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LIBA
LONDON INVESTMENT BANKING ASSOCIATION

Commissioner McCreevy
European Commissioner for Internal Markets and Services
European Commission
B-1049
Belgium

July 16th 2008

RE: Incentives in the originate-to-distribute business model

The BBA, CMSA-Europe, the EBF, the ESF, ISDA, IACPM, LIBA, and SIFMA ("the Associations") strongly object to the European Commission Service's alternative proposal to amend the Capital Requirements Directive (CRD) to address incentives in the "originate-to-distribute" (OTD) model. The new proposal aims to prohibit European investment in obligations where the originator or sponsor fails to retain a 10% interest in positions having "the same risk profile".

We agree with the Commission that there have been difficulties with certain loan origination practices, as well as weaknesses in risk management procedures at a number of financial institutions, but note that unprecedented credit market conditions have also played a critical role. We can appreciate the Commission's motivation to increase industry and regulatory focus on some aspects of the OTD model. But the Commission Services' proposal has the following fundamental flaws:

1. It will reduce the availability, and increase the cost of credit in the EU. The proposal will damage the European economy by permanently altering the amount and cost of credit available from the capital markets to European consumers and corporate borrowers. The 10% retention requirement permits EU institutions no room to mitigate their risk. This will reduce cash and liquidity available to wholesale and retail markets and the cost of capital will rise.

2. It will damage the competitiveness of Europe. Investment opportunities for EU institutions will be reduced, thus putting them at a significant disadvantage in the global financial system. Where it becomes more expensive to invest in a broader

range of European credit risk transfer products, investors in instruments like credit derivatives will go elsewhere.

3. It will not achieve the Commission's intended objective to better align the interests of originators with those of investors. The proposal potentially weakens the incentives for investors to perform appropriate additional due diligence and credit assessments.

4. It will impair credit risk transfer mechanisms. This will lead to consequences for the active management of risk exposure, including an impairment of the ability to disperse risk through the system so that individual institutions are not faced with the challenge of managing concentrated risk positions.

The widening of scope of the Commission's proposal will amplify all of the adverse consequences that we outline here.

The OTD business model relies upon strong loan origination and risk management procedures. Simple proxy methods mandating quantitative measures are unlikely to affect the behaviour of the different participants who operate in these markets. Instead we believe the following significant improvements already underway will, taken together, address the fundamentals of the Commission's concerns:

- CRD provisions already in place focus upon encouraging both the originator and the investor to conduct more effective due diligence and risk analysis (Annex V, point 3 of the CRD is explicit on this point).
- Enhanced Supervisory Review Process. Regulated firms already have a duty to measure the credit risk embedded in the transactions, under the CRD, with compliance subject to supervisory review. Investors (regulated or otherwise) also have the right to negotiate with the originators to obtain more information and even to require retention of some, or some more, of the risk.
- The industry, at the specific request of the Commission, is working on transparency principles in relation to securitisation exposure reporting
- We are also developing an industry market data report and undertaking a range of investor information initiatives. All of these initiatives are designed to assist investor-side credit assessment of securitisation structures so that investors can make investment decisions on sounder foundations.

We understand the Commission's desire to deliver a simple, quick, strong signal to the market. Our strong preference is for an appropriate timeframe to be given to the work needed to enhance transparency, to improve risk management and address supervisory standards, in line with ECOFIN and Financial Stability Forum recommendations. Nevertheless, we stand ready to continue to work with the Commission in creating the right incentives to ensure that EU markets remain secure and liquid and can serve the needs of EU firms and citizens.

We believe there is merit in considering some of the alternative proposals being considered by Member States and financial institutions in response to the concerns around the OTD model. We note that some of these alternatives - that would require more time to be fully assessed, in line with the better regulation principles - more accurately capture the products and markets associated with the OTD model.

Many of our member firms are global financial services companies regulated across multiple jurisdictions, and we are very concerned that in unilaterally pushing ahead with modifications to capital regulation the EU will disturb the international consistency achieved in drafting the new Basel II Accord. Since the Basel Committee is committed to undertaking a review of the securitisation framework, we would urge the Commission to defer making amendments until the outcome of that analysis is known and to work with the Basel Committee to maintain an international capital standard that would see EU firms operating on a level playing field with international peers rather than at a competitive disadvantage.

The Associations would be happy to discuss the concerns of the industry in more detail and include below further explanation of the problems with this proposal. Please do not hesitate to contact any of the associations listed below, and for your benefit we provide a description of each association at the end.

Yours sincerely,

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Why this proposal does not work

This proposal does not achieve the Commission's objectives with regard to the "originate to distribute" model.

We understand that the intention of the proposal is to align the interests of the investors with the originators, by ensuring that originators at all times retain some type of similar economic interest in the risk pool as the investors who purchase securities or other instruments. The central tenet of capital regulation is that the regulated entity should hold capital against its risk exposures, but this does not and should not absolve investors, including many among our joint memberships, from their responsibility to undertake appropriate due diligence on what they are buying.

The new proposal does not create incentives for this risk analysis; indeed, it does not create or foster direct incentives for the investor to perform due diligence as, arguably, investors would place undue reliance on the due diligence efforts of others (i.e., "the originator has made the required disclosure around the 10% risk profile retention requirement therefore it must be appropriate to invest"). It is only by gaining access to information on the underlying risk that the investor – i.e. the EU regulated entities in this instance – will have the capacity to manage their own risk exposures and accurately assess the amount of capital to set aside commensurate with the risks undertaken.

This is why the transparency initiatives – recently endorsed by ECOFIN and the Commission – are so important. If we wish to control the build up of poor quality assets in the balance sheets of EU regulated firms then the onus should be placed on the investors and the tools given to the investors to monitor this.

Furthermore we do not believe firms would have an incentive to improve their underwriting standards as a result of this provision. The originator's retained 10% risk exposure gives no information about the quality of the underlying assets. The risk profile could be of any quality. The originator could still determine a risk profile best suited to its own risk appetite, and the needs of the originator, and of any individual investor, would not become more closely aligned over time.

There would be a risk of moral hazard for firms and a contradiction with a principle at the heart of financial regulation. Formerly investors were guilty of relying too much on ratings. Now there is a risk that investors would assume that the 10% retained stake would mean that their exposure is "good quality" risk. It is more likely, under this provision, that investors would expect the originator to "rescue" a structure if problems emerge. Requiring a firm to retain a portion of the securitisation is thus a direct contradiction of the principle of removing the risk from the balance sheet. Furthermore it undermines the regulator's desire to extinguish the risk of implicit recourse, as required in the CRD. It would make yet more complicated the Commission's continuing attempt to define "significant risk transfer".

Placing a prudential restriction on the originator does not address the risk behaviour or profile of the investor. We observe that the proposal would effectively and inappropriately utilize capital requirements to address a conduct of business issue. We believe there are other more effective ways to effect a change in risk management behaviour.

Impact of the proposal

We believe this proposal has the potential to cause real damage to the competitive standing of the EU capital markets. The proposal as drafted has the potential to restrict liquidity in Europe and reduce investment opportunities for EU investors, while placing other institutions at a disadvantage in their ability to use risk transfer mechanisms for funding and risk management. The reduced level of competition in the market will further increase the costs of transactions.

The proposal suggests that these provisions apply to credit institutions that come under the CRD and other types of institutional investors such as insurance companies and firms under the UCITS directive. In a global financial system investors subject to the proposed regulation would be competing for investment opportunities against unregulated and third country investors as well as regulated EU entities. This proposal could not only push investment outside of the EU, it may shift liquidity away from regulated markets to those investors not regulated in the EU.

In addition to the above, these proposed rules will make both the origination and the risk transfer process through the European capital markets more expensive by fundamentally altering the availability and cost of credit in the EU. There are several factors that drive this analysis. First, as EU firms' balance sheets retain the 10% required stakes, (particularly if the 10% were to apply to all types of underwriting markets, including syndications) there will be reduced cash/liquidity available to both the wholesale and ultimately retail markets. Second, as firms will not be able to employ any credit risk mitigation technique to reduce the regulatory capital impact of the 10% on their books, whether in the form of a guarantee, swap, put option, sub-participation or other hedging instrument, capital costs will rise. Third, the current rise in interest rates will compound these negative effects and taken together these factors will act to create the risk of accentuating stagflationary pressures on the economy.

In terms of specific market impact, prior to the market turmoil, securitisation provided a vital source of funding to the markets, with funding levels in 2006 and 2007 of EUR481 and EUR454 billion respectively. In the first six months of 2008, the amount of public securitisation issuance sold that was issued to investors dropped to only EUR20 billion. This severe contraction has mostly affected the European mortgage market. In 2007, a total of EUR308 billion of mortgage funding was provided through securitisation (EUR260 billion for residential, and EUR48 billion for commercial). Although some residential and commercial mortgage lenders have other funding alternatives such as covered bonds, which have broadly been less affected by the market turmoil than the securitisation market, this market is not available to all lenders and it is unlikely that the covered bond market could absorb all of this supply without a seriously adverse affect on pricing in that market. This will in turn drive up the cost of borrowing to homeowners and commercial property borrowers. In 2007, the European covered bond market was smaller than the European RMBS and CMBS market, with European mortgage covered bond issuance in 2007, excluding Denmark, of EUR196 billion[1] (source: ECBC website). Based on approximately EUR 7,500 billion of residential and commercial mortgages at 31 December 2007, approximately 25% were financed through capital markets financings (14% through covered bonds, and 11% through securitisations).

We comment here on the impact on the credit derivatives market, as it is one of the major markets in which our members participate and because it is clearly identified in the Commission's proposal. Significantly, the Commission's revised proposal seeks to broaden the scope of application to all credit risk transfer products, not just investors in "originate to distribute" instruments. The many and various ramifications of this wider scope will affect numerous markets and stakeholders and it is important that the Commission has a full understanding of all the potential consequences of this element of the provision.

The credit derivatives market plays an important role in facilitating the active management and hedging of risk. This function is recognised in the CRD through incentives that are provided to firms who buy protection and through obligations placed on firms who sell protection. Despite recent turbulence, credit derivative markets have remained liquid enabling market participants to mitigate risks and minimize losses. These instruments are an important component in the armoury of risk management and hedging and for the market to survive both protection sellers as well as protection buyers need to be willing to continue trading.

The credit derivative market serves to illustrate several important concepts. It is not possible to affect only one side of the market. Focusing on the investors alone could have damaging consequences for the health of a market as a whole. Impairing credit risk transfer mechanisms will lead to consequences for the active management of risk exposure, including an impairment of the ability to disperse risk through the system so that individual institutions are not faced with the challenge of managing concentrated risk positions.

Similar considerations should also be given to other sectors that could be captured within the broad definition of credit risk transfer products, including leverage loans and corporate bonds. The proposal as drafted could have unintended consequences for these markets which should be considered in full.

In summary, where it becomes more expensive to invest in a broader range of European credit risk transfer products, investors in instruments like credit derivatives will go elsewhere. Investors not subject to the CRD will continue to invest in products in all markets that this provision intentionally or unintentionally scopes in. This could encourage growth in a more efficient, more liquid market away from the regulated financial market sector, and outside the EU, weakening EU markets' ability to compete with non-EU markets.

The proposal introduces new forms of risk

[1] Including Denmark, where covered bonds represent 100% of issuance, total European mortgage covered bond issuance in 2007 was EUR 345 billion.

Taking a risk management perspective we have identified material adverse effects if this proposal were to be implemented. On the one hand it is clear that the proposal introduces new legal and operational risk for the investor to manage but of greater concern is the conflict that is established between legal compliance in order to satisfy the directive requirements and active risk management. There are a range of major compliance issues, including: the obligation on the investor to ensure that the requisite 10% stake was being held by originator/sponsor both at the inception of the transaction and on an ongoing basis; and how to administer this regime in the non-cash markets. From a practical standpoint, the proposal will be clumsy to administer and difficult to comply with and enforce, which will reduce investor incentives to return to the securitisation and other risk transfer markets.

We further note that a mandated retention of risk could affect the accounting analysis, and in some jurisdictions, also the legal sale analysis as to a "true sale," which in turn could affect ratings and credit assessment. These factors could in turn affect the ability and/or willingness of certain significant originators/distributors to engage in securitisation. Their exit from these activities has not been thoroughly considered and is likely to reduce the availability and increase the cost of credit.

The Alternatives

The financial markets provide a number of incentives and potential mitigants for lenders and other risk originators to originate products that will perform well for investors, irrespective of whether the originator retains economic risk. Furthermore, in recent months, a significant number of risk mitigants have already been put in place by regulators as well as by the industry to enhance standards for risk transfer products. For example, as part of "Ten Initiatives to Increase Transparency" delivered to the European Commission in June (see association websites for details), the industry is developing investor-side credit assessment principles so investors do not solely rely on ratings when making investment decisions. These proposals were developed based on recommendations from ECOFIN and Financial Stability Forum.

It is also important to highlight that risk control procedures at the regulatory level have already been improved. Investors among our members in the many forms of tranched products are in the process of ensuring that sufficient internal and regulatory capital is allocated to these exposures. Capital held against securitised exposures is already far higher than pre-market turmoil levels of capital held. Through a combination of improved market risk models and changes in the parameter estimates in credit risk models, there has been a significant increase in the internal and regulatory capital allocated to certain types of securitisation exposures.

Conclusions

The provision as drafted provides no incentive to firms to improve their underwriting standards or target their contingent liquidity risks. We believe that any proposals, now more than ever, should maintain the principles of better regulation, including market failure analysis and impact assessments; and ensure that there is full consideration of the consequences, both intended and unintended.

The resilience of the international financial system and the robustness of individual firms rests on the quality of legislative proposals which must not therefore be rushed through without proper exposure and analysis.

The joint trade associations are:

British Bankers' Association

The BBA is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, the BBA's member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy

Commercial Mortgage Securities Association - Europe

The Commercial Mortgage Securities Association is an international trade association promoting the ongoing strength, liquidity and viability of commercial real estate capital market finance worldwide. CMSA plays a vital role in setting industry standards and educating professionals. With close to 400 member companies worldwide, and with a presence in Canada, Europe, Japan and the United States, our diverse membership base represents the full range of the industry's market participants, including senior executives at the largest money-center banks and investment banks, rating agencies, insurance companies, investors, lenders and service providers.

European Banking Federation

Set up in 1960, the European Banking Federation is the voice of the European banking sector, with over 30 000 billion EUR assets and 2.4 million employees in 31 European countries. The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions. The EBF represents, defends and promotes the interests of its members, promotes the development of the industry, provides value-adding information and efficient and professional services to its member Associations and assists new members in their accession procedures, be it to the EU itself or to the Euro.

European Securitisation Forum

The European Securitisation Forum (ESF) is an affiliate of the Securities Industry and Financial Markets Association (SIFMA). The ESF is the securitisation industry's forum, converting ideas into action to enhance the growth and improve the legal frameworks and practices of securitisation across Europe. Our membership encompasses all aspects of the industry, including issuers, investors, financial intermediaries, rating agencies, legal and accounting firms, trustees, servicers, guarantors, and other market participants.

International Swaps and Derivatives Association, Inc

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

International Association of Credit Portfolio Managers

The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest.
Membership in the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit sensitive financial instruments.

London Investment Banking Association

LIBA is the principal trade association in the United Kingdom for firms which are active in the investment banking and wholesale securities industry. LIBA represents the London offices of investment banks from around the world.

Securities Industry and Financial Markets Association

The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members’ interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.