

A response to the EBA consultation

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PCS

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EXECUTIVE SUMMARY

Prime Collateralised Securities (“PCS”) would like to thank the European Banking Authority for the opportunity to address the issues raised in the discussion paper on simple, standard and transparent securitisations published last December (the “Paper”). Also we would like to express our view that PCS sees the approaches sketched out in this paper as a very substantial and positive contribution to the future of a strong European securitisation market, framed within a robust regulatory framework. We also note and are honoured by the references in the Paper to our work in this area, for which we wish to express our specific thanks.

PCS is an independent, not for profit initiative set up by the securitisation industry, including originators, arrangers, investors and service providers. It was set up with the aim of assisting in the return of a strong and robust European securitisation market. This it seeks to do through the granting of a quality label and the definition (through its labeling criteria) of best standards including simplicity, structural strength and transparency.

[A] PCS strongly agrees with defining “simple, standardised and transparent securitisations” (“SST securitisations”), doing so on a conceptual basis, and including potentially all the tranches of a transaction within the definition.

[B] PCS also strongly agrees with the idea of a single core SST definition that can be used in all relevant European regulations touching on securitisation. PCS also acknowledges that the differing aims of these regulations may require additions to the core SST definition where relevant (the “modular approach”).

[C] PCS broadly agrees with the approach to SST securitisations found in the Paper. It specifically strongly supports an approach that separates, on the one hand, elements of structural integrity from, on the other hand, the pure credit analysis of the securitised assets.

[D] The use of the definition of SST securitisation should allow high quality securitisations to be fairly treated in regulation and receive treatment commensurate with their actual risk and comparable to other high quality investments.

[E] In the context of capital charges, PCS believes that a definition of SST securitisation should and will allow the application of a ‘capital neutrality’ approach.

[F] PCS believes that the certification of SST securitisations will be necessary. We further believe such certification is best done by one or more independent private sector entities under strong public authority oversight.

GENERAL CONSIDERATIONS

“Two stage” approach

At the broad conceptual level, PCS is very supportive of the “two stage” approach set out in the Paper. We concur with the analysis of the recurring factors common to those securitisations that did not perform in line with expectations during the crisis, as set out on page 7 of the Paper¹. Indeed, these factors are congruent with those proposed by PCS, as your Paper kindly points out on pages 36 and 37.

As we have outlined in previous publications², the factors hindering “simple, standardised and transparent” securitisation are the same as those affecting “structural integrity” of securitisations according to PCS. In the hierarchy of credit analysis, structural integrity, as the EBA paper rightly suggests, precedes the analysis of the core underlying credit risk of the assets (both logically and temporally). This is because the connection between these factors and poor performance is not a mere empirically deduced fact. It results from the impact these factors are bound to have on the capacity to perform a robust credit analysis.

In our view, the presence of one or more of these factors³, directly and negatively impacts the capacity to perform a reliable credit analysis. In other words, the capacity of investors and/or regulators to derive a high degree of confidence in the second step of the overall credit analysis, namely the analysis of the credit risk of the underlying assets, is always eroded by the presence of one of these factors.

It also, in our view, follows from this approach that an SST securitisation need not be a highly rated securitisation. We strongly agree with the Bank of England and ECB’s analysis in this respect that an SST securitisation is fundamentally a securitisation whose credit outcome is predictable and consistent. This is why we also agree with the EBA’s approach of not artificially limiting the definition of SST securitisations to any given credit step level. Such limitations may well have a place in the ultimate regulations as additional requirements beyond SST but should not be integrated in the core SST definition.

¹ Being (i) misalignment of interest between originators and investors, (ii) excessive leverage – or, in the terminology used by PCS, iterative credit tranching, (iii) embedded maturity transformation and (iv) complex structures. Here PCS adds “transparency” as its fourth factor whilst the EBA paper deals with transparency elsewhere.

² For example, “A response to the Bank of England and ECB discussion paper” (July 2014) (<http://pcsmarket.org/wp-content/uploads/2014/07/PCS-Response-to-BoE-ECB-consultation.pdf>).

³ The logical link between these factors of structural weakness and the confidence level of credit analysis have been analysed and described by PCS in its response to the Bank of England and ECB discussion paper – see above, specifically pages 14 and 15.

Tranching and asset classes

When looking at the key components of structural integrity underpinning the SST approach, it is clear that, by definition, they apply to the whole of each securitisation transaction rather than to any individual tranche of that transaction. If a securitisation transaction is not the product of a pure originate to distribute model, is not a re-securitisation, does not embed maturity transformation or suffer from deficiencies in transparency then none of the tranches of that securitisation do. Therefore, PCS supports the approach set out in the Paper that allows SST status to be available to all the tranches of a securitisation.

We also note that the proposed SST definition does not have any limits on the asset classes that may be the subject of SST securitisations. We believe that this is consistent with the overarching principles of the SST approach. However, we note that the proposal has a number of credit related criteria for some asset classes. We wonder if there is not a potential lacuna in this approach as the EBA appears to see the need for some additional safeguards in the traditional asset classes but does not provide for a mechanism to examine whether similar safeguards may be useful in other, unusual, asset classes.

Based on our experience with the PCS Label and in line with our response below to Question 4 (jurisdictional limitations), we wonder if the line of greater prudence may not be to provide within the SST securitisation definition a list of approved asset classes together with a mechanism for adding additional asset classes. Such additions could take place, over time, as diligence is conducted to ensure that there are no specific characteristics of these new classes that would make them somehow inappropriate for SST status.

There are clearly no issues with residential mortgages, consumer loans (including credit cards), auto loans and loans and leases to small and medium enterprises as asset classes eligible for SST status.

The reason we think a specified asset class list may also be a good idea is that we note that asset class restrictions do already appear in the rules for Solvency II and the Liquidity Cover Ratios under CRR. If a core definition of SST securitisations is crafted without an asset class list **but** (under the modular approach) such lists exist, in *ad hoc* form, in other regulations then we could lose the centralised mechanism for adding new asset classes to the SST securitisation definition. This could lead to an unnecessary divergence between the different regulations not based on the diverging regulatory purposes but solely on the diversity of mechanisms and authorities for inclusion of additional asset classes.

Finally, with an official list of allowable asset classes, the operation of the asset homogeneity rule (Criterion 4) becomes much simpler. If you have a list, Criterion 4 is met if all the assets in an SST securitisation belong to an asset class in the list and only one such asset class. Absent a list, we anticipate potentially serious difficulties in determining how similar assets need to be to be

for them to be considered as belonging to the same class for purposes of homogeneity.

Neutrality of capital charges

To the extent that SST requirements allow the credit risks associated with any securitisation to be robustly and fairly assessed, PCS strongly agrees that the regulatory framework should avoid, to the fullest extent possible, any non-neutrality of capital charges. At a broader level, we believe that throughout the regulatory rules dealing with credit risk SST securitisations should receive equivalent treatment to other credit products, commensurate with their credit risk. (Regulations dealing with other issues such as liquidity will, of course, need to take into account the liquidity characteristics of the different products.) Insofar as the credit analysis of SST securitisations is as robust and the outcomes as predictable as those of other products, there can be no logical reason to discriminate in a negative way against the former.

Credit components of the definition of SST

Although this issue is partially the subject of Question 8, we would like to make a few general comments on the inclusion of pure credit criteria (as distinguished from structural integrity criteria) in the SST definition. We will make some more detailed comments to that question later in our response.

The issue of the inclusion of credit criteria into the SST has caused the greatest debate and amount of reflection within PCS. The PCS label itself contains a number of criteria of a pure credit nature. However, the PCS label also seeks to define a “best market practice” standard that is explicitly above and beyond what we would consider a strong prudential regulatory standard. This is why the presence of credit criteria in the PCS Label does not, in and of itself, mean that PCS believes that such criteria are necessary for a prudential standard as distinguished from a “best market practice” standard.

The approach of intellectual purity would be, of course, to reject any credit criteria from the SST definition. If the SST definition is designed to capture the elements of structural integrity that logically precede, but are also separate from, the pure credit aspects of a securitisation, then the most coherent approach would be not to have any credit criteria included in the SST.

However, on reflection and bearing in mind the need to create, through the SST definition, a robust regulatory scheme for what could be described as “plain vanilla” securitisations, PCS believes that there can be a place in the SST definition for a few basic credit criteria. We think this, if not the most intellectually pure course, does accord with a common sense approach to this issue.

We would, however, caution against inducing investors to use the regulatory scheme as a means to substitute for their own credit analysis. SST credit criteria should be very few and set at the outer limits of what should be acceptable. They should seek to eliminate excesses from the SST definition, not set a high credit bar. They should also not seek to achieve specific macro-economic or

political objectives for the European economy. PCS believes that prudential regulations are not appropriate means to achieve such objectives. They should be designed to meet prudential requirements only, leaving macro-economic and political objectives to be achieved through political action by the authorities responsible for such tasks.

Operationability

The final aim for the definition of SST securitisations is not just a definition but a new regulatory architecture that is prudent, fair but is also capable of being operated in practice by both the regulators and market participants. In this respect, we would like to make some remarks.

Complexity

In respect of securitisation, the crisis taught us that what went wrong was not straightforward. As correctly analysed by the EBA, four or five separate areas of weakness emerged. As a result, it is unavoidable that a definition of SST securitisation that incorporates these lessons cannot be reduced to a very simple and short definition.

However, as we will note in our responses to specific questions in the Paper, we think that the proposed criteria contain many formulations that are quite vague, open to interpretation or very difficult – in their current formulation – to verify.

PCS has extensive experience of this difficulty since our own label is based on a set of criteria that seek to be as binary as possible. We have assumed in our response to individual questions that the difficulties or ambiguities that are presently in the text reflect the nature of the Paper as a discussion paper and will be eliminated should the proposed definition of SST securitisations move toward a statutory existence. But this is certainly something that needs to be borne in mind.

Certification

Once the various European regulations are such as to provide differing regulatory outcomes depending on whether a transaction meets the SST securitisation definition or not, it will become very important for market participants to know to which category a transaction belongs.

In our response to the Bank of England/ECB discussion paper, PCS provided an analysis of how the practical implementation of an SST securitisation definition could work. We set this out once more in this paper, as we believe this is a key topic not just for the period after the definition and its impact are agreed but during the design stage as well.

To set out our views on this issue we would like to put forward four possible alternatives.

(a) no certification

If there is no certification mechanism, then each investor must reach his or her own conclusions. If the definition of “SST securitisation” were simple and easily verified e.g. the issuance is denominated in an EU currency, then this system can work. However, the proposals in the Paper, with which PCS is in broad agreement, are not of this type.

This leads to the risk that different investors would develop different interpretations of the rules. In the primary market, this would make it extremely difficult to price any bond as different investors would require different remunerations for the different levels of capital they believe they need to set aside. The result, of course, is that pricing and distribution would then most likely drift to the most conservative position (since the less conservative investors would happily take the higher coupon but the more conservative ones would not accept a lower one). The probable end result would be to nullify all the benefit of creating a regulatory space for SST securitisations.

The impact of a lack of certification would also likely substantially affect secondary liquidity. This is for two reasons: consistency and timing. The first, consistency, is merely a mirror of the problem sketched out above for the primary market. If different investors have different interpretations of the application of the definition to any given securitisation, any holder will need to worry about how liquid is the market for such a securitisation since he or she will not know how many of the potential investors share his or her interpretation of the regulatory definition.

The timing problem in the secondary market, if there is no certification, relates to the logistics of a sale. If investor A wishes to sell to investor B, he or she will call the desk of investor B and offer the security for a price. If investor B is happy with purchasing that security at that price the deal is done. But if the price is ultimately dependent on whether the security falls within the “SST securitisation” definition, investor B will need to refer the matter back to some compliance function. That process may be fast – e.g. if the security is on some existing internal list – but it may also be slow, particularly if the compliance department is understaffed and busy. In that case, the trade may well fail since the quoted price will not be valid for the days or even weeks it takes the compliance function to come to a conclusion.

Ultimately, no doubt, unofficial lists of “SST securitisations” would probably start to circulate and regulators will be pushed to make public statements regarding their validity. But this is extremely inefficient and cannot help with new issues.

This strongly suggests then that a public list of qualifying SST securitisations with some official or quasi-official status would be necessary for the full benefits of such classification to be realised.

This leads to the question of what entities should be compiling such list and providing the certification. Three possibilities seem to exist.

(b) a self-certification process

Under this scheme, the originators would certify that the securitisations issued by them meet the definition. This solution seems to PCS to go against the general direction of regulatory development that has sought, in the last few years, to diminish the moral hazard that results from conflicts of interest.

From a point of view of political realism, it would also seem that reliance on the banking institutions to police themselves in the area of securitisation could be a difficult message to expect to find broad acceptance, especially after the dent in confidence caused by the EURIBOR and the FX debacles.

(c) the regulators or other public bodies as certification agents

Here either the regulators themselves or another public body (such as a central bank) could be the certification agent.

To examine the strengths and limitations of this model, it may be valuable to look at what qualities would be required for an effective certification system.

(i) universality

There needs to be one single list, publicly available. This would mean that one regulator or public body would need to do this for all the others. However, we agree that an approach with one core definition of 'SST securitisation' and additional elements for different regulatory schemes is an efficient way to proceed. This would require the public certification agent to interpret the additional rules of other regulators. If not, then the list loses much of its value since it cannot tell whether a given securitisation qualifies for any particular regulation. This could recreate the uncertainty of the situation where there is no certification at all.

(ii) timeliness

Any certification scheme needs to be able to provide a certification at least at the time of pricing of each securitisation. This means that any certification agent needs to possess a scalable operation that can guarantee an efficient and accurate assessment within a matter of days. This must be the case even when there is a temporary surge of issuance. This must also be the case, year on year, if the market increases by a greater amount than was anticipated. In other words, the operations of the certification agent must be strongly and swiftly scalable. In the absence of such scalability, the market will grind to a halt and financing of banks and the real economy could come under strain.

(iii) cost-effective

Any certification solution needs to be cost effective for the markets and be transparent as to how these costs are incurred and met.

Here, PCS must declare an interest, as this debate goes to the core of its purpose. However, it seems to us that a non-profit private sector entity, such as PCS, may be better suited to provide a global coverage encompassing different regulatory requirements, to set up (or in the case of PCS, maintain) a scalable operations and to ensure a very transparent cost structure. In addition, PCS already exist and is proven in this field.

(d) a private sector entity

The advantages of a non-profit private sector entity such as PCS providing the certification is that it already exists and has a proven track record. Also, it is more able to add resources and be scalable in line with market requirements. It can be paid for by the market in a transparent and efficient way and become a market utility.

This is important since, as we have mentioned above, the securitisation market does not necessarily have much time to create a workable regulatory and market environment. The time constraints involved in defining, setting up and staffing a new organisation could yet further postpone the time at which the market infrastructure is available to sustain a strong European securitisation market.

The drawback of private sector entities performing such regulatory functions must also be examined.

(i) no 'privatised' rule-making

First, considering some of the problems that have arisen recently, policy makers are understandably loath to 'sub-contract' regulations, as it had been done with CRAs. In this respect, it should be clear that any private sector entity that performed a certification task in the context of 'SST securitisations' should not have the power or the authority to modify the definition. The task it would perform is solely to certify the existing regulatory definition or definitions. To the extent that any issues of interpretation arise, such issues should be subject to discussion and agreement with the relevant regulatory authorities and should not, other than in very trivial cases, be determined by the certification agent.

Also, the regulations remain regulations and cannot be substituted, as a matter of law, by certification. So the certification remains a proxy: satisfactory evidence, in the absence of contrary facts, that a securitisation is a 'SST securitisation'. Any originator or investor who did not agree with the work of the certification agent should be able to ask for a definitive ruling from the relevant regulator. In practice, if the system operates well, this should be very rare.

A similar approach is well established in European law with the 'notified bodies' who are entrusted with the verification of many sensitive items from medical equipment to air traffic control. The extension to finance of this concept of 'notified bodies', with its extensive set of rules and precedents within European law, seems a promising way forward.

Indeed there is already in place a good template for such a model in finance: the STEP program used by the European Central Bank to validate eligible commercial paper for its repo operations. The European Data Warehouse is another good example of a private sector entity performing a quasi-regulatory role.

(ii) No conflicts of interest

To avoid a private sector entity from falling prey to conflicts of interest, any certification agent should be independent. It should not be run by banks or other market participants with an interest in the outcome of the certification. Its governance should be transparent and have appropriate involvement from regulatory and public sector bodies.

To avoid conflict of interest driven by commercial motives, we believe that any private sector certification agent should also be a 'not-for-profit' entity.

Also, such agent should have in place strong codes of conduct for its staff to avoid any other forms of conflicts of interest.

(iii) Transparency and accountability

Any private sector entity performing a certification function in this field needs to be committed to complete regulatory transparency regarding its operations, staffing, finances, policies and procedures.

This accountability could even go, if it is felt necessary, up to becoming a regulated institution. This, however, could require a complex legislative process and so may not be feasible in the short term. Again, we would like to stress that time to re-establish a strong securitisation market in Europe may be quite short and we urge policy makers to avoid solutions that require lengthy timetables.

Another important element of transparency is that the certificates must be available to the public at no cost, for example, on an unrestricted access website.

The private sector entity performing the certification function should be subject to regular auditing as a condition for continuing to perform the certification function.

There are other potential benefits of a private sector certification agent.

One is regulatory economies of scale. If, as mentioned, there is a core definition of 'SST securitisation' with additional elements to cater for the differing aims of distinct regulations, a private certification agent, looking at the same securitisation could incorporate all the various criteria in a single certification. This would create a certification that allowed different types of investors to rely on a single list of securitisations that met the different rules. Alternatively – or in addition – such a certification agent could look at a securitisation once and

give a number of certifications reflecting the various regulatory requirements. For example a transaction could receive certificates for “SST securitisation - Solvency II”, “SST securitisation – LCR” but not “SST securitisation – MMF”. The existence of this information in a single location would be strongly beneficial, in our view, to a liquid secondary market. This would avoid duplication of work and so lower costs and increase efficiency.

Another benefit is that, to do its work, such private sector certification agent needs access to a number of key documents. This makes it an obvious single repository for key information. Already, PCS has been told by a number of investors that it is the best (and only) place to access in the same location a number of prospectuses together with the criteria checklists that make finding key information in such prospectuses much easier. As a result, our website has apparently started to be used as a location of first resort for some investors looking for prospectuses irrespective of any connection to the label itself.

PCS would stress though that the capacity to nominate a “notified body” is one that finds its roots in the relevant legislative texts. It is not possible, in the absence of appropriate legislative wording, for a regulatory agency to nominate such a body out of its own authority. Therefore, bearing in mind the tight timeframe to which public authorities are working, we strongly suggest that the issues of operability not be left to a later round of rule-making, but be examined and resolved in parallel to the issues of definition of SST securitisations and the implementation of such definition in legal texts.

Standardisation

We would also suggest that the creation of SST securitisations should not solely be the work of regulatory or public authorities. In particular, PCS believes that the European securitisation market would be stronger and healthier if stakeholders in the market were to improve standardisation. We can see great benefits first in standardisation of prospectuses, definitions and reporting. Later, one could consider the standardisation of key documents.

PCS is aware, of course, that European securitisations proceed from different legal systems and that absolute standardisation is not feasible. However, the joint examples of the Dutch Securitisation Association⁴ and the International Swap Dealers Association (ISDA) demonstrate the benefits of such work. We also draw attention to the fact that the standardisation effected by ISDA also took place in the context of a multi-jurisdictional market.

Any standardisation work though should first proceed asset class by asset class and jurisdiction by jurisdiction. Later, cross-jurisdictional standardisation could be introduced.

PCS recommends that such work be done by the stakeholders in the industry with the support and encouragement of the public sector, rather than as a mandatory regulatory requirement. However, as standards are established, we

⁴ <http://www.dutchsecuritisation.nl>

would anticipate a mechanism for incorporating them in the definition of SST securitisations.

Based on PCS' own experiences with standardisation efforts, this is a fairly lengthy process but one that is entirely feasible. PCS would be ready to provide any assistance and coordination that such process might entail.

RESPONSE

We will now seek to deal with the questions set out in the Paper.

Question 1: Do you agree with identified impediments to the securitisation market?

PCS broadly agrees with the EBA's analysis of the impediments to the securitisation market. We would only add the following comments:

Stigma

Although the stigma associated with securitisation was profound around 2008/2009, based on our conversations with asset managers who relate the nature of their own conversations with real money accounts, it would seem that – for highly rated European securitisations in the classic asset classes (RMBS, auto, consumer assets...) – most of this stigma has now dissipated. The extremely robust credit performance of these transactions, amply demonstrated in the Paper, has been noted by most investors. They appear to have concluded, on the whole, that this is an asset class that they would, in principle, be prepared to invest in.

However, “in principle” is an important caveat. The key reasons why this “in principle” willingness is not translated into actual investment seems related to the double impact of regulatory uncertainty and low volumes.

Regulatory uncertainty and low volumes

Although economic textbooks like to posit that, for any product, the existence of a willing buyer and a willing seller together with a price point agreement is all that is required for a market to develop, the reality is more complex. For new investors to purchase securitisations a number of practical hurdles need to be overcome. The board and/or credit committee must analyse the market and determine whether, to what extent and on what terms they are prepared to enter this market. This requires meaningful and time-consuming analytical work. Then, depending on how they wish to enter the market, they will need to hire or train staff to purchase and monitor their positions. This staff will generate new direct (salary) and indirect ongoing costs. Therefore, entering (or re-entering) the securitisation market, even when one is “in principle” favourably inclined to

do so, contains both an upfront and an ongoing cost. Therefore, an investor will only be likely to initiate such a process if the prospect and likelihood of an acceptable return is sufficient to justify the endeavour.

The actual return for any investor is not just the spread on a securitisation but the spread multiplied by the notional. This is a trivial observation but is crucial to understand the reluctance of new investors to enter the market: with very low volumes of issuance any investor is unlikely to be able to purchase sufficient volume at a sufficient spread to generate actual monetary returns that make it worthwhile to incur the upfront and ongoing monetary costs of doing so.

If the primary driver of the low issuance was lack of investor demand, this would be a self-correcting problem as new investors would by themselves generate new issuance. However, the market widely acknowledges, and PCS agrees, that the primary causes of the low issuance at this stage are the other issues set out in the Paper: weak macro-economic conditions and bank deleveraging that drive down banks' funding needs and the availability of extremely cheap funding flowing through the ultra-accommodative monetary policy of central banks.

In addition, the regulatory uncertainty mentioned in the Paper means that most potential new investors are not clear what the future risk and rewards characteristics of securitisation will be.

With too little issuance available for the likely level of purchases to produce a return sufficient to overcome the entry and ongoing costs and, should the work and costs nevertheless be incurred, regulatory changes that may force an investor to withdraw in a couple of years' time, the majority of potential new investors have simply no incentive to even look into the idea of entering the market.

Once volumes begin to increase and the regulatory situation is clarified and not punitive, PCS would anticipate investors will once more turn to the securitisation market.

Reduction in the investor base

Although the disappearance of the structured investment vehicles (SIVs) has undoubtedly substantially reduced the volume of potential investors, this is not in our view a cause of the small size of the current market. The main driver for the small market, as mentioned above, is a lack of supply rather than demand.

However, the disappearance of leveraged arbitrage vehicles such as the SIVs, although a positive development for financial stability, does mean that once volumes start to rise the securitisation market will need to find new investors rather than just return to old investors and ask them to re-enter the market or increase their presence.

(It is worth noting, though, that with the disappearance of SIVs one has also seen the disappearance of a number of arbitrage products such as CDO's of

ABS, CDO squareds and CDO cubes. This means that even a return to a healthy securitisation market in Europe is not likely to see volumes return to quite the highs achieved in 2006 and 2007. In turn, this means that we may be able to sustain a strong market on a smaller investor base than existed then. In other words, the new investors need not *a priori* entirely replace those that have disappeared).

Lack of trust in rating agencies

We do not believe that this plays a meaningful role in keeping investors out of the market. We believe that investors have taken on board both the robust performance of the European securitisations during the crisis and the strong tightening of CRA criteria in this area.

“Alternative asset” label

A small issue that also helps keep the market smaller than it should be (or will, once supply begins to rise) is the fact that securitisation in Europe continues to be labeled by investors as an “alternative asset class”. This puts unnecessary constraints on the volumes that real money investors are willing to invest in SST securitisations.

Conclusions

The current low securitisation issuance is driven primarily by macro-economic factors including the late deleveraging by banks following the 2008 crisis. These factors are strongly amplified by the extremely accommodative monetary policies followed by European central banks: banks do not need money to lend and even if they do, they will get “near free” money from their central bank.

Europe today faces a supply constraint. However, this should not make us blind to the fact that the universe of existing investors is very small. Demand may be greater than supply, but current demand is also substantially smaller than the likely needs of the European economy once the conditions for increased supply come into being.

The most important step to avoid the securitisation market grinding to a halt as future rising supply crashes against a severely constrained demand is to finalise a rational and coherent regulatory framework based on a single core definition of SST securitisations. Only once this is in place will potential new investors be willing to undertake the analysis necessary to determine their willingness to invest in this asset class.

PCS does not wish though to give the impression that such a regulatory scheme is the only issue that stands between the current situation and a deep liquid European securitisation market. It is a necessary but not a sufficient condition. Such a regulatory scheme will justify new investors looking at possible purchases of SST securitisations. The next step will be to convince such investors that SST securitisations are indeed a safe, liquid and predictable investment with an appropriate return to justify their purchase. PCS hopes that

it may be of assistance in this process. PCS also believes, as mentioned above, that initiatives towards greater standardisation will also help in this process.

Question 2: Should synthetic securitisations be excluded from the framework for simple standard and transparent securitisations? If not, under which conditions/criteria could they be considered simple standard and transparent?

PCS does not label synthetic transactions. This is not because we do not believe that these may be of high quality. It is because the credit dynamics of synthetic transactions are fundamentally different from those of “true sale” securitisations. The heart of a synthetic securitisation lies not only in the assets but also in the legal drafting of the credit default swap (CDS) that defines what risks are transferred and under what conditions.⁵

PCS believes that it is entirely possible to create appropriate rules for synthetics to allow them to achieve the same degree of consistency and predictability – effectively, the same degree of structural integrity – as “true sale” SST securitisations.

However, we also believe that these rules would need to focus very strongly on the legal drafting of the CDS. This would require careful analysis involving possible variations depending on both the nature of the assets being securitised and the jurisdiction whose laws govern the CDS contract. This is not a small task.

For this reason, we do not believe it is practical to try to fit a set of criteria for synthetic SSTs within the current proposals. This is likely to result in an unnecessarily cumbersome SST definition, difficult for both investors and regulators to administer. This would also likely cause some meaningful delay in the finalisation of the “true sale” SST criteria. In view of the urgency to the European economy of reviving a strong and safe securitisation market, we believe such a delay would be unwarranted and damaging.

However, we also believe that synthetics can play a very important role in rebalancing the European financial architecture away from the dominance of bank funding. Synthetic securitisations can be a very powerful tool to transfer risk at the capital level from banks to the capital markets. As such they can allow banks to provide more financing for the economy without having to increase their capital; they can be a tool to break the artificial link between the availability of finance to borrowers who cannot access the capital markets directly (such as SMEs) and the capacity of banks to raise capital.

⁵ PCS acknowledges that it is theoretically possible to use drafting in the documents that compose a “true sale” securitisation substantially to modify the nature of the risks incurred by the investors. However, such drafting would be so unusual and egregious that it would need to be made very visible and would not be acceptable to traditional investors. This is not therefore a problem in practice.

PCS would therefore recommend that a specific set of synthetic SST criteria be drawn up. They would be based on the fundamental principles identified for SST securitisations generally: the pillars set out on page 7 of the Paper. In addition they would seek to draw up standard form CDS documentation – possibly based on asset classes and on the jurisdiction whose laws govern the CDS contract. In this, these forms would be similar to the standard forms one sees in a number of other markets such as derivatives (ISDA forms) or loans (LMA forms).

PCS does not, at present, have a view on what would need to be incorporated in these standard CDS forms to allow them to achieve SST status. We are prepared, however, to assist in any way in the process to craft such standards. In this respect, such work would be very similar to the work that was undertaken by PCS in creating the criteria for the PCS Label.

To ensure that synthetic SST securitisations were not solely arbitrage products, we would recommend that only securitisations where the originator held the reference portfolio be eligible. There are concerns that, unless synthetics are used for genuine risk transfer, they will be subject to substantial amounts of “gaming” and “model optimisation”. This could lead to problems similar to those that emerged prior to 2008 in the re-securitisation field.

Also, a synthetic securitisation which is not fully and effectively cash collateralised would rely on the credit worthiness of the originator. This adds the issue of counterparty risk. Although PCS has no definitive view on this, we believe that whether SST status for synthetic transaction should be limited to cash-collateralised securitisations or how counterparty risk needs to be taken into account in any synthetic SST criteria are matters that must be considered.

Finally, PCS would expect that any rules pertaining to the assets being securitised in “true sale” SST transactions (such as, for example, asset homogeneity) would also apply to assets in synthetic securitisations.

Question 3: Do you believe the default definition proposed under Criterion 5 (ii) above is appropriate? Would the default definition as per Article 178 of the CRR be more appropriate?

PCS agrees that pools made up of non-performing loans are not appropriate for SST securitisations. However, what is a “defaulted” loan is not, in our view, susceptible to a single definition. There are clearly some variations between different types of credit facilities and those variations are incorporated both in the business models of different types of lenders and in the credit analysis performed by investors on different types of assets.

To put it simply, a borrower who misses two or three scheduled payments on a mortgage is clearly in some difficulty and the loan would be considered in default. However, it seems that in credit card lending and some kinds of consumer lending, it is not uncommon for borrowers to fail to pay over a few months but to then return to scheduled payments. Also, in some forms of perfectly legitimate credit, such as credit cards, a small amount of charge offs

are a normal part of the business model and do not indicate per se a “sub-prime” lending model.

In its own criteria for the PCS Label, we acknowledge this by allowing up to 12% of loans in consumer securitisations to be overdue 30 days or more and in credit card securitisations up to 20% to be overdue 30 days or more. (Please note the shorter period – 30 days – rather than the default definition proposed in the EBA rules – 90 days).

Therefore, although we have no issues with the definition set out in criterion 5 (ii) and believe it is appropriate as a general criterion, we would suggest the possibility of seeking the views of credit card lenders and consumer lenders as to whether a small percentage of the pools may benefit from a de minimis exception.

Question 4: Do you believe that, for the purposes of standardisation, there should be limits imposed on the type of jurisdiction (such as EEA only, EEA and non-EEA G10 countries, etc): i) the underlying assets are originated and/or ii) governing the acquisition process of the SSPE of the underlying assets is regulated and/or iii) where the originator or intermediary (if applicable) is established and/or iv) where the issuer/sponsor is established?

As a matter of principle, PCS does not believe that there should be any artificial geographical limitations on the jurisdictions from which SST securitisations may come. If a securitisation objectively meets the criteria for structural integrity leading to a consistent and predictable credit outcome, we cannot see the justification in requiring an investor to pay more for such a securitisation merely because it is not generated in a particular jurisdiction.

However, we also recognise, based on our own work around the PCS Label criteria, that one cannot know *a priori* whether a securitisation from any given jurisdiction can conform to the SST principles. In each case, one needs to perform some legal due diligence to ensure that there are no provisions of relevant local law that effectively negate the criteria on which one relies to determine the SST standards.

To reconcile these two positions, PCS would recommend a list of acceptable jurisdictions for all four points mentioned in Question 4. Membership of this list should be determined by the regulators and not require primary or secondary legislation. The criteria for inclusion on the list should be that the regulator is satisfied, following appropriate due diligence, that no provisions of relevant law are such as effectively to negate any of the established SST criteria. It is important, for reasons of fairness and international comity as well as for investment opportunities for European savers, that this process not impose additional requirements on non-European securitisations. The process should be designed to ensure only that the criteria for SST can and are met in the relevant jurisdiction.

Question 5: Does the distribution of voting rights to the most senior tranches in the securitisation conflict with any national provision? Would this distribution deter investors in non-senior tranches and obstacle the structuring of transactions?

We are not aware of any national provisions that would be contravened by such distribution. We note however, that the laws that would most likely be relevant to such determination are the laws of the jurisdiction where the issuer (ie the SPE) is incorporated – although this could be modified by the applicability to the issuer of the insolvency laws of a third country. We also note that PCS has not done any diligence work on this issue.

We also would like to draw the EBA’s attention to the fact that the vesting of voting rights to the junior tranche investors is not an illogical approach. Although a cursory analysis would assume that the senior investors should, having regard to their seniority, have the voting rights, this is sometimes not sensible. The reason for this is that voting rights tend only to be relevant when things go wrong and the securitisation needs to be modified or the securitised assets needs to be dealt with. In this case, the view is usually expressed that the junior investors are at most risk. Therefore, they are expected to act rationally and seek to maximise the overall returns since any losses fall first on them. By seeking to avoid or minimise losses falling to them, the junior tranche investors automatically protect the senior note investors. On the other hand, senior tranche investors have no interest in minimising any losses that are less than the junior tranche credit enhancement. So, acting rationally, the senior note investors – in contradiction with junior note investors – have no incentive or motive to help the other noteholders. With no voting right, the investor in a junior note has little hope that, if a difficulty arises, it will have any relief.

Therefore, vesting all the voting rights in the senior note investors will, in our view, create a disincentive for junior investors.

PCS is not well placed though to comment on the extent this is a disincentive nor on whether such vesting of voting rights with the senior note investors is seen as important for those investors. As we note above, though, the issue of voting rights usually arises when the securitised assets must be heavily serviced or disposed of. This, in the past, has tended to occur in the context of securitisations with embedded maturity transformation, such as CMBS and SIV’s. Therefore, we suspect that for SST securitisations, this issue may be less problematic.

We also acknowledge that there already are in current market practice, and should continue to be, fundamental decisions regarding a securitisation (usually referred to as “basic terms modifications”), which can, as a matter of practice, only be determined by the holders of the senior notes.

Question 6: Do you believe that, for the purposes of transparency, a specific timing of the disclosure of underlying transaction documentation should be required? Should this documentation be disclosed prior to issuance?

PCS believes that, although superficially attractive, the disclosure of documentation prior to issuance poses not only serious practical but also profound conceptual issues.

Practically, the disclosure prior to issuance of documentation is very difficult since some of the data that is required to go into such documentation can only arise between pricing and close.

More serious though is the conceptual (and potentially legal) difficulties this would raise. It is a legal requirement of all capital market transactions that the prospectus contain all the information that an investor would deem relevant to making an investment decision. If the entire documentation is published, what is the relationship between this documentation and the prospectus.

It strikes us that a publication prior to issuance of the entire documentations raises some complex issues regarding the liability regime surrounding the placing of debt securities. It could, for example, lead to differences in the timing, quantum and nature of the liability falling on the issuer as between securitisations and other debt instruments. Such differences, in turn, could impede a return of securitisation.

PCS therefore believes such disclosure is impractical, unnecessary and likely to cause extremely substantial legal issues.

Question 7: Do you agree that granularity is a relevant factor determining the credit risk of the underlying? Does the threshold value proposed under Criterion B pose an obstacle to the structuring of securitisation transactions in any specific asset class? Would another threshold value be more appropriate?

The PCS Label criteria do contain granularity requirements. PCS believes that granularity is an important aspect of SST securitisations.

We note that the EBA has classified its proposed granularity criteria under the “credit risk” heading. PCS believes that granularity is an aspect of securitisation that straddles the structural integrity/pure credit risk divide. We see structural integrity criteria as those criteria that speak to the capacity for an investor to perform a credit analysis with a high degree of comfort as to the likely confidence that can be awarded to this analysis. The lack of granularity in a transaction increases idiosyncratic risk and therefore, all other things being

equal, lowers the confidence level of the credit analysis.⁶ As such, it is entirely possible to classify granularity as a structural integrity criteria.

We agree that a 1% threshold is not unreasonable for most asset classes. Most of the granularity requirements in the PCS criteria are more severe. However, we would draw attention to asset classes where this threshold may cause difficulties for otherwise robust transactions. These are the asset classes where, although the number of obligors may be too small in number to meet the 1% granularity rule, this is compensated by a recourse to an asset which is much more granular. The classic examples of this are dealer floor plan and vehicle fleet lease securitisations. In both these cases, the number of borrowers (car dealers in the first case and fleet lessees in the second) may be relatively small but, should they default, the investors will be looking for recoveries out of a very large and granular pool of vehicles.

The PCS granularity test for auto fleet leases is somewhat complex, dealing with incremental separate granularity requirements for the top 5, 10, 15 and 30 borrowers but with a requirement of at least 15,000 vehicles. For dealer floor plans we set the granularity test at 2% with an exception for a single obligor that can reach 4% and a sub-limit on the ten largest obligors of 15% but also a minimum of 300 underlying assets.

These examples suggest that, as a general rule and if the SST definition is envisaged to cover a wide variety of asset classes, picking a single number such as 1% in the hope that it is the correct number irrespective of the asset, may not be the best approach. Possibly a more discriminate approach that differentiates between assets would be better.

Question 8: Do you agree with the proposed criteria defining simple standard and transparent securitisations? Do you agree with the proposed credit risk criteria? Should any other criteria be considered?

Criterion 1:

The securitisation should meet the following conditions:

- ***It should be a securitisation as defined in the CRR (as per Article 4 (61));***
- ***It should be a 'traditional securitisation' as defined in the CRR (as per Article 242(10));***
- ***It should not be a 're-securitisation' as defined in the CRR (as per Article 4 (63)).***

PCS is aware that there is some concern in legal circles that the existing definition of securitisation in CRR is too wide and may unintentionally catch certain types of non-securitisation products. We have no views as to this point, as our mission statement concerns traditional securitisation only.

⁶ This, of course, is a generalisation and we acknowledge that it is entirely possible to construct securitisations where this is not the case. However, as a general rule and for the most traditional asset classes, PCS believes this holds true.

We note the exclusion of asset-backed commercial paper (“ABCP”). Our views on ABCP are very similar to those we expressed in our response to Question 2 on synthetic securitisation . ABCP is a good product but with credit dynamics that are quite different to term securitisations focusing on the nature and extent of the attendant liquidity facility.

As with synthetics, we believe that there is great potential benefit in crafting SST criteria for ABCP. However, seeking to conjoin these with the SST criteria for term securitisation is impractical and would result in unnecessary delays. We do, however, strongly urge that this important and valuable channel of finance be the subject of a working group as soon as possible.

For reasons we have discussed extensively in a number of publications, we believe that re-securitisations using junior pieces of other financings, which we describe as iterative credit tranching, can never be part of any sensible definition of SST securitisations.⁷

Criterion 2: The securitisation should not be characterised by an active portfolio management on a discretionary basis. Assets transferred to a securitisation should be whole portfolios of eligible exposures or should be randomly selected from those satisfying eligibility criteria and may not be actively selected or otherwise cherry-picked. Substitution of exposures that are in breach of representations and warranties should in principle not be considered as active portfolio management.

We agree. Actively managed securitisations, in our view, take on the nature of managed funds and are more properly covered by the regulatory requirements for funds.

When the more precise regulations are drafted though, attention will need to be paid to the exact definition of “eligible exposures” to avoid unnecessarily limiting the types of assets that are securitised.

Criterion 3: The securitisation should be characterised by legal true sale of the securitised assets and should not include any severe insolvency clawback provisions. A legal opinion should confirm the true sale and the enforceability of the transfer of assets under the applicable law(s). Severe clawback provisions should include rules under which the sale of cash flow generating assets backing the securitisation can be invalidated by the liquidator solely on the basis that it was concluded within a certain period (suspect period) before the declaration of insolvency of the seller (originator/intermediary), or where such invalidation can only be prevented by the transferees if they can prove that they were not aware of the insolvency of the seller (originator/intermediary) at the time of the sale.

⁷ For the sake of accuracy, re-securitisations that only re-securitise the highest rated senior tranches of securitisations, could, in some cases, meet an SST test. However, such transactions are not commercially relevant and so we see little practical benefit in adding additional complexity to the SST criteria to capture these transactions as they are never seen in practice.

We agree, in principle.

However, we would like to draw attention to the fact that “true sale” is not a term of legal art but a creation of the rating agencies that have determined over time what each of them considers an acceptable definition. The legal opinions never confirm “true sale” as such but state that, based on a number of often extensive assumptions and subject to a number of equally extensive qualifications, a sale has occurred that cannot be overturned in insolvency.

The PCS Label criteria also seek to set out a “true sale” requirement that seeks to provide clarity but also straightforward verifiability.

We assume that when the final text is written, it will take into account the need to clarify what the regulatory definition of “true sale” will be.

Criterion 4: The securitisation should be backed by exposures that are homogeneous in terms of asset type, currency and legal system under which they are subject. In addition, the exposures should meet the following criteria:

- i) They arise from obligations with defined terms relating to rental, principal, interest or principal and interest payments, or are rights to receive income from assets specified to support such payments;***
- ii) They are consistently originated in the ordinary course of the original lender’s business pursuant to uniform and non-deteriorating underwriting standards;***
- iii) They contain a legal, valid and binding obligation of the obligor, enforceable in accordance with its terms against any third party, to pay the sums of money specified in it (other than an obligation to pay interest on overdue amounts);***
- iv) They are underwritten: (a) with full recourse to an obligor that is an individual or a corporate and that is not a special purpose entity, and (b) on the basis that the repayment necessary to repay the securitisations was not intended, in whole or in part, to be substantially reliant on the refinancing of the underlying exposures or re-sale value of the assets that are being financed by those underlying exposures.***

PCS is in broad agreement with this criterion. As with Criterion 3, we assume though that upon the final text of the regulations being drafted a number of the definitions will be clarified.

PCS does, however, have a concern about the requirement of a “non-deteriorating underwriting standard”. On its face, this would require that banks going forward never lower their underwriting rules in any way if they still wish to securitise. However, there are many legitimate reasons to bring down your underwriting standards. For example, new technology may provide additional

information allowing you to better assess credit risk. More simply, a bank may decide to change its risk appetite. Provided this additional risk is covered in the bank's capital, provided the retention rules are met and the securitisations meet the transparency requirements thus allowing investors sensibly to determine any additional risk, PCS cannot see that this is a requirement of SST. If it was so, it is difficult to see any bank accepting to fetter for all time its credit decision process if it wished to rely on securitisation as a funding source.

Criterion 5: At the time of inclusion in the securitisation, the underlying exposures should not include:

- i) Any disputes between original lender and borrower on the underlying assets;***
- ii) Any exposures which are in default. An exposure is considered to be in default if:***
 - a. it is more than 90 days past-due;***
 - b. the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.***
- iii) Any exposures to a credit-impaired borrower. For these purposes, a borrower should be deemed as credit-impaired where he has been the subject of an insolvency or debt restructuring process due to financial difficulties within three years prior to the date of origination or he is, to the knowledge of the institution at the time of inclusion of the exposure in the securitisation, recorded on a public credit registry of persons with adverse credit history, or other credit registry where a public one is not available in the jurisdiction, or he has a credit assessment by an ECAI or a credit score indicating significant risk of default;***
- iv) Any transferable securities, as defined in Directive 2004/39/EC (MIFID) or derivatives, except derivatives used to hedge currency and interest rate risk arising in the securitisation.***

In addition, the original lender should provide representations and warranties that assets being included in the securitisation are not subject to any condition or encumbrance that can be foreseen to adversely affect enforceability in respect of collections due.

PCS is broadly in agreement with this criterion. We would have the following comments of detail:

- (i) the PCS Label criteria requires that there be no material dispute affecting the collectability of the money. There can be, in any lender/borrower relationship, immaterial disputes or disputes that do not affect the debt. To require that all assets subject to such trivial or irrelevant (for the securitisation) disputes be extracted from the pools puts a very onerous and unnecessary burden on originators.

- (ii) We have provided our views on default in our response to Question 3.
- (iii) In line with our response to EIOPA and the Bank of England and the ECB on this topic, we understand and can sympathise with the view that a pool resulting from business model that involves specifically and deliberately lending to credit impaired borrowers may not be appropriate for SST criteria. However, this criterion would catch businesses which do not deliberately target credit impaired borrowers but either (a) do not check this point because they lend against good security and so take little credit risk on the individual borrower – eg auto loans – or (b) lenders in those countries where the absence of a centralised register or any register at all makes it impossible for anyone to determine whether any borrower is indeed credit impaired. If it is felt important to maintain a limitation on credit impaired borrower securitisations, we would urge a limitation only on securitisations where the borrowers were deliberately chosen because of their credit impairment; in other words, sub-prime lending.
- (iv) We agree.

Criterion 6: At the time of inclusion, the underlying exposures are such that at least one payment has been made by the borrower, except in the case of securitisations backed by personal overdraft facilities and credit card receivables.

We agree but with the caveat that an exception should be made for assets – such as trade receivables – where there is only ever one payment. Faced with a similar issue relating to certain types of store credit, PCS in its label criteria has replaced this one payment criteria with the requirement that the originator has had a prior credit relation with the borrower in which that borrower has made a payment. (Trade receivables are, of course, a potentially important asset classes for European SMEs.)

We would also note, as a point of minute detail, that you may wish to clarify that “credit card” includes store cards and store credit.

Criterion 7: The securitisation should fulfill the CRR retention rules (Article 405 of the CRR).

Yes.

Criterion 8: Interest rate and currency risks arising in the securitisation should be appropriately mitigated and any hedging should be documented according to standard industry master agreements. Only derivatives used for genuine hedging purposes should be allowed.

We agree. Again, we would assume that terms such as “appropriately” and “genuine” will be the subject of clarification in the final texts.

Criterion 9: Any referenced interest payments under the securitisation assets and liabilities should be based on commonly encountered market interest rates and may include terms for caps and floors, but should not reference complex formulae or derivatives.

We agree with the same comment as for Criterion 8.

Criterion 10: The transaction documentation of those transactions featuring a revolving period should include provisions for appropriate early amortisation events and/or triggers of termination of the revolving period, which should include, at least, each of the following:

- i) A deterioration in the credit quality of the underlying exposures;**
- ii) A failure to generate sufficient new underlying exposures of at least similar credit quality; and**
- iii) The occurrence of an insolvency-related event with regards to the originator or the servicer.**

No comment.

Criterion 11: Following the occurrence of a performance-related trigger, an event of default or an acceleration event:

- i) The securitisation positions are repaid in accordance with a sequential amortisation payment priority, whereby the seniority of the tranches determines the sequential order of payments. In particular, a repayment of noteholders in an order of priority that is 'reverse' with respect to their seniority should not be foreseen;**
- ii) There are no provisions requiring immediate liquidation of the underlying assets at market value.**

We agree.

Criterion 12: The transaction documentation should clearly specify the contractual obligations, duties and responsibilities of the trustee, servicer and other ancillary service providers as well as the processes and responsibilities necessary to ensure that:

- i) the default or insolvency of the current servicer does not lead to a termination of the servicing of the underlying assets;**
- ii) upon default and specified events, the replacement of the derivative counterparty is provided for in all derivative contracts entered into for the benefit of the securitisation; and**
- iii) upon default and specified events, the replacement of the liquidity facility provider or account bank is provided for in any liquidity facilities or account bank agreements entered into for the benefit of the securitisation.**

We agree but would wish to clarify that this criterion only requires that the documents provide a clear path to replacement of the failing service provider and does not require that a replacement service provider has already been found and has contracted to provide such replacement. PCS does not view such a “hot back-up” (as it is known in market parlance) as necessary for a SST securitisation.

Criterion 13: The transaction documentation contains provisions relating to an ‘identified person’ with fiduciary responsibilities, who acts on a timely basis and in the best interest of investors in the securitisation transaction to the extent permitted by applicable law and in accordance with the terms and conditions of the securitisation transaction. The terms and conditions of the notes and contractual transaction documentation should contain provisions facilitating the timely resolution of conflicts between different classes of noteholders by the ‘identified person’. In order to facilitate the activities of the identified person, voting rights of the investors should be clearly defined and allocated to the most senior credit tranches in the securitisation.

Although PCS agrees with the idea of a robust trustee acting on behalf of the noteholders, we suspect this criterion will create some strong resistance because of the uncertainty around some of the terms. Provided that clarification can be provided in additional drafting, this should not be too difficult if the final texts do not require meaningfully more from trustees than they are prepared to provide in high quality securitisations today. However, if the intention behind this criterion was to create additional responsibilities for the trustees, we must query whether this can realistically be achieved.

As to the voting rights, please see our response to Question 5. One approach may be to carve out a list of key rights that must vest in the senior note investors.

Criterion 14: The management of the servicer of the securitisation should demonstrate expertise in servicing the underlying loans, supported by a management team with extensive industry experience. Policies, procedures and risk management controls should be well documented. There should be strong systems and reporting capabilities in place.

This is uncontroversial in essence, but should be framed in a way that makes it feasible in practice. PCS would urge the regulatory authorities to ensure that the tests that need to be met by servicers are not more onerous than required to test their competence or not so costly to demonstrate that they place a financial burden substantial enough to deter competent servicers from funding through securitisations.

Criterion 15: The securitisation should meet the requirements of the Prospectus Directive.

In order not to exclude non-EU securitisations from the ambit of SST criteria, PCS would urge a mechanism similar to the one we mentioned in our response

to Question 4, whereby qualifying jurisdictions can be added once appropriate diligence has been conducted by the regulator as to the satisfactory nature of that jurisdiction's disclosure rules.

Criterion 16: The securitisation should meet the requirements of Article 409 of the CRR and Article 8b of the CRA (disclosure to investors).

Without prejudice to any improvements that PCS may believe could be made to Articles 409 and 8b (or their replacement by a single statutory provision), we agree that a SST securitisation should be one that meets the requirements of the disclosure rules.

Criterion 17: Where legally possible, investors should have access to all underlying transaction documents.

Subject to our comments in our response to Question 6 regarding pre-closing disclosure, PCS believes that there is no harm in such disclosure. We would however query whether it is truly a necessary part of the definition of an SST securitisation.

Criterion 18: The transaction documentation should provide in clear and consistent terms definitions, remedies and actions relating to delinquency and default of underlying debtors, debt restructuring, debt forgiveness, forbearance, payment holidays and other asset performance remedies. The transaction documents should clearly specify the priority of payments, triggers, changes in waterfall following trigger breaches as well as the obligation to report such breaches. Any change in the waterfall should be reported on a timely basis, at the time of its occurrence. The originator or sponsor should provide investors a liability cash flow model, both before the pricing of the securitisation and on an ongoing basis.

We believe that this criterion should not seek to tie an originator to a rigid set of enforcement procedures. We believe that many investors rely on the originator to service the pool of securitised assets competently but also by taking into account the circumstances that prevail. By tying down the servicer to a very strict servicing regime, the rule could force the servicer into taking actions that, taking into account all the circumstances, run against the interests of the investors. This could occur if the nature of the problem encountered by the servicer was not foreseen at the time the securitisation was completed. The key comfort that the investors will have lies, for SST securitisations, in the retention rules that align the interests of the originator with those of the investors.⁸ Considering the wide variety of circumstance surrounding securitisations, we see very real issues with the regulator seeking to mandate servicing and enforcement procedures.

⁸ In the cases where the servicer is not the originator then the regulators should acknowledge that the investors will have got themselves satisfied that the level of discretion provided to the servicer is appropriate to protect the investors.

A criterion that requires that whatever discretion lies with the servicer should be explicitly disclosed and set out in documentation would not cause a problem. Another possible requirement to reinforce the alignment of interest would be a criterion that stated that, if the servicer owned similar assets to those it serviced under the securitisation, it must apply similar rules to both sets of assets.

We believe that liability cash flow models are useful tools and should be part of SST criteria. We would however suggest that the criteria should allow either for the originator to provide such a model or for the originator to provide a third party provider all the information necessary for such third party provider to create a model and procure that such a model is made available by such third party provider to investors and potential investors.

Criterion 19: The transaction should be subject to mandatory external verification on a sample of underlying assets (confidence level of at least 95%) at issuance, by an appropriate and independent party or parties, other than a credit rating agency. Confirmation that this verification has occurred should be included in the transaction documentation.

We agree although we do not believe the confidence level need be specified, especially if the nature of the data being verified is not itself specified. Why require 95% confidence level in “whatever is being checked”?

Criterion 20: investors and prospective investors should have readily available access to data on the historical default and loss performance, such as delinquency and default data, for substantially similar exposures to those being securitised, covering a historical period representing a significant stress or where such period is not available, at least 5 years of historical performance. The basis for claiming similarity to exposures being securitised should also be disclosed.

We agree.

Criterion 21: Investors and prospective investors should have readily available access to data on the underlying individual assets on a loan-by-loan level, at inception, before the pricing of the securitisation, and on an ongoing basis. Cut-off dates of this disclosure should be aligned with those used for investor reporting purposes.

We agree in general, although PCS is still very skeptical of the value of loan-by-loan disclosure in the case of micro-granular portfolios such as credit cards. We would urge an exception for credit card securitisations where stratification tables of sufficient detail should be provided.

Criterion 22: Investor reporting should occur at least on a quarterly basis. As part of investor reporting the following information should also be disclosed:

- ***All materially relevant data on the credit quality and performance of underlying assets, including data allowing investors to clearly identify***

- debt restructuring, debt forgiveness, forbearance, payment holidays, delinquencies and defaults in the pool;*
- *Data on the cash flows generated by underlying assets and by the liabilities of the securitisation, including separate disclosure of the securitisation's income and disbursements, i.e. scheduled principal, scheduled interest, prepaid principal, past due interest and fees and charges;*
 - *The breach of any waterfall triggers and the changes in waterfall that this entails.*

We broadly agree.

Criterion A: Underlying exposures should be originated in accordance with sound and prudent credit granting criteria. Such criteria should include at least an assessment of the borrower's creditworthiness in accordance with paragraphs 1 to 4, 5(a) and 6 of Article 18 of Directive 2014/17/EU or Article 8 of Directive 2008/48/EC, as applicable.

We assume that a non-EU originator could meet these requirements provided that it made an assessment similar to one of the type required by articles 18 or 8.

Criterion B: The pool of exposures to be securitised should be such that the largest aggregated exposure to a single obligor does not exceed 1% of the value of the aggregate outstanding balance. For the purposes of this calculation, loans or leases to a group of connected clients, as referred to in Article 4(39) of the CRR, should be considered as exposures to a single obligor.

See our response to Question 7.

Criterion C: The underlying exposures should fulfil each of the following criteria:

- i) They have to be exposures to individuals or undertakings that are resident, domiciled or established in an EEA jurisdiction, and***
- ii) At the time of inclusion they have to meet the conditions for being assigned, under the Standardised Approach and taking into account any eligible credit risk mitigation, a risk weight equal to or smaller than:***
 - a) [40%] on a weighted average basis where the exposure is a loan secured by a residential mortgage or fully guaranteed residential loan, as referred to in paragraph 1(e) of Article 129 of the CRR;***
 - (b) [50%] on an individual loan basis where the exposure is a loan secured by a commercial mortgage***
 - (c) [75%] on an individual loan basis where the exposure is a retail exposure***
 - (d) [100%] on an individual loan basis for any other exposures.***
- iii) Under (a) and (b) loans secured by lower ranking security rights on a given asset should only be included in the securitisation if all loans secured by prior ranking security rights on that asset are also included***

in the securitisation. Under (a) no loan in the securitised portfolio should be characterised by a loan-to-value ratio higher than 100%.

As set out in our response to Question 4, PCS does not see the prudential rationale for limiting SST securitisations to the EU or EEA. Provided an appropriate due diligence mechanism is put in place, we believe that transactions from outside the EEA should be capable of meeting the SST standards.

We are also not sure why loans that have second charges should not be capable of being considered as meeting SST standards when loans with no security whatsoever are acceptable. Surely, a loan with some security – even second ranking – is *prima facie* better than a loan with no security. We acknowledge that PCS uses such a rule in its label, but only for RMBS. We believe that this is appropriate in RMBS transaction because of the risk of confusion – we wanted to ensure that any RMBS labeled by PCS should be immediately understood, under our “best standard” approach to be a first ranking mortgage securitisation. In other word, that is was a “plain vanilla” RMBS. First, however, the PCS “best standard” requirement goes beyond the prudential requirement. Secondly, this rationale does not hold, for example, for SME transactions where a second charge is an improvement on a traditional unsecured loan securitisation.

On the LTV requirements for mortgages, this rule may eliminate some mortgage transactions with incredibly good records – such as Dutch RMBS. If a market has demonstrated that it can compensate for higher LTVs by other methods (such as strong debt/service ratio covers) we are not convinced these should be cast out of the SST definition.

Question 9: Do you envisage any potential adverse market consequences of introducing a qualifying securitisation framework for regulatory purposes?

Whenever one provides for a bifurcated regulatory outcome, there are adverse market consequences for the category that is treated less favourably. However, in the case of securitisation, the alternative to a bifurcated regulatory scheme is for all securitisation to receive the same treatment. Since these are prudential regulations, they will need to be calibrated to the worst performing group in the class. So the alternative to a definition of SST securitisation is for all securitisations to be treated as if they were US sub-prime RMBS. In the past, regulation was bifurcated by reference to credit ratings. For reasons that have now become clear, this cannot be the approach going forward.

Therefore, although one can envisage some adverse pricing effects for those securitisations that do not meet the SST standards, this should not be a problem. SST should receive a regulatory treatment proportional to their risk, non-SST should receive a (stricter) treatment proportional to their (higher) risk. Therefore, any adverse pricing effect, and so long as the regulatory treatment of non-SSTs is appropriately calibrated, would be no more than reflecting the different risk profiles of the two categories.

We would also note that the creation of an SST standard does not, in our view, imply that all non-SST securitisations should just be bundled together and “thrown to the dogs”. There is a very large difference between a commercial real estate securitisation with a large and diverse portfolio and a limited refinancing risk and a CDO cube. We therefore urge regulators to work on ways to ensure that some appropriate gradation can be made amongst non-SST securitisations.

Another aspect that requires some thought is the impact of the introduction of an SST securitisation standard in Europe on the global consistency of financial regulation. We note, in this respect, the work of the Basel Committee and IOSCO on a similar topic. In the view of PCS, the revival of the European securitisation market is of enormous importance to the economic future of the continent. We cannot see this revival without an appropriate bifurcated regulatory architecture. We therefore would urge speedy work on completing the SST standards and putting them into law without waiting for a global consensus. However, as we have urged in our response, we would wish to see these standards open to non-EU participants in the hope that they may become global standards following completion of the BCBS/IOSCO work.

Question 10: How should capital requirements reflect the partition between qualifying and non-qualifying?

Question 11: What is a reasonable calibration across tranches and credit quality steps for qualifying securitisations? Would reallocating across tranches the overall capital applicable to a given transaction by reducing the requirement for the more junior tranche and increasing it for the more senior tranches other than the most senior tranche be a feasible solution?

Question 12: Considering that rating ceilings affect securitisations from certain countries, how should the calibration of capital requirements on qualifying and non-qualifying securitisations be undertaken while also addressing this issue?

PCS, as an organisation dedicated to defining high quality securitisations conceptually and encouraging the return of a strong market in such securitisations, is not well qualified to provide any technical advice on financial quantitative issues relating to capital requirements. We will therefore limit our response to these questions to some very high level considerations and let those who are qualified respond fully.

For PCS, the defining difference between SST securitisations and others is not the level of risk per se but the level of confidence that can be ascribed to the credit analysis performed on the former and the latter. The elements of structural integrity that define SST securitisations mean that an analysis of credit can be performed on them with a substantially greater level of confidence ascribing to the result. Seen from the other side, the absence of one or more

of these structural integrity elements in non-SST transactions makes them, all other things being equal, more subject to tail-risk.

So a non-SST securitisation rated AAA is almost certainly, in the great majority of cases, a much safer investment than an SST securitisation rated B-.

How you reflect the partition for capital risk would therefore, in our view, turn on how you account in the capital models for tail risk. How this should be done practically is an issue well beyond our competence.

As for the principles of calibration across tranches, we would merely aver that SST securitisations should be treated in such a way as to maintain the pre and post securitisation capital levels: achieve capital neutrality. In this respect we would wish to draw your attention to the work of G. Duponcheele, A. Linden and William Perraudin⁹. However, since the current Basel III proposals do not appear to achieve capital neutrality, a mere re-allocation of the capital requirements across the various tranches would of logical necessity be insufficient.

Equally, the principle of capital neutrality would militate towards removing artificial “floors” on capital requirements. If the SST definition rules ensure alignment of interest and transparency, there is no rationale for such floors to remain part of the capital regulations.

We believe that the issue of the sovereign ceiling effect will also benefit from the principle of capital neutrality. To the extent that the sovereign rating reflects macro-economic or institutional threats and weaknesses, then this should be incorporated in the credit assessment of the underlying assets located within that sovereign (e.g. the credit analysis of mortgage assets in that country). Therefore, no additional account need be taken of the sovereign ceiling in those cases if one follows a capital neutral approach. If, however, the impact of the sovereign ceiling rules applied by any rating agency reflects a mechanical approach that adds an additional layer of credit risk beyond the risk attaching to the securitised assets, then the capital neutrality approach should also be able to strip out that effect.¹⁰ This approach, similar to that which can be seen in the Duponcheele, Linden and Perraudin paper, works well when the calibrations are based on the calibrations of the assets when held by the bank.

⁹ “How to revive the European Securitisation Market: a Proposal for a European SSFA” (G. Duponcheele, A.Linden and William Perraudin) Nov 2014 http://www.riskcontrollimited.com/public/How_to_Revive_the_European_Securitisation_Market.pdf.

¹⁰ This does leave open the issue of the transfer and convertibility risk, but we believe this risk is probably best addressed in another part of the capital rules regarding sovereign exposures.

THE WAY FORWARD

We see this consultation as a key step towards reviving a safe and strong European securitisation market.

We would suggest that possibly the best way forward would be for the public authorities swiftly to reach an agreement on a definition of simple, standardised and transparent securitisation. Following such agreement, the definition will need to be given some form of legislative status.

Although the idea of a specific European Directive or Regulation dealing with all securitisation aspects has been mooted, PCS is concerned about the timeframe and complexity of such a legislative endeavour. Since many of the relevant legislative texts which touch upon securitisation are already in place or about to be finalised (Solvency II) and others are still in process (such as the draft rules on money market funds), creating a text that can wrap itself round existing and yet to be devised statutes is a potentially challenging task.

PCS therefore wonders whether the insertion of an SST securitisation definition in a single text, followed by its use by cross-reference in all other relevant level 2 legislation would not be a swifter and easier path.