market-led initiative defining best market practices and creating the incentives to enforce these practices through a label granted and maintained by an independent third party.

The PCS label is intended to be available for European securitisation transactions that meet industry best practices in terms of quality, simplicity, standardisation and transparency. We also see these four factors as pre-conditions to enhance secondary market liquidity.

Conclusion

We would have expected changes in rules and policy arising from Solvency II to be driven by an evidence-based approach. This should take the form of a balanced and informed assessment of the crisis, its features and causes and the regulatory steps already taken globally to address these issues and prevent a recurrence. Therefore, we would have expected most RMBS to be permissible under the revisions proposed in the Paper.

Improving the health of the securitisation market, including that for UK RMBS, and encouraging insurance company investors to continue to support it and indeed increase their participation in it, will be crucial to the financial stability and funding capabilities of our banking sector, as well as to the ability of insurance companies to manage their assets and liabilities prudently, balancing attractive yields in return for prudently managed risk.

We would therefore welcome urgent clarification and reconsideration of the views expressed with regard to RMBS in CP11/23

Yours sincerely

Richard H. Hopkin

Richard Hopkin
Managing Director
Association for Financial
Markets in Europe

Annex I

AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the U.S. Securities Industry and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). For more information, visit the AFME website, .afme.eu.

Annex II

European Securitisation – an essential, stable, well established and prudent funding mechanism that has performed well through the financial crisis

I. Securitisation: definition and key features

- Securitisation is the process which enables the funding of assets such as mortgages, auto loans or SME loans, held on the balance sheet of a bank or other financial institution (the "Originator"), through a process of collecting them together into a portfolio and selling them to a "securitisation special purpose entity" or SSPE which finances the purchase by issuing bonds to investors. These investors rely for the repayment of their bonds solely on the cash flows from that portfolio of assets; they have no recourse to the Originator that created and collected the assets together in the first place. The SSPE which issues the securities is created by, but is legally separate from, the Originator. However, the Originator remains as servicer of the portfolio, for example collecting monthly mortgage payments from homeowners, and also retains a portion of the risk inherent in the portfolio. In this way, assets which would otherwise not normally be bought and sold are converted into more liquid securities which are traded on international markets.

- Because large numbers of loans are used, statistical analysis can be applied to the portfolio to determine the likelihood that some loans will default. Although some will do so, analysis has shown that the great majority will not. This very low credit risk means that the greater part by far of the loans can support a high credit rating, typically AAA/Aaa. In this way, securitisation enables a bank (or other institution) to raise funding on attractive terms. It allows such institutions to diversify their sources, maturity and cost of financing by addressing a different set of investors from that which would normally provide their unsecured funding, or participate in covered bond programmes. Securitisation is also match-funded to maturity and carries no refinancing risk, as the portfolio of assets is self-liquidating.

II. Reviving the European securitisation market is critical for Europe's recovery

- As the European bond market developed from the 1990s onwards beyond government bonds, **securitisation became one of the most important term funding instruments for European financial institutions:** banks, insurance companies and finance companies owned by large corporates such as auto manufacturers.

- The raison d'être of securitisation is to provide such term funding for the granting of mortgage loans, consumer loans, credit cards, auto loans and loans to small & medium-sized enterprises. **In doing so it is an enabler for growth of the real economy.**

- Europe's funding needs in the coming years will be considerable, so it is crucial that a stronger and reinforced securitisation market plays its part in this, alongside other funding tools such as bank lending, covered bonds and retail deposits. **No single type of borrowing can provide a complete solution to Europe's funding needs; all have their part to play in a balanced funding strategy.** In this respect, rebuilding the confidence of investors and regulators in the securitisation market is critical for Europe's recovery from recession.

III. The features and performance of the European securitisation market: some key facts

- Four years after the onset of the crisis, European securitisation has shown that it has withstood the crisis well in credit terms. **Asset performance for mainstream, "real economy" assets such as residential mortgages, auto and consumer loans and credit card securitisations has been very strong, and well within expectations.** For example, the cumulative defaults to date incurred by European mortgage backed securities originated in mid-2007 – at the height of the "boom" – amount to only 0.07 per cent.

- This is attributed at least in part to the strong regulatory environment governing lending practices in the asset classes underlying European securitisations such as residential mortgages, SME loans and auto/consumer loans. This regulatory environment, governing for example mortgage lending, has been in place in most European countries for many years before the financial crisis. Exhibit 2 shows the asset classes that typically underlie most European securitisations, together with the actual default performance of securities backed by those asset classes. Other, less common, asset classes are also included for comparison. **As can be seen, the major asset classes of RMBS, auto and consumer and SME lending have shown an excellent credit history.**

- In addition, not only has credit risk been low, but also market risk, namely forced selling at fire sale prices, has been low. **During the recent sovereign crisis, the secondary market pricing performance of senior tranches of European real economy securitisations has been better than many other sectors such as sovereigns, senior unsecured bank debt and many covered bonds.** Exhibits 3 and 4 show recent data for the spread volatility of European RMBS compared with sovereign bonds, covered bonds and senior unsecured bank bonds during 2011. It can be seen that, compared to other asset classes, European RMBS has been less affected by volatility - implying stability which is positive from a secondary market liquidity point of view.

- At the moment, "real" investors (i.e. genuine third party investors providing "new" money, not central banks purchasing under repo schemes) own approximately EUR 975 billion of European securitisations. From 2006 to 2011, AFME's figures show that such annual new "placed" issuance dropped from EUR 480 billion to around EUR 90 billion . Simultaneously, average maturities of placed bonds dropped from 5-7 years to 2-5 years.[2] This decline in activity was caused by a combination of a sharp slowdown in lending activity by banks as economic growth decelerated sharply, combined with a reduction in appetite amongst investors who had suffered losses on specific non-European securitised assets such as poorly underwritten US sub-prime mortgages and overly leveraged structures such as collateralised debt obligations.

- The fall in placed issuance comes at a time when European financial institutions are being confronted with a serious shortfall in availability of senior unsecured bank debt. Some, but not all, of this has been absorbed through increased covered bond issuance (see Appendix, Exhibit 1). Consequently, the deficiency in the amount of funding available - the "wholesale funding gap" - is growing. Combined with the pressure on some European banks to meet higher capital ratio requirements this is leading very quickly to significant deleveraging, squeezing economic growth. Just to meet the new Basel requirements, the Quantitative Impact Study undertaken by the Basel Committee on Banking Supervision found that, at the end of 2009 (since when funding conditions have worsened considerably) there was a global funding shortfall of EUR 2.9 trillion[3]. Narrowing this funding gap is vital to help banks meet new regulatory requirements, to stabilise the economy and to allow business and industry to grow.

IV. It is important to highlight the fact that covered bonds cannot plug the gap. Covered bonds are issued by a bank, not by a SSPE. Because of this, and because investors in covered bonds have recourse to the bank issuer in the first instance, covered bond issuance is limited by investors' credit line capacity constraints towards the bank issuer, and the credit rating is much more dependent on the bank issuer's senior unsecured rating. Because of this linkage to the issuer, the pricing of covered bonds has also been affected by investor sentiment toward the banking sector, although less so than for senior unsecured bank debt. This is because the presence

[2] In addition to the placed EUR 975 billion, EUR 1.1 trillion has been retained by issuers for potential use in central bank "repo" schemes. However, this type of funding does not provide any net new lending to the overall banking system.

[3] See: http://www.bis.org/publ/bcbs186.pdf

of collateral in covered bonds provides some reassurance to investors. However, the provision of collateral has a price: covered bonds encumber a larger share of a bank's assets than securitisations, constraining a bank's access to other types of funding and potentially weakening the average credit quality of the remaining unencumbered assets. Unless greater health is restored to the securitisation market, the wholesale funding gap is unlikely to stabilise or shrink. **Access to the securitisation market has become increasingly important to overcome the funding shortfall.** This is because securitisation investment does not utilise investors' credit line capacity to the bank originator to the same extent, and appeals to different types of investors from senior unsecured bonds and / or covered bonds. **Securitisation in Europe: is it a prudent, strictly regulated technique or an inherently dangerous tool?**

- Securitisation is simply a technique which, prudently deployed and sensibly regulated, can deliver major benefits for the real economy – as the experience in the European market shows. It is true that securitisation has been associated with the 2007-2008 financial crisis. This is because in the US it was used to enable (predominantly) non-bank originators to fund badly underwritten subprime mortgages which subsequently performed poorly[4]. These transactions were then leveraged excessively by further (and, with hindsight, mistaken) application of the securitisation process to the securitisation transactions themselves[5] in the form of re-securitisations (known as "CDOs" and "CDOs squared"). Many of these instruments were sold not just domestically within the US but also offshore to European and other non-US investors. These practices created an inaccurate but understandable perception amongst policy-makers, the press and the public that the securitisation technique itself, and all asset classes with which it is associated, are "toxic"[6]. Partially as a result of this, the European investor base has declined significantly, resulting in lower secondary market liquidity and higher execution risk. This has dampened issuance in some European countries, and brought issuance to a complete halt in others.

- This false perception has led to an "image" problem, rather than a problem of actual performance. Given the size of the funding gap for European financial institutions, and the macro-economic aim to promote lending in many of these real economy asset classes to ensure European economic stability and growth, it is essential that this strong track record of performance through the financial crisis is recognised by policy-makers and regulators.

V. The risks of marginalising high quality securitisation

[4] Poor underwriting has led to poor performance throughout the history of banking; it is not specific to securitisation or any other form of funding.
[5] Rather than the underlying mortgages, auto loans, SME loans etc.
[6] In reality, of course certain asset classes, especially in Europe, have performed well.

- European regulators have introduced many new rules and regulations[7] and the industry has worked constructively in their implementation. However, due to the mistrust towards securitisation even in those jurisdictions where – as shown in previous paragraphs – rules, practices and performances were sound, **securitisation investment, its role and potential benefits for the European recovery, have been marginalised and the highly damaging impact of a number of recent regulatory initiatives is being neglected**. For example, securitisations are absent from ECB purchase programmes, they are not eligible for inclusion in the Basel III liquidity buffers and current Solvency II Level 2 guidance proposes capital charges for EU insurance companies that will make securitisations prohibitively expensive for them to invest in.

- Regulators' acknowledgment of the benefits of best practices for European securitisations, on the contrary, would contribute to the expansion of the investor base, thereby encouraging greater issuance and liquidity as well as improving the ability of European financial institutions to attract funding which would be used to finance economic growth.

[7] For example, Rule 122a of the CRD requiring an Originator to retain "skin in the game" - broadly, 5% of the risk. Also initiatives sponsored by the ECB and other central banks requiring increased transparency and greater granularity for the contents of loan portfolios, full access for investors to legal documentation, investor reporting, cash flow modelling and so on.

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APPENDIX

Exhibit 1

Exhibit 1 provides the percentage change in issuance volumes between the 9 months period ended 30 Sep 2011 and the comparable period in 2010 for European bank debt, covered bonds and ABS/MBS.

Source: Dealogic (Bank debt, Covered Bonds), AFME/SIFMA for European ABS/MBS

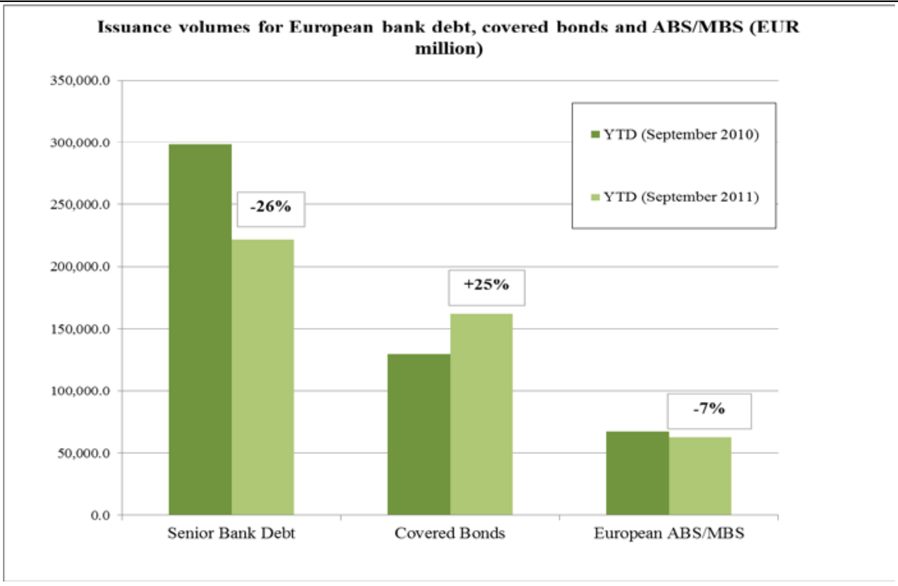


Exhibit 2:[8]

Exhibit 2 shows that for issuances outstanding in mid-2007 in Europe, the credit performance of PCS eligible asset class was excellent (0.09% default rate). Please note that this default rate includes all tranches, not only those rated 'AAA' in mid-2007.

Source: Standard & Poor's

Credit Performance, by asset class, Europe vs US Mid-2007 to end Q3 2011

By Asset Class	Original Issuance (EUR billion)	Default Rate (%)
Europe		
Total PCS eligible asset classes	**958.8**	**0.09**
Credit Cards	33.2	0.00
RMBS	753.6	0.07
Other Consumer ABS	69.0	0.13
SMEs	103.0	0.20
Only senior tranches to be PCS labelled, the default rate for which is zero, like Covered Bonds		
Total Non-PCS eligible asset classes/ structures	**733.8**	**2.97**
Leveraged loan CLO	71.3	0.10
Other ABS	60.1	0.19
Corporate Securitisations	78.3	0.19
Synthetic Corporate CDOs	255.1	1.87
CMBS	165.0	3.23
Other CDOs	75.2	5.78
CDOs of ABS	28.9	24.19
Total European securitisation issuances	**1,692.6**	**1.34**
Covered Bonds	**934.6**	**0.00**
Total European issuances	**2,627.2**	**0.86**
Select US asset classes		
Credit cards	295.2	0.00
Autos	198.2	0.04
Student loans	266.8	0.17
RMBS	3,254.5	11.67

[8] Please note:
In this Exhibit, we have assumed that the entire European credit card, consumer, SME and RMBS universe would be PCS eligible, although in reality this will not be the case since the historical data categories are not exactly comparable with likely PCS eligibility definitions. For example, only the senior tranches of these deals would be PCS eligible. The Default Rate for senior tranches in PCS–eligible asset classes was zero, i.e. the same as Covered Bonds, which exclusively consist of un-subordinated, senior securities.
The Leases asset class, which is PCS eligible, is not highlighted separately in the table since the S&P data is not configured as such.

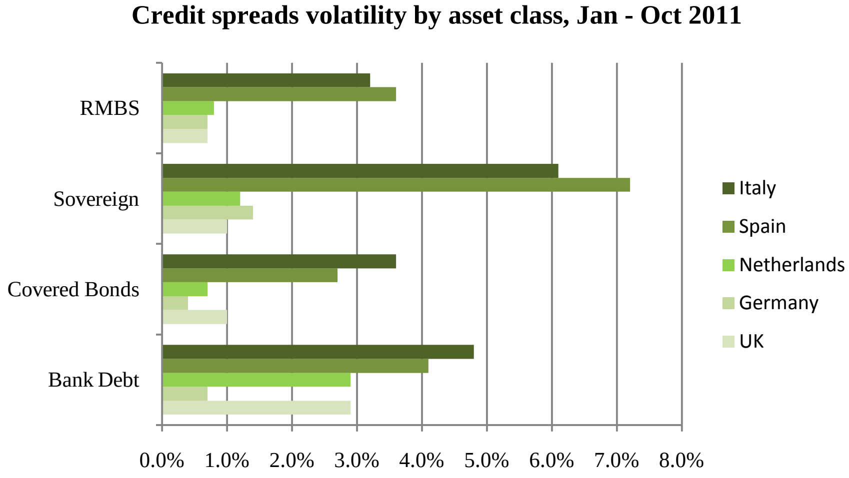
Exhibit 3 Exhibit 3 shows the volatility in credit spreads of asset classes during Jan – Oct 2011. RMBS has demonstrated lower spread volatility than bank debt, sovereigns and some covered bonds. Source: BoA Merrill Lynch Global Research	

Exhibit 4

Spread volatility by sector				
	Jan 2011 - May 2011	Jun 2011 - Oct 2011	Increase	Jan 2011 - Oct 2011
	CB Bank Sovs RMBS	CB Bank Sovs RMBS	CB Bank Sovs RMBS	CB Bank Sovs RMBS
United Kingdom	0.5% 1.2% 0.6% 0.5%	1.3% 3.7% 1.3% 0.9%	0.8% 2.5% 0.7% 0.5%	1.0% 2.9% 1.0% 0.7%
France	0.6% 0.8% 0.9% NA	2.2% 5.1% 2.9% NA	1.7% 4.2% 2.0% NA	1.7% 3.7% 2.1% NA
Germany	0.3% 0.6% 0.8% 0.5%	0.5% 0.8% 1.7% 0.9%	0.2% 0.3% 0.9% 0.4%	0.4% 0.7% 1.4% 0.7%
Netherlands	0.7% 1.2% 0.7% 0.7%	0.7% 3.7% 1.5% 1.0%	0.0% 2.5% 0.8% 0.3%	0.7% 2.9% 1.2% 0.8%
Portugal	2.7% 8.1% 8.3% NA	8.6% 19.3% 18.7% NA	5.9% 11.2% 10.5% NA	6.6% 15.0% 14.4% NA
Spain	2.3% 3.1% 4.0% 2.6%	2.9% 4.6% 9.4% 4.1%	0.6% 1.5% 5.3% 1.4%	2.7% 4.1% 7.2% 3.6%
Sweden	0.4% 1.3% 1.1% NA	0.5% 3.0% 0.9% NA	0.0% 1.6% -0.3% NA	0.4% 2.3% 1.0% NA
Italy	1.9% 1.2% 2.4% 0.7%	4.5% 6.4% 7.8% 4.1%	2.5% 5.2% 5.4% 3.4%	3.6% 4.8% 6.1% 3.2%

Source: BofA Merrill Lynch Global Research

Covered Bonds data include all covered bonds (not just mortgage covered bonds) rated by S & P. Additional credit performance data is available from other sources.