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for securitisation

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

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

www.pcsmarket.org

Banking Capital Policy Division
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

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Response to CP13/24 – Remainder of CRR: Restatement of assimilated law

This is the response of Prime Collateralised Securities (PCS) UK ("PCS") to the consultation CP13/24 – Remainder of CRR: Restatement of assimilated law (the "Consultation").

The PCS initiative is an independent not-for-profit initiative set up with the purpose of revitalising the European securitisation market on a safe and sound basis. PCS also generates income from its verification of the STS status of securitisations. This is done, in the UK, pursuant to an authorisation and under the supervision of the Financial Conduct Authority. (In the European Union, this work is done pursuant to an authorisation and under the supervision of the French Autorité des Marchés Financiers.)

As an initiative solely dedicated to improving the securitisation market, we have only responded to Part 3 of the Consultation.

We confirm that we agree to the publication of our name and inform you that we will publish our response in full on our website.

Introduction

We wish to thank the PRA for the opportunity to respond to their proposals on securitisation. We acknowledge the PRA's commitment to helping revive the market and its understanding of the issues.

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General Matters

Before commenting on the individual proposals, we have three points of general application.

[A] BCBS

We understand that any analysis of the PRA's approach to conforming with the Basel rules must take into account the exact terms of the PRA's secondary objective:

"'facilitating, ***subject to aligning with relevant international standards*** – (a) the international competitiveness of the economy of the United Kingdom (including in particular, the financial services sector through the contribution of PRA authorised persons), and (b) its growth in the medium to long term."

We also note, and agree with, the PRA's willingness, when it is deemed necessary, to depart from strict compliance as set out, for example, in paragraph 3.24 of the Consultation.

We do admit to being somewhat at a loss though to understand the principles underlying the PRA's approach as to when and where to comply or depart from the Basel rules and the extent that it is willing to do so in any given case. For example, paragraph 3.20 clearly states that there is a limit to how far the PRA is prepared to depart from the rules but without any indication of how this limit is determined. This makes it challenging to comment on the PRA's approach to this matter.

However, when – as in a number of cases – the PRA has indicated that the Basel rules are excessively conservative and so some appropriate degree of relaxation would cause no deterioration of the prudential safety of the UK's financial system, the decision to follow or not the BCBS rules clearly ceases to be a prudential decision and becomes purely a political one. As such, we assume that the PRA would liaise closely with HMT before reaching any final conclusion.

When reaching a conclusion, we believe a number of factors will be important:

- First, as acknowledged by the PRA (paragraph 3.24), there is a genuine question of whether the BCBS rules can even be described as an "international standard" taking into account the willingness of many jurisdictions to make exceptions when the rules are not advantageous to their banks. The now extremely likely abandonment of the final implementation of Basel 3 by the United States (and the suspension of implementation by Japan pending US decisions) is the latest case in point.

- Secondly, the UK system, inherited from the EU, is substantially more robust around securitisation than any other jurisdiction's (save, obviously, the EU). This is particularly true around the STS rules which are considerably more

comprehensive than the rules around STC. This, in the STS space, lowers the idiosyncratic and the systemic risks of securitisations in the United Kingdom compared to other jurisdictions governed by the BCBS rules. It can fairly be argued that, notwithstanding the BCBS' attempt at creating with STC a pale shadow of the European and UK STS regime, the detailed rules and guidelines, the existence of third-party verification agents and the sanctions regime of the STS regime mean that it is something that has no equivalent in the BCBS framework and should be approached, prudentially, as *sui generis*.

- Thirdly, the BCBS has indicated that it has no intention of re-opening the securitisation rules. This lack of interest is unlikely to change in respect of rules (including capital calibrations) around STS since key players have not implemented STC (USA, Australia, China).

The consequences of the above mean that decisions taken today not to modify rules that are acknowledged to be over-conservative will extremely likely lead to a quasi-permanent miscalibration of prudential rules for UK institutions. Such miscalibration will continue to erode UK banks' international competitiveness and their capacity to fund growth. We note that this will not be the case in jurisdictions such as the USA. This is because (a) the size of the non-bank investor base means that punitive rules on bank investors have limited impact on overall US securitisation issuance and (b) the existence of GSEs provides US banks with a capital management tool unavailable to UK banks that have to rely on synthetic or true sale securitisations to achieve what US banks can by selling their mortgages. EU banks, in turn, have a competitive advange created by the EU's willingness to allow synthetic SRT trades to benefit from the STS status.

These considerations lead us to conclude that the PRA should be more willing to depart from the Basel rules than it has proposed to do so in the Consultation if it wishes to see UK institutions compete on an overall level playing field. By "overall" we mean taking into account not just the specific rule but the context in which such rule is deployed in competing jurisdictions (eg, the existence in the USA of GSEs and large NBFIs funding the retail sector).

[B] Evidence based calibrations

Paragraph 3.13 states that: "The PRA has taken an evidence-based approach in considering possible adjustments to the calculation of capital requirements for securitisation positions."

This is clearly welcome, but the absence of additional information on what evidence and what methodology has been used to achieve the proposed calibrations makes it difficult for us to comment on the proposed outcomes and the extent to which they are supported by the data.

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PCS has long advocated that, for STS securitisations, the evidence for a proper calibration exists and is extremely robust. In this respect we will reiterate the statements that appear in our response to the European Commission's consultation on this topic.

"Crucial to understanding the data-based approach, the STS standard was not designed to create a new, higher standard than existed in well-structured pre-GFC European securitisations. On the contrary, the STS standard codified "best practices" of the European pre-GFC true sale securitisations. As a third-party verification agent, PCS is extremely familiar with the 100 plus STS criteria. Not a single one is novel. Not a single one departs from features familiar to virtually all simple, "plain vanilla" true sale securitisations in the classic asset classes both before and after the GFC.

It follows from this that those traditional pre-GFC European securitisations are extremely good proxies to gauge the credit strength of STS securitisations. We believe the onus lies with those arguing that data analysis through the credit cycle cannot be performed for STS securitisations because the standard has only existed since 2019 to point to any STS criterion that was not routinely present in those pre-GFC transactions. (Incidentally, even if such criteria could be identified, this would make the proxy data argument even stronger rather than weaker, since any such additional criteria would presumably be improving elements indicating that STS credit performance is likely to be even better than that of pre-GFC traditional securitisations.)

We believe the p factor can be calibrated for STS on the data not just through the economic cycle but through the greatest financial shock since the 1930s. We are confident that this will generate a p factor that is very small."

In the whole section, "UK" can safely be substituted for "Europe".

Looking at the current proposals in paragraph's 3.7 onward dealing with the p factor, it looks as if the PRA has proposed in respect of the floors to move from one set of arbitrary numbers (roughly derived from US sub-prime performance) to another set of arbitrary numbers. The fact that the new numbers are less distant from reality is clearly welcome. But a better prudential approach would be to conduct a thorough analysis of the available data.

As we will set out in more details in our response to proposition 3.1, we believe that for STS the p factor calculations should be based on the pre-GFC and GFC performance of traditional UK securitisations.

[C] STS for synthetics

We note that the PRA is not proposing to allow synthetic securitisations to achieve STS status.

We agree with the analysis set out in the PRA's earlier discussion paper (DP 3/23) that STS, in and of itself, does not add additional safety to a synthetic transaction's

senior position. However, as we pointed out in our response to that discussion paper, this misses the point.

STS allows banks to achieve a lower capital requirement for holding a securitisation position because its criteria are designed to eliminate the reasons for the current framework's non-neutrality. But the elements that drive non-neutrality in securitisation generally never applied to a senior tranche held by a bank in an SRT synthetic transaction in the first place. An analysis of the drivers of non-neutrality demonstrates that, in the case of a bank originator entering into a synthetic SRT transactions, those drivers either:

(a) do not exist – eg information asymmetry, misalignment of interests, cash management risk

(b) are problematic for the mezzanine (non-bank) investor but not the protection buyer – eg cherry picked pools

(c) are issues that can and would be solved by regulators refusing to grant capital relief under the SRT rules – eg inverting loss distribution upon the occurrence of certain events (prohibited, by the way, by STS rules)

Therefore, the current rules, by not distinguishing between senior positions in traditional securitisations held by third party banks and senior synthetic positions held by the originator, unjustifiably punish such originators by miscalibrating the capital requirements necessary for a sound prudential approach. They do this by assuming that the same level of non-neutrality is appropriate for both types of securitisations when only a much lower one is justified for a senior tranche protection buyer.

Allowing STS for synthetics, with all the additional criteria (including SRT criteria) is the easiest way to begin to rectify this miscalibration by aligning the level of non-neutrality to the reality of a synthetic SRT.

Not allowing SRT synthetics to achieve STS status is not only unjustified it is also damaging UK banks' international position. EU banks, using synthetic SRT securitisations, are able to achieve cheaper solutions to their capital management needs and, as mentioned, US banks have a government backed capital management solution on which they can fall back.

This state of affairs is, and will continue to be, a drag on UK banks' capacity to compete internationally.

The proposals

Proposal 1 – p factor

1. Formula derived p factor

This is a substantial improvement on the original proposal of a fixed p factor at 0.7.

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However, we refer you to our general comments above on “evidenced based calibrations”. Although the approach of a formulaic p factor appears theoretically sound, we would welcome the floor for STS to be derived from GFC and pre-GFC data. As currently set, it appears to be another arbitrary number. Indeed, the explanation set out in paragraph 3.20 suggests that the reason for setting the floor at 0.3 for STS (and 0.5 for non-STS) was a desire to limit the divergence from the Basel rules to some, again seemingly arbitrary, percentage. For the reasons set out in our general comment on Basel, we believe this is not the best approach. It is also an approach that disadvantages UK banks.

We recognise that, although there is abundant data to calibrate STS securitisations, the calibration of the floors for the p factor for non-STS securitisations is more difficult since, by definition, those encompass every type of structure and asset class. We would recommend a data and evidence-based calibration for STS as a starting point and then a percentage increase for non-STS that reflects the distinction between the two types of securitisations and a prudential policy to encourage the safer STS issuances. We recognise that this re-introduces an element of arbitrariness to the framework but are not clear how this could be avoided.

As a minor point, if the PRA does elect to maintain its current proposal, it is odd to have the STS p factor floor at 0.3 when the European Union approach – for the purposes of the output floor calculation – sets it at 0.25. It is a small step but aligning the two would help international convergence.

More significantly, we would also draw attention to two very different approaches that we believe would be better at dealing with both the excessive non-neutrality and the cliff effects of decreasing p. These are set out in our response to the European Commission’s consultation (https://pcsmarket.org/publication/pcs-response-to-the-commissions-consultation-on-europes-securitisation-framework/).

The first, and in our view better, solution is to use two different values of p. We note that it is a solution also mentioned by the PRA as a possible answer to the problem in its discussion paper 3/23. The second is the use of a scaling factor for Ka.

However, both these solutions would require no longer assigning a 1250% weight to the “table” of the half-pipe equivalent to Ka. We note that this was rejected in paragraph 3.17 as being an unacceptable deviation from Basel. We are not convinced that this is so and refer you back to our general comment on Basel.

2. Availability of new p factor for output floor calculations

We believe this is an important and necessary step and agree with the PRA’s approach.

3. No changes to the rules on synthetics

We believe this is not the appropriate approach for the reasons set out in our general comments on STS for synthetics. We note the comments in paragraph 3.18. Although they are, by themselves, uncontroversial they fail to disclose *why* the current floor is appropriate. For the reasons we have set out above, we believe that there are compelling reasons why this is not so.

4. Risk sensitive floors

As the Consultation acknowledges in paragraph 3.19, the current risk floors do not support risk-sensitivity.

For example, the floor (in each case for an STS transaction) for:

(a) a pool of BB+ corporates is 10% of its pool RW
(b) a pool of residential mortgages (with 80%< LTVs) is 33% of its pool RW
(c) a pool of consumer loans is 13.33% of its pool RW

Intuitively, this is illogical. It also has several unwelcome consequences.

First, it disincentives the securitisation of the safest assets. A securitisation market based on the safest, most stable and predictable assets is, by construction, systemically more stable. As such it should be encouraged.

Secondly, the current one-size-fits-all framework works against SME securitisations, since the floor eliminates the SME support factor.

We note that the main reason for not introducing risk-sensitive floors is a reluctance to depart from Basel. Again, we refer you back to our general comment on Basel

Proposal 2 – capital treatment of certain guaranteed mortgages

This is more an issue of the capital requirements for banks' own assets than a securitisation issue *stricto sensu* and as such, not one that is of direct relevance to our work.

It does seem to us, as an entity with deep securitisation knowledge, that the problem arises fundamentally from treating these mortgage loans as "securitisations". They are clearly not what the legislator had in mind when they passed the EU Securitisation Regulation. They have no "originator" and the risk is not passed on.

We also note that "credit tranching" appears in many types of financial lending. There are trade receivables with partial parent company guarantees. There are asset-based loans (aircraft, ships, etc…) with partial guarantees. There are mortgages with partial guarantees from parents of the borrower. There are trade credits with partial insurance. Clearly, none would be treated as "securitisations".

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It also seems strange to us, although it is not an area with which we are familiar, that all the obligations set out in articles 5 and 7 of the Securitisation Regulations (as onshored) are imposed on these partially guaranteed mortgages. Are continuous cash flow stress tests conducted on each mortgage at intervals? Does the "originator", as required by article 7(c)(iv), provide the FCA with a list of triggers in every mortgage?

It seems to us that this entire issue would probably best be resolved by a determination that such mortgages are not "securitisations".

Proposal 3 – Unfunded credit protection

We strongly support the PRA's approach of allowing unfunded SRT issuance.

We also agree with the PRA that such issuance raises legitimate issues regarding the availability of protection when required and the continued solvency of third-party protection sellers. It also raises issues if a meaningful portion of UK bank risk for which capital is provided through SRT synthetic securitisations is concentrated in a small number of counterparties.

We support the general conclusion that such risks must be monitored but also that they can be monitored. We note that the PRA, having the powers to refuse SRT treatment also has the means, should it determine that these risks were becoming systemically meaningful, to remedy the situation.

Proposal 4 – Oversight and approvals

This is a matter of internal bank procedures rather than a securitisation matter. We have no views on this point.

Proposal 5 – Changes to STS criteria

The three proposed changes are straightforward and technical. We have no comments.

Proposal 6 – Treatment of undrawn portions of cash advances

This is a matter for banks rather than PCS. However, at first blush, the proposal appears entirely sensible.

Proposal 7 – Procedure flowcharts

This is a matter of internal bank procedures rather than a securitisation matter. We have no views on this point.

Proposal 8 - Simplifications for SDDTs

PCS has no means of calculating the impact of the proposal on banks or the securitisation market and so has no comment.

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Proposal 9 – SEC SA vs SEC IRBA selection

Paragraph 3.121 is straightforward and paragraph 3.122 just adds a month to the timeframe in which a bank must notify the PRA of its annual selection. This appears entirely reasonable.

Proposal 10 – Permission process

This is a matter of internal bank procedures rather than a securitisation matter. We do not usually comment of required internal procedures unless they are so burdensome in time or money as to impact the functioning of the securitisation market in an unnecessarily onerous manner. We have no views on this proposal and leave it to banks who are much better placed to gauge its impact.

Proposal 11 – Powers of the PRA

This proposal deals with the exercise by the PRA of its powers to deny SRT to securitisation transactions.

PCS accepts that such powers are necessary to preserve the systemic integrity of the UK financial system and this proposal appears to lay down the technical legal basis through which the PRA intends to exercise these powers. As such PCS has no comments on the proposal.

We do note, however, that more important is the way in which the powers are exercised. One point that has been raised by stakeholders is the importance of imposing the relevant SRT test at the inception of the securitisation on a once and for all basis, rather than on an ongoing basis. We urge the PRA to clarify that this is also its intention. Any other approach would reduce systemic stability by creating cyclically driven volatility in banks' capital positions when such cyclicality is not justified.

Proposal 12 – Clarifications to the SEC IRBA and/or SEC SA

PCS has no comment.

Proposal 13 – Avoiding double counting of defaulted exposures

PCS agrees with the proposed approach to defaulted receivables and avoiding their double counting.

Proposal 14 - Change to the calculation of maximum capital requirements

We have no views on this proposal and leave it to banks who are much better placed to gauge its impact.

Proposal 15 – Notification of breaches

It is very difficult to provide a meaningful *ex ante* definition of materiality for breaches of statutory obligations connected to securitisations. There are too many obligations and their importance in any given case is too dependent on the circumstances obtaining at the time of the breach and the identity of the institutions involved. Therefore, we agree with the PRA approach that all breaches should be reported

Over time, as low-or-no impact breaches are reported, we would hope and anticipate that the PRA would, through a constructive dialogue, indicate in writing to prudentially regulated institutions that certain breaches need not be reported. This would prevent the valuable time of both bank and regulatory personnel being wasted on issues of no prudential relevance. But such a development would, of necessity, be an *ad hoc* process.

Proposal 16 – Other small changes

We have no comments.

We are at your entire disposal should you wish to discuss any matter raised in our response.

Yours faithfully

Ian Bell
CEO
Prime Collateralised Securities (PCS) UK