



Setting the standard
for securitisation

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Dear Sirs and Madams

Consultation response to the draft Regulatory Technical Standards specifying the determination by originator institutions of the exposure value of synthetic excess spread pursuant to Article 248(4) of Regulation (EU) No 575/2013

PCS thanks the EBA for the opportunity to comment on the draft RTS regarding the capital requirements for synthetics excess spread (“SES”).

Background

The proposed RTS is a key component in the crafting of a safe, balanced and workable framework for synthetic securitisations.

Such a framework is fast becoming a key strategic and economic necessity for the European economy. The deadline for the final implementation of the Basel 3 accords is fast approaching and, with the introduction of output floors, will place substantial pressure on European banks’ capital positions. This pressure is coming at the time of looming crisis driven by inflationary pressures and a destabilising military conflict that is resulting in an energy crisis.¹ Should this crisis result, as is not unlikely, in an economic recession and increased defaults, banks’ capital positions will be put under additional stress as they try to hit the new Basel requirements at the same time their capital base is eroding. In other parts of the world, banks have mechanisms (such as the GSEs in the United States) proactively to manage their capital by removing risk from their balance

¹ The similarities with the 1973 petroleum crunch resulting from the Yom Kippur war which ushered a decade of stagflation is not lost on anyone and stands as a stark warning of the perils ahead

sheet. In Europe, the only realistic option to do so is securitisation and, depending on pricing, in many cases, synthetic securitisation.

If banks cannot manage sensibly their capital positions by reducing the risk on their balance sheet via synthetic securitisation, they will have no option but to curtail their financing of the economy. This could further drive down an already damaged European economy and potentially do so in a volatile political climate.

The reason we felt it necessary to paint this dramatic, almost lurid, picture is to draw attention to the fact that what may appear as an incredibly narrow technical issue – the exposure value of synthetic excess spread – has significant real-world consequences. To the comment that PCS has sometimes heard of “what is the harm in being somewhat over-conservative and cautious in this hyper technical matter?” the answer is “quite considerable harm to growth and prosperity in Europe, actually”.

General Comments

For reasons PCS will set out in this paper, we believe the proposals contained in the draft RTS are fundamentally flawed. The proposed approach results in capital requirements that are substantially disproportionate to the risks they seek to address. Were they to become law, they would preclude in almost every case the use of excess spread in synthetic securitisations by making such deals uneconomic. This, in turn, would seriously restrict the flexibility of the European financial system prudently to manage its capital for no actual prudential benefit.

We do believe that a better approach exists. One that completely removes the risks for which the co-legislators believed some quantum of capital might be required. We have set it out below.

Acknowledgement

Before setting out the reasons why we believe the proposed approach is disproportionate, PCS acknowledges two crucial facts that must underpin the final RTS.

First, it is theoretically possible for a bank to use and abuse SES to seek to reduce capital without a commensurate reduction in risk. This can happen if the amount of contracted SES exceeds the actual excess cash generated by the assets². In this case, the difference between the contracted SES and the excess cash is an amount which is not covered either by the protection seller or by cash received from the assets. It is therefore a real loss for the protection buyer and should be covered by capital (to the extent that it represents losses for which the CRR requires capital).

² By “excess cash” we mean the interest paid on the assets minus the cost of funds and the costs of administration of the pool; in other words, the amount available to cover losses and a possible profit element. For a fuller definition, see our response to Question 11

We believe that this is the risk for which the co-legislators are mandating capital. We also wish to point out that this is a theoretical risk since (i) there is no evidence that any European banking institution contracts SES in this manner; (ii) such a level of contracted SES would be unlawful in STS securitisations³ and (iii) were a bank ever to seek to do this, the regulators have the power to deny SRT in such eventuality; a power we assume they would use⁴.

But abuse of SES is conceptually possible and therefore appropriate rules to capitalise a portion of SES that exceeded a legitimate quantum are sensible.

The second acknowledgement is that the EBA must reflect the level 1 text in drafting the RTS.

However, we do not read the level 1 text as mandating the approach taken in the draft RTS as the consultation suggests.

The RTS is required by Article 248(4) which reads:

4. *EBA shall develop draft regulatory technical standards to specify how originator institutions are to determine the exposure value referred to in point (e) of paragraph 1, **taking into account** the relevant losses expected to be covered by the synthetic excess spread.*

This is an adjunct to Article 249(1)(e):

- (e) *the exposure value of a synthetic excess spread shall include, **as applicable**, the following:*
 - (i) *any income from the securitised exposures already recognised by the originator institution in its income statement under the applicable accounting framework that the originator institution has contractually designated to the transaction as synthetic excess spread and that is still available to absorb losses;*
 - (ii) *any synthetic excess spread that is contractually designated by the originator institution in any previous periods and that is still available to absorb losses;*
 - (iii) *any synthetic excess spread that is contractually designated by the originator institution for the current period and that is still available to absorb losses;*
 - (iv) *any synthetic excess spread contractually designated by the originator institution for future periods.*

³ Article 26(e)(7) of the Securitisation Regulation

⁴ Article 245(2) CRR

For the purposes of this point, any amount that is provided as collateral or credit enhancement in relation to the synthetic securitisation and that is already subject to an own funds requirement in accordance with this Chapter shall not be included in the exposure value.

We have highlighted what we consider the key words: “**taking into account**” and “**as applicable**”.

If the CRR text merely intended that all the elements listed in Article 249 be added mechanically to arrive at the exposure value requiring capital to be allocated against it, it is difficult to see what the point would have been to mandate the EBA to provide technical input on this matter.

It seems to us that the only sensible interpretation of these level 1 provisions, as indicated by the highlighted words, is that the EBA needed to determine what portion of the SES if not backed by capital would result in a bank receiving an excessive and unjustified capital requirement reduction. This was to be achieved by taking into account the risks that had not been effectively removed from the balance sheet via the synthetic securitisation.

It is PCS’ contention that this portion, for which capital is needed, is capable of determination and is not that set out in the draft RTS.

Comments on the general approach

A conservative approach?

One argument put forward in favour of the EBA’s proposal is that requiring capital against the lifetime expected loss covered by SES is a conservative approach and therefore better prudential regulation.

The problem with this argument is that it ignores all the other existing “conservative” elements of the securitisation regulation. It seems that on every technical standard related to securitisation on which the regulatory authorities have been asked to opine, they have indicated that a “conservative” approach adding additional layers of protection would be appropriate, without taking note that similar additional layers have already been added in earlier regulatory measures. When added together though all these additional layers have produced a regulatory framework for securitisation that is not “conservative” but unbalanced and excessive when set against any historical data set or any reasonable conceptual analysis.

This is illustrated in the case of this draft RTS where the approach to SES of adding additional layers of capital based on a conservative approach ignores the fact that the securitisation regulations already contain, through the p factor, additional layers of capital based on a conservative approach. The p factor is an arbitrary number, not derived from, nor required by, any past performance data, to “be conservative” when it comes to securitisation. However, it is neither mentioned nor taken into account in this consultation since this is a consultation

on synthetic excess spread. So, the two sets of “conservatively” added capital are treated as unrelated and distinct even though they both add to the overall capital held by the protection buyer, above and beyond any balanced approach based on historical data.

This siloed approach to the regulatory framework for securitisation in Europe is an issue that PCS has raised many times. We would again urge the EBA and the Commission, when looking at technical regulatory matters, to take a holistic view that reflects not narrowly on the matter at hand but how the matter at hand fits into the overall regulatory framework, not only for securitisation but across similar capital market instruments. This holistic approach is the only way, it seems to us, to avoid the regulatory arbitrage that rightly concerns public authorities.

Difference between synthetic and true sale

Regulatory concerns over synthetic securitisations have traditionally centered on the capacity of the parties to arbitrage the prudential rules set out for true sale securitisations by contracting rights and obligations that go beyond what exists in a traditional transaction where the investors effectively own the underlying assets and their cash flow. It has therefore been the approach until now to align the rules on true sale and synthetic by seeking to ensure that the risks and rewards of the synthetic securitisation mirrored those of a true sale securitisation.

It is not clear why the EBA departed from this approach in this case. We note the explanations set out in paragraphs 4 and 8(ii) but cannot agree with their conclusions – at least insofar as the contracted SES is equal to (or smaller than) the actual excess cash generated by the assets.

In paragraph 4, the EBA asserts that SES “encumber(s) the originator institution’s income statement in a manner similar to an unfunded guarantee”. This is only true if, and to the extent, the contracted SES is greater than the excess cash generated by the securitised pool (or can be accumulated across periods). To the extent the SES is equal to the excess cash then this is equivalent (on a UIOLI basis) to a guarantee **100% funded by real cash receipts from the assets**.

In paragraph 8(ii), the EBA asserts that “by contrast with a traditional securitisation, the securitised exposures in case of a synthetic securitisation remain on the balance sheet of the originator and their future proceeds will continue to be recorded in the income statement of the originator”.

Although this is correct, it is not a difference for that part of the SES that is equal to or smaller than the actual excess cash. Actual excess cash in a traditional securitisation is returned at the bottom of the waterfall to the originator and is

treated by the originator as income. That amount therefore also continues to be recorded in the income statement of the originator.

In addition, that income generated by a traditional securitisation, just like all future income generated by all unsecuritised assets on the balance sheet of the originator, is never subject to capital requirements under the CRR. It seems therefore that requiring capital to be allocated to SES equal to or smaller than the excess cash generated by the assets amounts to nothing less than requiring – for synthetic securitisation and synthetic securitisation alone of all financing instruments – that capital be allocated against future profits. This is a major departure from the basic principles of Basel and the CRR and was extremely unlikely to be what the co-legislators had in mind.

We strongly recommend that the traditional approach of aligning true sale and synthetic securitisation prudential rules be followed and therefore, to the extent that the contracted SES mirrors the flow of actual cash excess spread in a traditional securitisation, the capital requirements be aligned. No prudential justification appears to us to support a more punitive approach to synthetics.

Consistency with the CRR's general approach

The proposals in the RTS require capital to be set aside against SES calculated over the whole life of the transaction. PCS notes that a basic feature of the CRR, as a whole, is that it operates on a one-year horizon. By departing from this approach, the EBA's proposal would result in yet another tilting of the uneven playing field against which European securitisations must struggle. It would be another example of a burden falling solely on securitisation and from which all other financing tools are exempt.

This pushes against the Commission's, the European Parliament's and the EBA's own assertion of the importance of a large yet safe securitisation market in Europe to fund the economy and manage systemic risk. We are aware that, in a different context, the EBA has also asserted that the absence of meaningful growth in the European securitisation market was entirely unconnected with the exorbitant regulatory burden falling on this instrument. PCS respectfully disagrees. But even if other causes such as central bank monetary policy were depressing the market, we suggest that making yet more punitive regulatory exceptions for securitisation will seriously undermine any likelihood of a resurgence.

We can find no conceptual or prudential justification for departing from the CRR's overall approach.

Our proposals which PCS believes would address the issues discussed above can be found in our response to Question 11.

QUESTIONS

QUESTION 1

Q1. Do respondents find the provisions clear enough or would any additional clarification be needed on any aspect?

The provisions are clear.

One small item that was brought to our attention is that the definition of UIOLI does not reflect the existence of two mechanisms. One where the SES is applied in the period where the payment is required by under the securitisation, the other where it is applied in the period where a default has occurred. In the latter case, it is applied before the work out and therefore on an estimate of the loss with a potential adjustment at the end of the work-out.

So long as the estimate is made in good faith, there is nothing unusual in the estimation mechanism and it is made in accordance with the regulatory rules, we do not perceive any difference between these two methods from a prudential point of view. In some cases, the first method would *in retrospect* be favourable to the protection seller. In other cases, again *in retrospect*, it would advantage the protection buyer. Since no-one can determine *ex ante* which it would be and, if the estimation mechanism is robust, the differences should be marginal, we do not think the rules should differ depending on which UIOLI mechanism is chosen.

QUESTION 2

Q2. Do you agree with the possibility of choosing between the full and the simplified model approaches in a consistent manner?

In one sense, this question is entirely academic. Both the full model approach and the simplified model approach will result in the near total disappearance of the use of SES from the market. Therefore, the option is not really an option as market players will have no economically viable opportunity to choose either.

In another sense though, the proposal illustrates PCS' concerns over the overall approach of the EBA and what it terms its "conservative approach" (see General Comments above).

By proposing the full model approach AND the simplified approach, the EBA is asserting that both approaches are legitimate and meet the prudential standards set by the CRR.

For originators, for certain asset classes and maturities, the full model approach will produce a better outcome. For other asset classes and maturities, the

simplified model approach will be more favourable. In some cases, lack of data will preclude the use of the full model.

But the EBA in this draft RTS has asserted that both are acceptable.

Why then would an originator not be allowed to choose, transaction by transaction, which of the two legitimate methods it wishes to or can use?

Why would an originator who has many pools with sufficient data but some without be required either (a) to use an unfavourable approach for all its transactions or (b) forsake the securitisations of some assets even though these could be done following a method approved by the EBA and which another bank was using for the synthetic securitisations of identical assets?

The EBA asserts that such an option would amount to “regulatory arbitrage” and therefore be abusive. We do not see how a bank, or any corporate entity, presented with two options both labelled as acceptable by a regulatory entity and choosing the one which is optimal for it is abusive. Optimisation is not regulatory arbitrage. If it were, regulations would have to require each regulated entity when alternatives are set out in the rules systematically to select the alternative that resulted in the worst outcome.

We also assume that when the RTS provides an annual option, this choice only affects future transactions and does not require the protection buyer to recalculate past transactions’ capital. The text appears a little ambiguous.

QUESTION 3

Q3. Instead, would you favour that the RTS consider only one method (i.e. the full model approach or the simplified model approach) for the calculation of the exposure value of the synthetic excess spread of the future periods?

See our response to Question 2 and Question 11.

QUESTION 4

Q4. Do you agree with the specifications for determining payments on the securitized exposures made in Article 3?

We consider that both the full and the simplified models do not reflect the expectations of the level 1 text, do not reflect the actual risk identified, require additional capital way in excess of what would be needed to cover the genuine prudential risk and would result in most synthetic securitisations being unable to use SES.

In this respect we note that the greatest number of transactions using SES are those where the protection seller is the European Investment Fund, using public funds primarily to help SMEs. In fact, we are aware, through our work as third party verification agent, that the EIF **requires** SES to be used in certain types

of transactions. Should the final RTS reflect this draft, this entire section of European Union funding would likely disappear and the EIF would have to find some other way to deploy the funds made available to it with potentially a substantially deleterious impact on this public sector function. For the reasons set out in General Comments, we believe the approach is fundamentally flawed.

We are aware that other market participants have provided detailed feedback on the model.

QUESTION 5

Q5. Do you agree with the specifications for the determination of the relevant losses made in Article 5?

See our response to Question 4.

QUESTION 6

Q6. Do you agree with the calculation of the exposure value of synthetic excess spread for future periods made in Article 6?

See our response to Question 4.

QUESTION 7

Q7. Shall the average of the scenarios be made in a different way for UIOLI and trapped mechanisms (e.g. back-loaded and evenly-loaded only for UIOLI mechanisms, and front-loaded and evenly-loaded for trapped mechanisms)?

Taking into account our response to Question 4, our proposal in Question 11 and the general comment as to the alignment of prudential rules between synthetic and true sale securitisations when the former accurately mirrors the latter, PCS does believe that a distinction must be made between the prudential approach to UIOLI securitisations and securitisations using a trapped mechanism.

In a true sale securitisation, actual excess spread is returned to the originator at the end of each period. Therefore, it is not available to meet losses in subsequent periods.

In keeping with the one-year horizon approach, we would propose that, for securitisations using a trapped mechanism, all unused SES available to meet losses in later years should attract a capital requirement. This is consistent with the intent of the legislator and reflects the comment made by the EBA in paragraph 4 of the consultation. Unused SES available for later periods is indeed equivalent to an unfunded guarantee and should be treated as such from a regulatory capital point of view.

QUESTION 8

Q8. Do you agree with the specification of the simplified model approach made in Article 7?

See our response to Question 4.

QUESTION 9

Q9. Do you consider that the formula can be further simplified (e.g. by using the maturity of the credit protection multiplied by a conservative scalar instead of WAL)?

See our response to Question 4.

QUESTION 10

Q10. Do you agree with the scalar assigned for UIOLI mechanisms? If not, please provide empirical evidence that justifies a different scalar based on the different loss absorbing capacity of UIOLI vs trapped mechanisms.

See our response to Question 4.

QUESTION 11

11. Regarding the current supervisory practices on synthetic excess spread (SES), described in paragraphs 9 to 11 of the background section, the question is whether these practices could be adapted while keeping them aligned with the amended regulation, and the relative impact they would imply in comparison with the approaches included in these draft RTS.

One way to try to further adapt the current supervisory practices on UIOLI SES to the provisions of the amended regulation could be by taking into account the part that is expected to cover for losses in the next period instead of the part that it is not, including at issuance of the transaction, keeping the rolling-window approach.

Would you favour that approach? If so, how do you think that this rolling-window approach for calculating UIOLI SES will affect the efficiency and viability of synthetic transactions in comparison with the current supervisory practices? Please justify your response with specific illustrative examples or data.

PCS sees two possible approaches that cover the actual prudential risk of abusive SES consistent with the level 1 text. One or both could be selected for the RTS. If both, consistent with our comments on Question 2, we believe that

originators should be allowed to choose which they apply on a transaction-by-transaction basis.

The Alternative Approach

This is the approach currently used by the ECB with a rolling one-year window. Under this approach SES net of losses is required to be capitalised in each year. For reasons set out below, this is likely to require more capital than necessary to remedy the actual prudential problem. However, it is well known by the market, fits well with the level 1 text and seems to be satisfactory for most issuers. PCS is an independent body and our views are our own. But we do not see great value in being “more royalist than the king”. To the extent a substantial majority of market participants are satisfied with this approach, we think it fine even if somewhat overly conservative.

The True Sale Mirror Approach

Whether securitised by a true sale transaction or a synthetic transaction, the pool of assets will generate actual cash. That cash will be available to the originator to meet actual losses. This is indeed the essence of “excess spread” being the revenue generated by the underlying exposure net of funding cost and administrative costs. Its purpose is to meet expected loss and, hopefully, provide a profit.

Abuse of SES only occurs when contracted SES is greater than actual cash excess spread (“ACES”).

In that case, the positive difference between SES and ACES is an amount that, should it be lost by the originator through defaults in the underlying pool cannot be met by (a) the protection buyer who will deduct the SES from his payment or (b) cash available as part of the ACES. As such, prudentially it needs to be covered by capital. Otherwise, the application of SRT to such a transaction would result in a fall in capital requirement unmet by a fall in credit risk to the tune of the difference between SES and ACES.

PCS would therefore propose that capital should be required to be allocated to an amount equal to the positive difference between SES and ACES. Obviously, if contracted SES is below ACES, as can happen, no additional capital is required.

In addition, protection buyers could elect to define contracted SES as being the lower of a fixed number/percentage and ACES in any period. This would result in actual SES never, by definition, exceeding ACES. This, in turn, would result in no capital being required to cover SES.

ACES should be carefully defined in the RTS and should reflect the contracted return on the underlying exposures (usually interest but not necessarily) minus

(a) the administrative costs of servicing the exposure plus (b) the cost of financing the asset including the cost of protection (COF).

In a true sale securitisation, the administrative costs appear in the waterfall as various servicing items and the COF, appear as the coupon on the bonds plus any other similar costs (eg hedging costs or liquidity facility fees). The entirety of the return on the underlying exposures is available to meet those costs, including that portion of the return that exceeds expected loss and was originally intended to generate a profit for the originator.

Using the True Sale Mirror Approach, ACES should therefore reflect the full amount contracted with the underlying debtors (rather than simply the Expected Loss component of that revenue).

The COF and administrative costs are known to the originator as otherwise the originator could not calculate the financial value of the securitisation. The RTS should simply specify that the originator is required to use “actual” COF and administrative costs so that it cannot create arbitrary COF and administrative cost numbers. If it is felt necessary, the RTS could provide more detailed definitions to avoid any arbitrage.

We believe that this approach fully eliminates the risk of prudential arbitrage and the abuse of SES. We also believe that it is consistent with our reading of articles 248 and 249 of the CRR.

We believe that this capital should be required under the rolling one-year window approach to be consistent with the overall approach of the CRR.

QUESTION 12

Q12. Do you agree with the treatment of the ex-post SES of future periods in the RTS? If not, please provide rationale and data supporting your views.

See our response to Question 11

QUESTION 13

Q13. Do you have any other comments on these draft RTS?

Grandfathering and/or transition

PCS acknowledges that philosophically, a capital requirement rule should not be grandfathered. If the capital is required to meet a risk, then it would be

imprudent to allow that risk to exist without appropriate capital, simply because it was entered into in a period before the rule came into force.

However, capital rules are there to ensure financial stability. The RTS is likely to be introduced both as banks are preparing for the final implementation of Basel 3 (including the output floors) and possibly battling an economic crisis.

As the new rule – should it not be adapted from the draft RTS - results in additional capital requirements, banks will be faced with two possibilities. They can either (a) maintain the transaction standing and find the additional capital required by the RTS somewhere or (b) exercise the regulatory call option existing in almost all synthetic securitisations. Upon the exercise of the regulatory call, the originator will then need to find the additional capital necessary to be set against the erstwhile securitised assets that are no longer protected.

This dilemma resulting in either case in a need for additional capital will strike all financial institutions that have used synthetic securitisation with SES at the same time. These transactions, as the EBA is aware, are large.

Therefore, the absence of grandfathering or a long transition period could result in substantial additional pressure on bank capital across Europe. In turn, this could generate a potential systemic risk either across Europe or in one or more European jurisdictions as the banks scramble to find additional capital at the same time.

This could result in a prudential rule triggering rather than reducing the systemic risk of the European financial markets.

PCS therefore would strongly recommend that a worst-case scenario impact study be conducted looking both at the European Union as a whole and individual jurisdiction and appropriate grandfathering/transition provisions be inserted in the RTS to avoid destabilising the European banking system.

These could include not applying the additional capital to existing transactions, a long period before the coming into force of the new rule or graduating over time the increases in capital requirements.

We are at the EBA's entire disposal to discuss further any of the matters raised in this response.

Yours faithfully

A handwritten signature in blue ink, appearing to be 'Ian Bell', written over a horizontal line.

Ian Bell
CEO
Prime Collateralised Securities (PCS) EU sas