

**An EU framework for simple, transparent and  
standardised securitisation**

**Consultation Response**

**13 May 2015**



**PCS**

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Prime Collateralised Securities (“PCS”) would like to thank the European Commission for the opportunity to address the issues raised in the Consultation Document on an EU framework for simple, transparent and standardised securitisation published on 18th February 2015 (the “Consultation”).

PCS sees the Commission’s approach to securitisation as set out in the Consultation but also the Green Paper on Building a Capital Markets Union as a major positive contribution to this key debate. It is a contribution not only to the future of a strong European securitisation market, framed within a robust regulatory framework, but also to making it an essential component of a strong and resilient European capital market. To quote the Chairman of PCS, Francesco Papadia: “Although a strong securitisation market is not *the* solution for a strong European economy, it is difficult to see a solution that does not include such a market.”

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

## EXECUTIVE SUMMARY

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[A] A definition of simple, transparent and standardised securitisation (“STS securitisation”) should be drafted to form the core of a new European regulatory regime for securitisation. This regulatory regime would be crafted so as to assist in the creation of a deep, liquid but safe securitisation market, able to channel funds to the real economy.

[B] The best starting point, at this stage, for a definition of STS securitisation is the work of the European Banking Authority as set out in their recent consultation.

[C] The new STS securitisation definition should be used systematically in all European regulation where it is appropriate and beneficial to distinguish between safe and predictable securitisations and others. This includes Solvency II and the Capital Requirements Regulation (both for capital requirements and for recognition as Liquidity Cover Ratio assets) as well as in the AIFMD, the forthcoming Money Market Funds legislation and the Bank Structure Regulation.

[D] The only way properly to “operationalise” the STS securitisation framework is to appoint third party private sector not for profit bodies as certification agents. These bodies would verify the compliance of securitisations with the STS criteria and, through publication on a common public data base, provide the certainty that investors will require before being willing to fund the economy through the STS securitisation channel. The model for this approach is the “notified bodies” regime ubiquitous in EU law.

[E] Although there may be some benefit in more complex, longer term projects such as standardisation (within securitisation and SME lending) and/or the creation of new pan European legal vehicles, such endeavours are difficult and time consuming. The

STS securitisation project under the CMU umbrella should therefore proceed in stages. The first stage would consist of an STS securitisation definition, its insertion in all relevant regulation and operationalisation through certification agents. This will allow the re-opening of this vital channel of funds for the real economy as soon as possible but on a sound and prudent basis. The second stage could involve longer term streamlining projects to create a best in class securitisation market.

[F] Global level playing fields and consistent international rules are important and should be sought. However, the current BCBS rules are not appropriate to the nature of STS securitisations. They are also not consistent, nor do they create a level playing field. The timeframe for global rule making is no longer, at this stage, compatible with the needs of the European economy and the European authorities should forge ahead with an STS securitisation framework within the CMU project even at the temporary cost of international inconsistency.

## GENERAL CONSIDERATIONS

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### ***Risk transfer and non-bank funding***

We strongly agree that two of the key elements that make a deep, liquid and safe securitisation market essential to a thriving economy are its capacity to provide for risk transfers away from the banking system and allow non-bank lenders access to wholesale funding. Both these aspects are key to the goal that underpins the Capital Markets Union: rebalancing the European financial architecture towards the capital markets while increasing the stability of European finance.

### ***Tranching***

We would also like to draw attention to another important aspect of securitisation: its ability to create, through “tranching”, a large pool of very safe and potentially liquid securities and, more generally, to create securities for investors with different risk propensities.

We believe this aspect is worth emphasizing as some voices have suggested that tranching was an unnecessary and potentially negative aspect of securitisation.<sup>1</sup>

Tranching has a number of important and beneficial consequences for the European economy.

First, it allows conservative investors such as pension funds to invest directly in the productive aspects of the European economy. It also gives such investors a more diversified spectrum of investments and thus reduces systemic risk within the European capital markets.

Although we agree, in the current conditions, with the statement in the Consultation that direct retail investment in securitisation may not be wise<sup>2</sup>, STS securitisations of

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<sup>1</sup> FinanceWatch: “A missed opportunity to reviving “boring” finance?” (December 2014) (<http://www.finance-watch.org/our-work/publications/998-position-paper-on-ltf>).

<sup>2</sup> Page 2 of the Consultation

a high credit quality are a good instrument for professionally managed retail funds. This provides a way directly to mobilise European savings to fund the European economy.

As a corollary, STS securitisation, through tranching, can provide the bridge that unites the two sides of a traditional dilemma: the wish to mobilise European savings for innovative and entrepreneurial activities (such as SMEs) and the desire not to expose individual savers to high levels of risk. Through tranching, securitisation is able to fund such activities on a pooled basis, and then allocate the safest portion of that risk to the most conservative investors. The riskier part of the investment can then be left with highly professional investors able to analyse it and willing to take the higher risk for the higher reward.

Tranching also allows public sector actors to remedy market failures without mobilising large amounts of funding. For example, if private sector investors cannot be found to invest in the riskier tranches of SME securitisations, the public sector may intervene without having to fund the entire project.<sup>3</sup>

In other words, tranching allows, given the right conditions, public money to be leveraged, multiplying its positive impact on the real economy.

Finally, by allowing the creation of a substantial amount of safe securities, tranching securitisation can assist in providing better tools for the transmission of the monetary policies of central banks. It also provides a pool of high quality collateral that can be used in various types of repo and swap transactions to reduce overall risk and volatility within the European financial system.

The benefits of tranching can be maximized if the STS criteria do not exclude non-senior tranches. We believe this makes sense, as we will set out later in our response.

### ***Two step and modular approaches***

We strongly support the Commission's approach to a definition of STS securitisation that separates the "structural integrity" elements and the ultimate credit risk of any securitisation. As we have argued elsewhere, the former is essential to be able to analyse effectively the latter, but the two should not be confused and only the former should be part of the definition of STS securitisation.<sup>4</sup>

We also support the Commission's "modular" approach seeking to provide a core STS securitisation definition of general applicability and then foreseeing additional elements that would reflect the specific purposes of the various regulations.

## **RESPONSES TO THE QUESTIONS**

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We were able to address a number of aspects of the Consultation in our responses to earlier consultations. We will therefore sometimes respond, in part and where

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<sup>3</sup> A similar approach can be found in the European Fund for Strategic Investments (EFSI) project under Europe's Investment Plan.

<sup>4</sup> See, for example, page 4 of our "Response to the EBA consultation on simple, standardised and transparent securitisations" (January 2015) at <http://pcsmarket.org/pcs-publications/?type=cr>

appropriate, by quoting sections of our earlier responses and/or by cross-referencing those responses.

**Question 1:**

**A. Do the identification criteria need further refinements to reflect developments taking place at EU and international levels? If so, what adjustments need to be made?**

**B. What criteria should apply for all qualifying securitisations ('foundation criteria')?**

Since the passage of the delegated acts for Solvency II and the CRR, a number of bodies have examined the question of what the criteria should be for STS securitisations. These include the Bank of England and the ECB, issuing a consultation document in May 2014<sup>5</sup>, the European Banking Authority, with a consultation in October 2014<sup>6</sup> and the Basel Committee on Banking Supervision and IOSCO, with a consultation in December 2014<sup>7</sup>. We will refer to these collectively as the “Earlier Consultations”.

Many stakeholders, including PCS, responded to these consultations. We feel that both the consultations and the responses provided an abundance of serious reflections and considerations for a robust STS securitisation definition. We therefore believe that the better approach is to devise a new set of STS criteria based on this more recent body of work rather than keeping the definitions that currently appear in the earlier delegated acts.

For our response to the second part of the question regarding specific criteria, we would refer to the approach we outlined in our earlier response to the Bank of England/ECB consultation. Our response then was based on our analysis of the four elements that had led to the catastrophic performance of some securitisations during the crisis and on how this analysis tied in to a possible definition of STS securitisation.<sup>8</sup>

PCS strongly agrees with the approach that sees STS securitisations as securitisations where, to quote the Bank of England and the ECB, “the risks and pay-offs can be consistently and predictably understood.”

Although a fairly trivial point, it is often forgotten that the crisis triggered by the defaults in securitisations such as US sub-prime RMBS was not the result of the defaults themselves. It was the sudden and catastrophic collapse of bonds that had been rated AAA. In other words, the issue was not the defaults *per se* but their unforeseen nature.

***The lessons of the crisis and predictability***

As set out above, PCS believes that to learn the lessons of the crisis and seek to define simple, transparent and standardised securitisations requires not just to understand

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<sup>5</sup> <http://www.bankofengland.co.uk/publications/Documents/news/2014/paper300514.pdf>

<sup>6</sup> <http://www.eba.europa.eu/-/eba-consults-on-simple-standard-and-transparent-securitisations-and-their-potential-regulatory-recognition>

<sup>7</sup> <http://www.bis.org/bcbs/publ/d304.htm>

<sup>8</sup> The text of our response follows closely but in abbreviated form our response to that BoE/ECB consultation. For the more complete analysis of these elements and their impact on securitisations, see pages 15 et seq of that response (<http://pcsmarket.org/wp-content/uploads/2014/07/PCS-Response-to-BoE-ECB-consultation.pdf>).

why certain securitisations failed (and others did not) but to understand why the weakness of those that did fail was not understood from the beginning. In other words, why did the rating agencies, the investors and the regulatory authorities not perceive these inherent weaknesses?

PCS has worked on this this issue and reached the following testable conclusions: all securitisation types that ran into unexpected difficulties contained one of four distinct elements (or, in some cases, more than one of those elements). Conversely, securitisations that did not contain any of these four elements performed in line with expectations, even when their underlying assets suffered high financial stresses.

#### Four elements

The four elements that led to difficulties in securitisations are not, in the view of PCS, particularly controversial:

1. Pure originate to distribute business models.
2. Iterative credit tranching (ie re-securitisations).
3. Embedded maturity transformations.
4. Lack of transparency.

Looking at the proposed sets of STS criteria that appear in each of the Earlier Consultations and in response to the question of whether any of them contain the 'correct' definition, PCS believes there is no simple and absolute answer. There is no finite number of structural features that transform a bond from 'objectively unsafe' to 'objectively safe'. It is always possible to add additional features that will create additional levels of safety. We believe that, even if one limits oneself to describing a concept of 'structurally high quality securitisation', such a concept has no ceiling. However, we also do believe, based on the analysis we set out above, such concept does have a floor. For PCS, that floor is determined by the four elements of structural weakness revealed by the crisis. Any meaningful definition of STS securitisations must be one that, at the very least, excludes the presence of the four elements that caused the problems in the crisis.

Based on this approach, we believe that features generating structural safety in securitisation products can be ranked. As such, we would propose to classify these structural elements into first order elements, second order elements and third order elements. The first order captures the four key elements without which securitisations will be intrinsically fragile. They represent the "floor". The second order contains the elements that increase safety but are not alone sufficient in the absence of first order elements. The third order elements represent additional criteria, often asset or jurisdiction specific, that seek to go beyond the prudential approach to define a standard of 'very best practice' in securitisations. These are the additional criteria that are embedded in the PCS Label, above and beyond those PCS Label criteria that encompass the first and second orders.

The list of second and third order elements does not purport to be a complete list since, as we mentioned, one can always find additional ways of strengthening any financial product. An example would be the agency RMBS in the US which is strengthened by a credit guarantee of the United States government!

#### **First Order Elements**

The four structural elements which belong to the first order are those already set out in our analysis. In different words these are:

- Alignment of interest
- A single iteration of credit tranching (ie no re-securitisations)
- No embedded maturity transformation
- High levels of initial and ongoing disclosure

### **Second Order Elements**

These include:

- Granularity
- Homogeneous pools
- Concentration limits
- Third party due diligence
- Certain legal elements (eg true sale)
- Standard underwriting procedures
- No arrears or defaulted assets
- At least one payment on the securitised assets

### **Third Order Elements**

These represent the very detailed criteria, including numerous criteria regarding representations and warranties, that make the balance of the over 150 separate criteria that compose the PCS Label. These represent a benchmark not just for securitisations that are structurally robust, but for those that meet the very best practices in each asset class and jurisdiction covered by the PCS Label rules. Originally designed with the help of both investors and issuers and overseen by the independent board of the PCS Association, these can be found on our website<sup>9</sup>.

#### *Trade-offs*

In determining what elements should comprise the definition of STS securitisations policy makers need to decide the purpose of the definition. The definition could be used to:

- (a) merely cordon off the truly toxic products such as CDO squareds and CPDOs; or
- (b) define structurally robust securitisations which, when combined with an accurate and high credit estimation, could be suitable for conservative investors (including, potentially and via funds, retail investors) and/or for inclusion in regulation on par

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<sup>9 9</sup> <http://pcsmarket.org/wp-content/uploads/2014/11/V8-Rule-Book-CLEAN-121114.pdf>



with similarly conservative products, such as covered bonds; or

(c) define, as PCS seeks to do, the “best practices” in securitisation.

When determining this, policy makers also need to look at the trade-offs that such decisions imply. One obvious trade-off is that of complexity versus operationability. Securitisation, even if it is not the uniquely complex financial product it is sometimes made out to be, is still not simple. An analysis of the crisis demonstrates that what went wrong with securitisation is not unidimensional. Therefore, any set of rules that seeks to ensure structural robustness of securitisations will need to be complex enough to capture the different ways in which securitisations fail. But if the rules are too complex, and such numerous and complex rules become embedded in the regulatory framework, then the system becomes too burdensome to operate both for regulators and market participants and the market disappears as regulatory transactional costs destroy its economics.

Another trade-off is certainty versus flexibility. Securitisation is a structured product that can and should evolve over time. If the rules are too constraining, positive developments can be stifled. If the rules are too loose, the market may seek to game them and negate the regulatory aims.

It would appear to us that the approach of all the Earlier Consultations and of the Commission lies in the middle amongst those mentioned above: not just avoiding toxic products but not seeking either to define best practice.

We think this is a legitimate choice and one that is most likely to yield a definition that can be used positively in the regulatory field and achieve the goals of the Capital Markets Union.

*What criteria should apply?*

Based on our analysis and our statement that there is no absolute “correct” definition of STS securitisation, we would recommend that the Commission base its approach to STS criteria on the European Banking Authority’s suggestions, as outlined in their consultative document.<sup>10</sup> We also would urge the Commission to take into account the specific comments that we made in our response as well as the constructive comments of other stakeholders.

In particular, we would like to draw attention to three specific aspects of the PCS’ response to the EBA consultation.

### **Seniority of tranches**

When looking at the key components of structural integrity underpinning the approach not only of the EBA but also of all the other authorities that authored the Earlier Consultations, 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.

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<sup>10</sup> <http://www.eba.europa.eu/-/eba-consults-on-simple-standard-and-transparent-securitisations-and-their-potential-regulatory-recognition>

Therefore, PCS supports the approach that allows STS securitisation status to be available to all the tranches of a securitisation.

Under the “modular” approach, it always remains open to disallow non-senior tranches for any specific regulatory purposes. But this should not occur at the STS securitisation definition level.

### **Asset class restrictions**

The Earlier Consultations had differing approaches to the issue of whether the definition of STS securitisation should be limited to a specific list of asset classes.

Based on our experience with the PCS Label, we believe the line of greater prudence is to provide within the STS 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 regulatory diligence is conducted to ensure that there are no specific characteristics of these new classes that would make them somehow inappropriate for STS 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 STS status. But without a specified list, it is always theoretically possible that an asset class be included in the STS securitisation category notwithstanding some characteristics inherent to that asset that should, all other things being equal, rule it out of the type of capital market instrument one is comfortable with.

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 STS 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 STS 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 authorities and mechanisms for inclusion of additional asset classes.

Finally, with an official list of allowable asset classes, the operation of the asset homogeneity rule (included in the simplicity criteria of the Consultation) becomes much simpler. If you have a list, the homogeneity criteria is met if all the assets in an STS 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 for them to be considered as belonging to the same class for purposes of that criterion.

### **Granularity**

Although the argument has been made that granularity is not a necessary element of safe securitisations, we believe this is mistaken. The argument seems to have proceeded from work suggesting that highly granular securitisations had suffered substantial failures during the crisis. Although this is correct, one cannot draw from the premise that granular securitisations are not, *ipso facto*, robust the conclusion that non-granular securitisation are.

PCS believes that granular securitisations are better able to be analysed using appropriate statistical methods that reduce “tail risk”. We therefore support a definition

of STS securitisation that includes not only a “granularity” criterion, but also a “concentration limit” criterion to avoid the “granularity criterion” being circumvented.<sup>11</sup>

**Question 2:**

**A. To what extent should criteria identifying simple, transparent, and standardised short-term securitisation instruments be developed? What criteria would be relevant?**

**B. Are there any additional considerations that should be taken into account for short-term securitisations?**

This question seems to be related to asset-backed commercial paper conduits (“ABCP”) which provide finance with very short maturities and backed by liquidity facilities provided by banks.

PCS does not currently label ABCP conduits and therefore does not have in-depth knowledge of the criteria that would be relevant to defining what would constitute STS ABCP. However, real economy, non-arbitrage ABCP conduits performed very well during the crisis. They can also be a key source of funding to SMEs in Europe, since trade receivables have long been an ideal asset class for ABCP conduits.

Therefore, PCS believes that it should be possible to devise STS criteria for ABCP conduits and that the European economy would benefit from a strong and broad ABCP conduit market.

As we understand it, the key issue for ABCP conduits is the nature of the liquidity facility that supports it. In particular, the issue relates to the condition that set out the amount that can be drawn under such liquidity facility if it proves impossible to refinance in the markets the short term commercial paper issued by the ABCP conduit.

It seems to us that a good starting point for a set of STS criteria for ABCP would be a definition of what the minimum conditions for a liquidity facility draw would need to be.

We are aware that work has not yet started on defining the criteria for STS ABCP conduits and none of the Earlier Consultations found them to be in scope. Therefore, although PCS strongly supports the creation at the earliest opportunity of STS ABCP criteria and urges policy makers to leave open the possibility of allowing STS ABCP conduits at a later stage, we would be weary of delaying the passage of a set of term ABS STS criteria.

On the other hand, PCS is also aware that a substantially punitive regulatory regime imposed on ABCP conduits during the period prior to devising such new STS ABCP conduit rules could cause a damaging reduction of the funding provided through this channel. As we have mentioned, a decent proportion of this funding appears to go to SMEs. Therefore, the Commission may want to consider whether some form of interim relief could be provided to this financing tool.

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<sup>11</sup> A “granularity criterion” specifies a minimum number of assets in the securitisation. This may be circumvented by an imbalance in the size of the individual assets so that a large part of the risk is concentrated in a very small number of assets. (For example, one could have a €500m lease securitisation with 200 leases but only 3 of those could account for €200m of the risk.) Concentration limits are designed to prohibit this.

**Question 3:**

**A. Are there elements of the current rules on risk retention that should be adjusted for qualifying instruments?**

**B. For qualifying securitisation instruments, should responsibility for verifying risk retention requirements remain with investors (i.e. taking an "indirect approach")? Should the onus only be on originators? If so, how can it be ensured that investors continue to exercise proper due diligence?**

As we have made clear in our responses to Earlier Consultations and in our original White Paper of March 2013<sup>12</sup>, PCS believes that the misalignment of interests which prevails in pure originate to distribute models was one of the key factors of the crisis that hit certain (mainly US) securitisations in 2007/2008. We therefore believe that aligning interests through retention is an absolutely key aspect of any STS securitisation criteria.

Therefore, no changes should be made to the retention rules that would dilute them.

We believe that the risks that flow from those underwriting assets to be securitised not having an interest in their future are absolute and do not depend on the nature of the party originating the securitisation or of the assets being securitised.

Therefore, no changes should be made to the retention rules to disapply them for certain categories of originator.

Equally, no changes should be made to the retention rules to remove from their purview any category of assets deemed somehow of "better quality".

PCS also believes that the capacity of securitisation to transfer risk and allow some element of bank capital relief is one of the key benefits securitisation can bring to the European economy and the Capital Markets Union. This is what allows the financing of households and SMEs no longer to be tied to the capital raising powers of banks and allows banks to be less vulnerable as they are less dependent on interbank funding and deposits.

Therefore, no changes should be made to the retention rules that prevent originators from complying with them by either taking a "vertical slice" of the securitisation or by randomly selecting from the assets to be securitised a proportion that will be kept in the banks' balance sheet.

We are aware that some have questioned whether the current 5% retention requirement is sufficient when the originator only retains a "vertical slice" or a random selection of assets. We have sympathy with these concerns. The Commission may wish specifically to consult stakeholders to determine whether the rules could be strengthened by increasing the retention requirement in cases of a "vertical slice" or a random selection of assets to be kept on the books.

We also share the concerns of the Bank of England and the European Central Bank<sup>13</sup> that some gaming of the rules may be taking place. We strongly believe that the rules

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<sup>12</sup><http://pcsmarket.org/wp-content/uploads/2013/03/Europe-in-Transition-Bridging-the-Funding-Gap1.pdf>

<sup>13</sup> Joint Bank of England and European Central Bank response to the Consultation ([https://www.ecb.europa.eu/pub/pdf/other/ecbboe\\_response\\_ec\\_consultation\\_on\\_securitisation20150327.en.pdf](https://www.ecb.europa.eu/pub/pdf/other/ecbboe_response_ec_consultation_on_securitisation20150327.en.pdf))

on retention must be applied not in a mechanical way but in a manner that actually aligns economic and financial interests.

In particular, we are concerned that the rules should require the party holding the retention either to be the party that originated the securitised assets or, if these assets were purchased, that one of these three cases should apply (i) the originator retains the requisite interest, (ii) the purchased assets are subject to a full re-underwriting, (iii) the purchaser can demonstrate that the assets were generated by the originator in the ordinary course of business, on a business model that was not an “originate to distribute” model and were held by the originator for a certain length of time.

Also, we are concerned that whatever party holds the retained interest, that party should be a real economic entity and not merely, *de jure or de facto*, a special purpose vehicle.

Finally, the party retaining the interest in the securitised assets should be able to demonstrate that those who hold the equity in their operation are truly at risk should the assets default.

On the other hand, PCS is sympathetic to the idea that the rules should allow, during the life of a securitisation, the originator to modify the form in which it holds the retained interest. So long as the alignment of interest is maintained, there can be little value in forcing the originator to choose upfront the manner of retention and compel it to maintain its interest solely in this form. If, at a later stage, another legitimate form of alignment of interest is more appropriate, the originator should be entitled to select it and switch over to such other form of retention.

On the issue of who should be responsible for verifying that the retention rules are met, PCS strongly believes that the onus cannot reasonably be left with investors. This is not an issue of freeing investors from their due diligence requirements. However, as we will have occasion to discuss at length in the response to Question 4 and Annex 1, in all parts of the capital markets investors are not required individually to perform due diligence on aspects of the securities they purchase when they cannot reasonably be expected to have the information or the tools to ascertain the facts. This is why laws such as the Prospectus Directive require issuers to provide certain information under penalties and we allow investors to rely on that information. This is also why we allow investors to rely on audited accounts of companies whose bonds they purchase.

PCS believes that only the originators have the information required to enable a determination of whether the retention rules are complied with. Therefore, we believe that the onus on compliance should be with the originator.

However, since rebuilding the securitisation market in Europe will turn on convincing new investors to fund it and since, following the crisis, such investors may be wary of trusting banks on securitisation matters, the best approach may be that of “trust but verify”. Under such an approach, one of the roles of a certification agent (discussed in our response to Question 4) could be periodically to verify the continued compliance with the retention rules. This would be of particular value if the originator, as we suggest above, is allowed to change the format in which it holds its retained interest.

Such verification could be done based on some form of appropriate originator certification accompanied by supporting documentation

**Question 4:**

**A. How can proper implementation and enforcement of EU criteria for qualifying instruments be ensured?**

**B. How could the procedures be defined in terms of scope and process?**

**C. To what extent should risk features be part of this compliance monitoring?**

We believe this question pertains to the issue of how the proposed regulations may be “operationalised”. This is a matter which PCS has always believed needs to be thought through at the time the regulatory rules are devised so as to avoid the risk that such regulations, seeking as they do to revitalise a strong but safe securitisation market, become a Pyrrhic victory as it becomes evident that they cannot be put in practice in a manner that allows investors to return.

PCS is very aware and grateful that the Commission has grasped this issue and has focused on it in a timely manner.

Since PCS was formed with a specific aim to provide certifications of “high quality” securitisation, this is a matter of great concern for us.

PCS believes that it is essential that investors be able to tell not just whether they believe a security meets the STS criteria but also have certainty that this view is shared by both regulators and the rest of the market. ***This is not a due diligence issue but market architecture issue.***

We also believe that the investors need to know whether a security is to be treated as STS compliant by the market and regulators at or before the moment that security is priced.

We have analysed the possible ways in which this could be achieved and concluded that the best way would be for this to be done by third party private sector agents under regulatory oversight.

We have produced a number of documents setting out how this could operate and why this reflects the best, safest and most efficient manner for STS securitisation regulations to operate. These reflections have been brought together in a single document which we have annexed to this response. We invite you to consult this document (“Certification in the context of a regulatory framework for securitisation”) as PCS’ full response to Question 4.<sup>14</sup>

**Question 5:**

**A. What impact would further standardisation in the structuring process have on the development of EU securitisation markets?**

**B. Would a harmonised and/or optional EU-wide initiative provide more legal clarity and comparability for investors? What would be the benefits of such an**

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<sup>14</sup> We have also annexed to this response our reflections on the possibility of operating the STS securitisation rules on a self-attestation basis: “The illusory promise of self-attestation” – see Annex 2.

## **initiative for originators?**

**C. If pursued, what aspects should be covered by this initiative (e.g. the legal form of securitisation vehicles; the modalities to transfer assets; the rights and subordination rules for noteholders)?**

**D. If created, should this structure act as a necessary condition within the eligibility criteria for qualifying securitisations?**

Since the issue of standardisation of information is dealt with in Question 6, we assume that this question refers to the idea of creating harmonised pan-European legal structures for securitisations – possibly a new type of pan-European legally defined vehicle.

PCS believes that there could be some benefit in such a project. However, we would note a number of points.

First, a strong securitisation market did exist in Europe prior to 2007/2008 without such harmonisation and nothing indicates that the absence of such rules, structures or vehicle would now prevent a return of such market.

Secondly, such harmonisation within the world's greatest trading block is always helpful to the creation of integrated, deep and liquid markets. PCS does not believe though that there is any distinguishing feature about the European securitisation market that would make such harmonisation uniquely beneficial and different from similar benefits that harmonisation may bring to any other European financial market whether covered bonds, corporate bonds, infrastructure or SME bank lending.

Thirdly, although, under a new regime based on a definition of STS securitisation there could be some benefit to a single type of European instrument or vehicle, the elements that made that instrument or vehicle a “STS securitisation instrument” or a “STS securitisation vehicle” would still need to be incorporated in the actual securitisation and verified. In other words, the law creating such a single EU securitisation instrument or vehicle could require it to meet the STS criteria but it could not, by itself, obviate the need for such criteria. This is because the problems of “pure originate to distribute” business models, for example, can only be resolved by aligning interests. They cannot be resolved by a legal device or by the creation of a new legal vehicle. As such, the new legal securitisation instrument is not a problem solving instrument but a signal that the instrument has solved certain problems – namely by being an STS securitisation. In this case, one needs to question whether such an instrument or vehicle would add much value, if any, beyond the creation of a STS securitisation standard and a certification process.<sup>15</sup>

Finally, such project is likely to touch upon issues of corporate law, contract law, property rights and often tax regulation in all 28 member states. Therefore, it may well take a long time to put together and turn up unexpected problems. These then throw out the anticipated timetable.

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<sup>15</sup> Please note that the statement that the new legal instrument or vehicle is automatically and by operation of law a STS securitisation instrument or vehicle in no way obviates or lightens the need actually to check whether this is indeed the case, since the STS criteria are all factual and not legal. In this respect, it would be like creating the concept of single European bicycle helmet that, “by law” had to meet specified safety standards. Since safety standards are factual elements not legal element – eg how much impact can the material take - such designation would still require the verification that any helmet is indeed a “European helmet.”

Therefore, PCS would suggest that such a harmonisation project should begin now but should not be a necessary part of the CMU-STS securitisation project so as not to risk derailing the latter effort.

Additionally, and on balance, such a harmonisation project or new vehicle should provide an alternative way to effect STS securitisations rather than be a mandatory requirement. This would allow STS securitisations to be issued out of any European jurisdictions where, for whatever reasons, such harmonisation could not be implemented.

Finally, PCS does not believe that the status of STS securitisations should only be available for European securitisations. It is in the interest of European investors to have other investment options and, for reasons of comity, we cannot expect other trading areas to allow European issuers to fund themselves there if we close our own borders to their issuance.

If the harmonisation rules or the use of the European instrument or vehicle became mandatory, it would be all but impossible for non-EU securitisations to be purchased in Europe as it would not be possible for non-EU issuers to issue through such an instrument or vehicle.

Should it be determined that the long term benefits of such a harmonisation project still made it desirable, then the most profitable avenue would be the creation of a European special purpose securitisation vehicle that would benefit from (a) a special tax status – so that payments of principal and interest under the securitised assets and swaps payments could be made free of withholding tax, (b) an exemption from certain swap collateralisation rules and (c) a special form of security interest, similar to that afforded under covered bond legislation, so that the benefit of the securitised assets always lay with the securitisation investors in accordance with the provisions of the waterfall.

In addition, a specific form of property transfer to such vehicle could be created so that assets transferred by originators to such vehicles could not ever form part of the insolvency estate of the originator. (Again, this provision would share attributes with similar rules under covered bond legislation).

All these new rules would, of course, need to be accompanied by appropriate safeguards to avoid abuse.

**Question 6:**

**A. For qualifying securitisations, what is the right balance between investors receiving the optimal amount and quality of information (in terms of comparability, reliability, and timeliness), and streamlining disclosure obligations for issuers/originators?**

**B. What areas would benefit from further standardisation and transparency, and how can the existing disclosure obligations be improved?**

**C. To what extent should disclosure requirements be adjusted – especially for loan-level data – to reflect differences and specificities across asset classes, while still preserving adequate transparency for investors to be able to make their own credit assessments?**

As a general point, PCS would like to point out that the state of disclosure around securitisation in Europe is fairly good. Whereas lack of transparency was an issue



prior to the crisis, the work of the Bank of England and the ECB together with the work of organisations such as the European Data Warehouse, the Dutch Securitisation Association, the True Sale International and the PCS have substantially ameliorated the situation. We are now at a point where disclosure is no longer a substantive issue – although continued vigilance and appropriate rules – especially within the context of STS securitisations – remain vital.

[A] The response to part A of the question must perforce be of a general nature. Any response, though, in our view needs to be grounded in certain fundamental principles.

### *Asset based lending*

The first principle is founded on the basic proposition that securitisation is asset based lending. The investors are required to take the risk of the assets and (save for some counterparty risks such as swaps) only the risk of the assets. Therefore, as a starting point, there can be no argument that the investors are not entitled to all the information on the assets in which they invest. PCS has little sympathy with the proposition that some asset information is too confidential to be disclosed by the originators to those investors who purchase their securitisations<sup>16</sup>. If this is so, then the originator cannot expect a reasonable investor to lend against a “black box” and should seek other types of funding<sup>17</sup>.

### *Utility*

The second principle is that it does not necessarily follow that because investors are entitled to all asset related information, they actually either need or wish to have access in real time to all asset information. We therefore have sympathy with those market participants who argue that some information is very onerous to gather, maintain and transfer and provides no real benefit to investors.

For example, PCS remains unconvinced that individual loan level data on very small credits with very fast turnovers (such as credit card receivable and trade receivables) provides any meaningful benefit to investors.

The guiding principle here should be to listen to the investor community. It remains the best judge of what needs to be disclosed, when and in what form, for its members to feel comfortable in purchasing a securitisation.

### *Comparability*

The third principle is that of comparability. Some rules have been put in place and others have been proposed based on the view of securitisation as uniquely opaque, uniquely complex and uniquely dangerous. The aim of the STS securitisation project is to identify securitisations that are simple, transparent and standardised.

Therefore, the disclosure requirements of STS securitisations should be comparable

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<sup>16</sup> Please note that this is an argument for full disclosure by originators of asset information to those investors who invest in specific securitisations. It does not follow from this that originators should be required to make public disclosure of asset information, even when the information relates to privately placed transactions. PCS is unconvinced by the argument that there is a public good to be found in the public disclosure of information that is of no use whatsoever to the public.

<sup>17</sup> This is, of course, without prejudice to cases where local or European data protection law or bank secrecy rules prohibit the disclosure of some private information. In PCS' experience though, this information is not of the type of information that investors need or require to perform appropriate due diligence and these laws and rules have not hindered the issue of high quality STS compliant securitisations.

in scope and onus to those of other capital market instruments that are simple, transparent and standardised, such as covered or corporate bonds.

PCS believes that these three principles should provide good guidance in seeking to frame a response to the correct balance when it comes to disclosure.

#### [B] Standardisation

PCS' view is that there is a fairly low level of standardisation within securitisation but that this level is rising. In this respect we note the positive work of the Dutch Securitisation Association<sup>18</sup> on the standardisation of RMBS in the Netherlands and our own work with British RMBS issuers to standardise certain representations and warranties. Of course, through its extensive criteria that require to be met in order to obtain the label, PCS is itself an agency of standardisation.

Our thoughts on standardisation are as follows;

1. It is often said that differences in legal frameworks and financial practices render standardisation of securitisations impossible. Although this is, to some extent, true and absolute standardisation is not feasible, there remains a huge amount that can be standardised.
2. A greater level of standardisation would be very positive for the development of a sustainable securitisation market and should be encouraged as a key priority.
3. Standardisation is something that we can see as very beneficial within each asset class (mortgages, auto loans, SME loans, etc...). Standardisation across asset classes becomes rapidly quite difficult except for fairly trivial aspects. In addition, PCS is not convinced that cross-asset class standardisation brings substantial benefits.
4. Greater standardisation across jurisdictions is, in our view, entirely feasible and to be encouraged. However, as a process matter, we strongly encourage that standardisation efforts as a first stage should be done within each jurisdiction or region and, then, as a second stage, across jurisdictions. This will be more likely to yield results.
5. Although public sector involvement and encouragement will be important, we strongly urge that standardisation be done by and through industry bodies. We believe that "from the bottom up" standardisation led by an issuer/investor partnership is much more likely to produce positive results for the investor community than "from the top down" standardisation introduced by regulation. Once more, the work of the Dutch Securitisation Association and PCS in this field are good examples of what can be achieved.
6. Although standardisation is often seen as a simple process, PCS is aware that the standardisation of items such as definitions is not merely a matter of preference. Changes to definitions, for example, can (and often do) lead to a requirement for originators to change procedures and IT. These are changes that can result in substantial costs for issuers. Therefore, although we are strongly in favour of standardisation, we believe that it should take place with due awareness of and consideration for the costs/benefit realities.

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<sup>18</sup> <http://www.dutchsecuritisation.nl/terms-website-use-agree>

7. The areas where we believe standardisation will be possible and beneficial are as follows:
- (a) Standardisation of the internal structure of prospectuses. This should ensure that investor can navigate with ease the prospectuses of different issuers, with each item in the same location and arranged in the same manner.
  - (b) Standardisation of definitions used in prospectuses. For the reasons mentioned in point 6 above, PCS believes this should be done – at least for an initial period – on a “comply or explain” basis. If an originator chooses to use a different definition, this should be clearly set out in a separate section of the prospectus with an explanation of the differences with the standard definition.
  - (c) Standardisation of investor reports both as to their internal structure and the definitions of terms used in the reports. Again, for the latter and at least for an initial period, this may be done on a “comply or explain” basis.
  - (d) Standardisation of loan level data or stratification tables. This standardisation should be both as to the type of data disclosed, the format of disclosure and the definitions of the terms used in the data disclosure.<sup>19</sup>
  - (e) Standardisation of originator representations and warranties regarding the assets and their transfer. As an example of this we draw your attention to the standard representations and warranties that appear in the PCS label criteria. Again, and at least for an initial period, this should be done on a “comply or explain” basis.
  - (f) Standardisation of the voting rights of investors and the duties of parties with fiduciary obligations so as to protect investors from the unpleasant surprises that many had during the crisis when transactions suffered difficulties and the investors discovered that their rights were not as they had anticipated.

We would recommend a review period within the STS securitisation framework of 24 months. If, upon review it is determined that additional standardisation is required and the market has not been able to provide it, then a role would be there for a public sector mandatory process.

#### [C] Loan level data

For reasons set out above, we believe that loan level disclosure should be standardised in stages: first by country and asset class, then by asset class across Europe.

We do not believe, as previously stated, that loan level data is useful for very small and short duration credits such as credit cards and trade receivables.

Loan level data disclosure needs, of course, to be mindful of data protection and bank secrecy rules. However, the problems these can cause should not be overstated as much loan level disclosure already takes place, for example, within the ambit of the European Data Warehouse.

#### **Question 7:**

##### **A. What alternatives to credit ratings could be used, in order to mitigate the**

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<sup>19</sup> Much of this work has already been performed for securitisations that are used in the Eurosystem through the work of the European Data Warehouse. See <https://eurodw.eu/>

**impact of the country ceilings employed in rating methodologies and to allow investors to make their own assessments of creditworthiness?**

**B. Would the publication by credit rating agencies of uncapped ratings (for securitisation instruments subject to sovereign ceilings) improve clarity for investors?**

Ultimately, there is no good answer to part A of the question other than the investor's own due diligence and credit work. Any solution that would provide a view/assessment of the credit quality of a securitisation absent a sovereign ceiling would definitionally be just another form of credit rating – whether it came from a CRA registered under the EU rules or any other body.

The publication by the credit rating agencies of uncapped ratings would certainly improve clarity for investors in that it would provide an additional data point. We should be very careful though in understanding such uncapped rating not as a substitute for the existing rating or, somehow, the “real” rating, but just another piece of the credit puzzle.

Also, we should be aware of the complexities involved in exactly what such an uncapped rating signifies. The sovereign risk is connected to the risk of a securitisation emanating from that sovereign's territory in complex ways. First, the sovereign rating is connected to the economic strength and resilience of that nation. That economic strength and resilience is also a component of the likelihood of payment by borrowers (households or SMEs) in that country. A sovereign default is, additionally, usually accompanied by other legal and economic shockwaves that can impact the likelihood or possibility of payment by borrowers in that country<sup>20</sup>. Finally, for countries outside a currency zone – and, arguably, even for them – sovereign default can be linked to transfer and convertibility risk.

Therefore, understanding exactly the nature of an uncapped rating is not straightforward and may not be sufficient to overcome the limitations generated by sovereign caps in current ratings.

There is also the issue of whether, if such uncapped ratings are required for STS securitisations, they should also be required for other capital market instruments such as covered bonds and corporate bonds.

**Question 8:**

**A. For qualifying securitisations, is there a need to further develop market infrastructure?**

**B. What should be done to support ancillary services? Should the swaps collateralisation requirements be adjusted for securitisation vehicles issuing qualifying securitisation instruments?**

**C. What else could be done to support the functioning of the secondary market?**

[A] We refer you to the need for a STS securitisation “master list” as set out in our response to Question 4.

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<sup>20</sup> These could include, amongst others, bank closures, depositor bail-ins, suspension of tax reimbursements and interruption or diminution of pension payments to former state employees.

The market would also benefit from ease of access to documents, prospectuses and verification of STS status. These can be provided within the certification framework envisaged in our response to Question 4<sup>21</sup>.

Availability of models would also benefit the market as well as the already discussed availability of loan level data and investor reports. However, these are utilities that the market has already provided and/or is in the best position to provide and centralise. PCS does not believe these require a mandatory and centralised public sector solution at this stage.

As a general point and as with standardisation, PCS would recommend a 24 month review process. If, upon review, it is determined that the creation of a strong, deep and robust securitisation market is being held back by the lack of centralised market created infrastructures, then a role will be there for possible mandatory public sector rules.

[B] PCS believes there is a strong case to provide an exemption to securitisation vehicles from swap collateralisation rules.

[C] Nothing springs to mind above and beyond items already mentioned.

**Question 9:**

**With regard to the capital requirements for banks and investment firms, do you think that the existing provisions in the Capital Requirements Regulation adequately reflect the risks attached to securitised instruments?**

No. The current approach does not differentiate between STS securitisations and others. It is a rule of any conservative prudential rule making that the safety buffers – here the capital requirements – be calibrated on the worst performers in the relevant asset class. Any other approach would lead to substantial moral hazard.

Adopting quite reasonably this conservative approach, the CRR calibrates securitisation capital requirements on the performance of non-STS securitisations. In addition, the data sets used to calculate these calibrations pertain not only to non-STS securitisations but to securitisations that no longer exist and can no longer exist.

Since the crisis, regulators and legislators globally have introduced a myriad of changes with the explicit intention of changing the characteristics of securitisations. Indeed, the Commission and the EU generally took a decisive leadership position in this process. These measures include the regulation of rating agencies, the requirements for originator retention, increased capital penalties or outright prohibitions on entities purchasing re-securitisations and increased disclosure and investor due diligence requirements. These official rules have been complemented in Europe by the action of central banks whose repo rules now require substantially increased disclosure for securitisations. To this can be added market initiatives such as the PCS quality label.

This leaves us with no reasonable option other than to recalibrate as best we can the CRR requirements as well as the Solvency II requirements taking into account the new definition of STS securitisations and based on the actual performance of this type of

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<sup>21</sup> For details, please refer to Annex 1 – page 42.

securitisation during the crisis. In this respect, we draw your attention to the excellent work done by William Perraudin and Risk Control in a recent paper commissioned by PCS.<sup>22</sup>

### **Question 10**

**If changes to EU bank capital requirements were made, do you think that the recent BCBS recommendations on the review of the securitisation framework constitute a good baseline? What would be the potential impacts on EU securitisation markets?**

We assume that this question pertains to the latest proposed revisions to the securitisation framework published by the BCBS on December 11<sup>th</sup>, 2014 (BCBS309)<sup>23</sup>.

Although this framework contained a number of improvements on the earlier proposals, it suffers from some key limitations. These are likely to have very serious negative impacts on the hopes of a revived European securitisation market. PCS also believes these limitations are not warranted by the facts.

As an institution that focuses on the structural integrity elements that create a differentiation between safe and predictable securitisations and others, PCS claims no quantitative analytical skills. We therefore have always left the drafting of mathematical formulae and quantitative data analysis to those who have the requisite knowledge. We shall therefore limit our commentary on the BCBS proposed framework to issues of overarching principle rather than detailed mathematical critique.

Amongst the issues we see arising from the BCBS framework, the most important ones are as follows:

#### [A] Absence of an STS securitisation differentiation

The current framework continues to treat all securitisations as created equal and then anchors its capital requirement calibrations on the performance of the worst types of securitisations. To be fair, the BCBS has indicated that it would seek to work out how to incorporate their concept of “simple, transparent and comparable” securitisation within the current framework sometime in 2015. However, until this is done, the BCBS framework will fail the European securitisation market and will fail to reflect the realities of European STS securitisation performance.

There is no doubt that the current BCBS capital charge numbers are unrealistically high for STS securitisations.

#### [B] Unequal hierarchies and uneven playing fields

The BSBC proceeds through a hierarchy of approaches, starting with the internal ratings-based approach (“IRBA”), then the external ratings-based approach (“ERBA”) then the standardised approach (“SA”).

The results of the formulae are much more punitive for banks using the ERBA than the IRBA.

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<sup>22</sup> <http://www.riskcontrollimited.com/insights/high-quality-securitisation-an-empirical-analysis-of-the-pcs-definition/>

<sup>23</sup> <http://www.bis.org/bcbs/publ/d303.pdf>

First, we would question the rationale for such stark differences. They appear grounded in a dislike of the credit rating agencies flowing from their failures in the crisis. However, agencies are now regulated and more conservative.

Secondly, such dislike of agencies and the concomitant desire to incentivise banks to use the IRBA over the ERBA will have a disproportionately negative impact on European banks and a disproportionately positive impact on their US counterparts. This is because US law bans the ERBA approach. However, as large US banks generally operate across the whole of the USA, this ban is not overly problematic. Most US banks will have the credit models necessary to run the IRBA approach.

European banks work within a fragmented continent with different laws and different cultures. So a German bank may well have a model for German car loan lending but is unlikely to have a similar model for France or Italy. It certainly will not have 27 additional models for each European country. The result is that for all purchases of securitisations other than those originated within the bank investor's own country, that bank investor will have no option but to use the ERBA. The IRBA will not be available.

Since the aim of the CMU is for a pan-European capital market, a market where a bank can only benefit from a better capital treatment if it purchases its own jurisdiction's securitisations is a major retrograde step.

The real result of the BCBS's unequal hierarchy is that US banks will be relying on the comparatively lighter IRBA and European banks will have to rely on the much more punitive ERBA. This means that the idea of the current BCBS proposals as the foundation of a level playing field is in fact an illusion. It institutionalises a trans-Atlantic schism to the disadvantage of European institutions.

#### [C] Lack of capital neutrality

The current BCBS framework still results in the aggregate capital required by a bank holding the whole securitisation – ie the senior notes, the mezzanine and all the equity – being considerably greater than the capital required by the same bank holding the totality of the securitised assets on its books in a non-securitised form. In other words, a bank that securitises assets needs to hold much more capital after the securitisation to cover exactly the same risks as before the assets were securitised.

Since capital requirements are designed to cover credit risk and the credit risk of the assets does not transform itself upon securitisation, this approach makes no logical sense. This approach also entrenches a systemic barrier to the return of a securitisation market as it requires the banking system as a whole to hold greater aggregate capital if it uses securitisation than if it does not.

In addition to these three major points, there are a number of technical issues with the BCBS framework regarding the impact of maturity calculations, the use of proxies and divergences in approaches between the various regulators that appear to be to the disadvantage of the European securitisation market.

#### **Question 11:**

**How should rules on capital requirements for securitisation exposures differentiate between qualifying securitisations and other securitisation instruments?**

Clearly, we believe that an objective analysis of the crisis indicates that STS securitisations are more predictable and capable of a robust credit analysis. This does not mean that they are “safer” from a credit point of view but that they are transparent. They conform to what computer people call the WYSIWYG principle – “what you see is what you get.”

Therefore, the differentiation needs to reflect the greater degree of certainty that a bank and a regulator has when looking at the risk embedded in a STS securitisation.

How to quantify the benefit of such additional certainty falls within the realm of the quantitative analytics on which PCS prefers not to comment.

However, over many months we have discussed these matters with experts and feel that the proposals made by Risk Control appear to be grounded on sound general principles – particularly capital neutrality.

We would therefore encourage the Commission to look favourably in its approach on calibrations on the work of Risk Control and particularly their recent paper: “Default Probability Risk and Securitization Capital” (April 2015)<sup>24</sup>.

We would encourage applying calibrations of the type emanating from this capital neutral approach to STS securitisations. We would then leave to those better placed than us to see how and to what extent these calibrations should be modified to take into account the lower level of certainty attaching to other types of securitisation.

#### **Question 12:**

#### **Given the particular circumstances of the EU markets, could there be merit in advancing work at the EU level alongside international work?**

PCS believes that a global level playing field is an important goal and a positive element for the European and the global capital markets. Our own analysis on what went wrong during the crisis with securitisations and what elements are constitutive of simple, transparent and robust securitisations is rooted in principles of general application. These principles are not specific to any geography. They certainly do not flow from the particular circumstances of the EU markets.

Therefore, there is no reason why the STS securitisation principles could not be the foundational principles of a globally consistent approach and we believe that the Commission should work alongside other international players to create an internationally agreed framework centered on common STS securitisation criteria.

In this respect, the work of the Basel Committee on Banking Supervision and IOSCO on the topic of STS securitisation is thoroughly welcomed.<sup>25</sup>

However, PCS is also aware of the complexities inherent in the process of global rule making and the often elongated timeframes required to reach satisfactory conclusions. PCS notes also that even agreed upon principles can be jettisoned in certain jurisdictions to take into account local political realities. We cannot but note with some

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<sup>24</sup> <http://www.riskcontrollimited.com/insights/default-probability-risk-and-securitisation-capital/> . For a more general introduction to the approach: <http://www.riskcontrollimited.com/insights/afa-capital-an-introduction/>

<sup>25</sup> <http://www.bis.org/bcbs/publ/d304.pdf> and for the PCS response - <http://pcsmarket.org/wp-content/uploads/2015/02/PCS-BCBS-IOSCO-response1.pdf>



dismay – based on our own fundamental analysis – that the United States rules allow “no retention – pure originate to distribute” securitisations for residential mortgage loans with no down payments.

PCS also notes that whereas some economies appear to be recovering from the crisis quite robustly, the European economy is only now starting to pull through and many question marks still hover over the recovery prospects of the Eurozone. One of these is the availability of adequate finance going forward and particularly funding for SMEs.

In these circumstances, PCS believes that Europe does not have the luxury of waiting for the work of global institutions to be completed before moving ahead. The pressing needs of the European economy and the fact that the challenge before us is, to a large extent, the mobilisation of European savings to fund the European economy militates for a swift and decisive conclusion to the STS securitisation work under the CMU umbrella.

We believe this should be done, as best one can, together with international institutions and with a view to shaping the global framework along similar lines. But the timetable must be European.

PCS believes that the proposals being discussed by the Commission and the European authorities are globally sound and is therefore quietly confident that they can form the basis of a globally adopted framework.

**Question 13:**

**Are there wider structural barriers preventing long-term institutional investors from participating in this market? If so, how should these be tackled?**

The absence of benchmarks is certainly an impediment. However, such benchmarks are not likely to be feasible until the market recovers some volumes. If the market does recover volume though, we see no reason why the market would not create the necessary benchmarks. Therefore, we do not feel this is a matter that requires public sector involvement.

**Question 14:**

**A. For insurers investing in qualifying securitised products, how could the regulatory treatment of securitisation be refined to improve risk sensitivity? For example, should capital requirements increase less sharply with duration?**

**B. Should there be specific treatment for investments in non-senior tranches of qualifying securitisation transactions versus non-qualifying transactions?**

It is crucial for the European securitisation market’s revival on a safe and robust basis that the regulatory schemes that frame it all revolve around the same definition of STS securitisation.

Therefore, the first step in addressing insurers’ investment in securitisation would be an amendment to the Solvency II regime to replace the existing Type A/Type B distinction with a STS/non-STS distinction.

As STS securitisations are likely to be different in nature from the existing Type A securitisations under Solvency II, this would require a new look at the existing calibrations of capital requirements.

One of the key elements of distortions within Solvency II appears to be the classification of securitisations within the spread risk sub-module whilst assets that are the subject of securitisations are placed within the counterparty risk module.

Because the 2007/2008 crisis had its beginnings in securitisations, the price volatility was very substantial. Since they are in the spread risk sub-module, this results in very substantial capital requirements under Solvency II. This is the case even though most of these securitisations (and especially the STS securitisations) suffered no credit impairment of any kind.

Because mortgages loans, for example, are brought under the counterparty risk module, the capital required to be set against them under Solvency II is very low.

This produces the clearly illogical result that the highest rated tranching part of a mortgage pool that has been securitised (and rated AAA) requires 3 to 4 times more capital than the equivalent untranching, unprotected mortgage pool. And the rationale for this is the even more bizarre proposition that the securitisation is not very liquid (and so punished in the spread risk sub-module) whereas the mortgage pool is totally illiquid (and so measured against the counterparty rules and thereby privileged).

Surely, it cannot be right that when assets are made safer (through credit enhancement) and more liquid (by being turned into securities) they should suffer a multiplication of the capital required by insurance companies owning them. Not only is such a result logically irrational, but it is perverse in that it pushes insurance companies, in the name of prudential regulations, to privilege riskier investments.

We believe that a new securitisation regulation is an opportunity to remedy this distortion by bringing STS securitisations within the counterparty module. (It has been suggested to PCS that such change would not require Level 1 modifications to the Solvency II regime, as the allocation of securitisations to the spread risk sub-module is a Level 2 determination. We have no definite position on this legal issue but it is not necessary for this to be resolved as we anticipate some Level 1 rule making will be necessary to provide the desired STS securitisation framework).

Once STS securitisations are nestled within the counterparty risk module and the distortions eliminated, the same work over credit performance as will be needed under the CRR calibrations can be used to calibrate anew the Solvency II capital requirements.

Should such a re-allocation not be deemed possible, and the distortions be left untouched, then – at the very least – new calibrations should be undertaken to reflect the new definition of Type A and the changes that will have occurred within the regulation of securitisations and the concomitant improvement in likely liquidity.

The issue of non-senior tranches cannot be easily disentangled from the issue of which module is to apply since the credit and liquidity characteristics of non-senior tranches are driven by very different elements.

However, to the extent that seniority is not part of the STS securitisation criteria, we see no reason to exclude non-senior tranches from Type A securitisations.

**Question 15:**

**A. How could the institutional investor base for EU securitisation be expanded?**

**B. To support qualifying securitisations, are adjustments needed to other EU regulatory frameworks (e.g. UCITS, AIFMD)? If yes, please specify.**

It is essential, as we have stated above, that the definition of STS securitisations be the same throughout the regulatory framework (subject to any additional requirements of the modular approach). It is also essential that, whenever the distinction between STS securitisations and others makes sense within the aims of a given regulatory regime, the distinction be made.

We would therefore suggest three other regulatory frameworks which should be adjusted or drafted to include the distinction.

[A] MMF

First, the upcoming money market funds rules contain a list of assets which it is appropriate for such funds to purchase. At present, certain types of securitisations are allowed by the draft. It would be important that the final text contain the STS criteria as the defining requirement together with some possible maturity requirements under the modular approach.

[B] AIFMD

Secondly, the AIFMD contains very onerous and costly due diligence requirements for funds seeking to purchase any securitisation. These requirements were specifically designed to address what was perceived as the uniquely opaque, uniquely complex and uniquely dangerous nature of securitisations. It follows that securitisations that are identified as transparent, simple and safe should not be punished with due diligence requirements which were drawn up for a totally different product with totally different risk characteristics.

In no way would such a change to the AIFMD free investors from their due diligence requirements. These are imposed as a matter of general law. But this would result in comparable capital market instruments being governed by comparable rules. One of the key elements to creating a strong and liquid European STS securitisation market is the rehabilitation of this instrument in the eyes of investors. The most visible way in which this can be done is to impose requirements in respect of STS securitisations that are neither more, nor less, onerous than those imposed on equivalent instruments.

[C] BSR

Thirdly, we would contend that, if STS securitisation is seen as a channel for the funding by capital market investors of real economy assets generated through the banking system, it would seem uncontroversial that the rules enacted pursuant to the Bank Structure Regulation should allow commercial banks both, on the one hand, to originate and issue STS securitisations and, on the other hand, to purchase them.

**Question 16:**

**A. What additional steps could be taken to specifically develop SME**

## securitisation?

**B. Have there been unaddressed market failures surrounding SME securitisation, and how best could these be tackled?**

**C. How can further standardisation of underlying assets/loans and securitisation structures be achieved, in order to reduce the costs of issuance and investment?**

**D. Would more standardisation of loan level information, collection and dissemination of comparable credit information on SMEs promote further investment in these instruments?**

As a general point, we would like to draw attention to the fact that the benefit to European SMEs of a vibrant European securitisation market extends beyond the existence of a substantial SME securitisation market.

Each of bank funding and bank capital is fungible. So money raised from issuing STS securitisations backed by residential mortgages can be used by banks to fund SMEs. More crucial, if the issuance of a residential mortgage securitisation is able to free up bank capital, this will give more head-room to that bank to lend additional amounts to any client segment, including SMEs.

The reason we stress this is that SME securitisation, although a substantial asset class prior to the crisis, always has been a relatively small part of the European securitisation market. This is, in part, because there are some aspects of SME lending that make SME securitisation slightly more challenging than that of other asset classes such as residential mortgages, consumer loans and equipment leases.

To the argument that banks may not recycle funds and freed capital generated by securitisation in the direction of SME lending, we can only stress that securitisation provides, and can only provide, the *capacity* for additional SME bank lending. Whether the banks chose to avail themselves of this opportunity depends on many greater issues.<sup>26</sup> However, without the opportunity, such additional SME lending will not be available under any circumstances.

The issue of additional steps and unaddressed market failures in SME securitisations is difficult to assess. One possible interpretation of the difficulties in creating a substantial SME securitisation market is that SME loan pricing is below normal market risk pricing. This may be the result of cross-subsidies within the banks (ie the loan is a means to obtaining more profitable ancillary business from an SME such as cash management, FX management, etc...) or cross-subsidies at a wider structural level where certain banking institutions are created and supported by the public sector in exchange for making loans available to SMEs at low(er) rates. If this is the case, once the SME loans have been extracted through securitisation from this cross-subsidy environment, it is difficult to fund them as the yields they generate as a result of the cross-subsidy are too low.

This could be remedied by public sector institutions being prepared to purchase the

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<sup>26</sup> In fact, even with a thriving SME securitisation market there is no guarantee of additional funds for SMEs since the fungibility of money and capital cuts both ways and a bank can use the funds and capital generated by the securitisation of part of its SME book to fund any other part of its overall business.

mezzanine tranches of SME securitisation at a yield that bridged the gap between the international capital markets' SME risk price and the cross-subsidised actual SME loan yields.

However, such a remedy would imply a substantial public sector subsidy to European SME lending. Such an institutionalised subsidy raises very substantial issues of market distortion and appropriate use of tax payer funds. PCS is agnostic on the wisdom of such a step but merely wishes to point out that it would likely be an effective way to increase SME securitisation in Europe.

Some loan standardisation would indeed assist in reducing the cost of SME securitisations and making them more attractive to investors in lightening their analytical loads.

However, the diversity of SMEs and the diversity of legal regimes across Europe (including and especially enforcement and insolvency rules) make such standardisation very difficult. This is a long term project and should not form part of the first round of the STS securitisation project.

On the other hand, some standardisation of some aspects of SME securitisations along the lines suggested in our response to Question 6 could be achieved relatively quickly.

The dissemination of information on SMEs on an anonymised basis through data aggregators would, it seems to us, be of great benefit. This would be similar to the type of information that already appears in the European Data Warehouse. However, the information in the European Data Warehouse only relates to loans that are already securitised. One could envisage this system being universalised for all SME loans. Again though, this is a large and costly task. We do not believe that, in and of itself, it will transform the SME securitisation market in Europe. We would therefore also recommend that a rigorous cost-benefit analysis be conducted by the Commission, together with industry stakeholders.

In each case, one also needs to bear in mind the data protection issues and the confidentiality issues that are embedded in the distribution of such data. Amongst the stakeholders whose voices need most essentially to be heard in this regard are, of course, the SMEs themselves.

Another issue that should be looked into to stimulate the flow of funds to SMEs is the removal of distortions to the capital requirements imposed on banks depending on the form of their SME lending rather than its substance. This is connected to STS securitisations because banks will sometime structure their bank lending in the same format and using the same legal structure as a securitisation: a "true sale" of assets, a special purpose vehicle, "tranching" through the use of attachment points. However, if there is no issuance of securitisation bonds by the vehicle, but merely a bank loan, the capital the bank needs to set aside for this lending is substantially greater than for a bond form securitisation. If a new STS securitisation regulatory framework is established, this gap in the capital requirement will become even greater.

However, there are sometimes good reasons for banks to wish to lend directly against SME assets out of their bank book. Therefore, rules that align the capital requirements for bank that structure SME funding meeting all the STS securitisation criteria but without an actual bond issue could benefit SMEs in the long term. It also appear to be logical. We recognise that this does not assist the securitisation market or the CMU

objective of rebalancing the European financial architecture towards the capital markets. It is though a point relevant to increasing the possible flows of SME funding.

**Question 17:**

**To what extent would a single EU securitisation instrument applicable to all financial sectors (insurance, asset management, banks) contribute to the development of the EU's securitisation markets? Which issues should be covered in such an instrument?**

We are not entirely sure what the question is referring to as a “single EU securitisation instrument”.

If this is a reference to a specific legal instrument created under EU regulation as a *sui generis* instrument to be capable of being purchased and receiving specific regulatory treatment for all types of financial investors, then our response may be found in our reply to Question 5.

**Question 18:**

**A. For qualifying securitisation, what else could be done to encourage the further development of sustainable EU securitisation markets?**

**B. In relation to the table in Annex 2 are there any other changes to securitisation requirements across the various aspects of EU legislation that would increase their effectiveness or consistency?**

**Non-European securitisations and non-European investors**

As mentioned earlier in this paper in our response to Question 5, we believe that it is in the interest of European investors to be able to diversify their investments and, through a comity approach, to obtain a good treatment for European securitisations from non-EU investors. Therefore, PCS encourages the Commission to craft a STS securitisation framework that remains open to non EU securitisations and to work with other policy makers to ensure that European STS securitisations can receive the most favourable treatment under local rules.

**Risk transfer and synthetic securitisations**

As we have stressed, one of the key benefits of securitisation in rebalancing European finance away from the banks and towards capital market participants is the capacity to generate capital relief for banks. This allows banks to continue to use their infrastructure (credit teams, branch networks, etc...) to channel funds to the real economy without being the sole providers of such funds. Therefore, although PCS does not have specific rules in mind, we wish to draw the attention of the Commission that the promise of STS securitisation can only be fulfilled if the risk transfer rules are drafted in such a way as to allow for relief both for capital purposes and for leverage ratio purposes when banks genuinely transfer the risks associated with the securitised assets.

It is in this context that we note, in the “standardisation criteria”, that synthetic securitisations have been excluded. However, we 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 useful tool to transfer

risk 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 also therefore help 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.

PCS does not label synthetic transactions. This is not, however, 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.

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” STS securitisations.

However, we do not believe it is practical to try to fit a set of criteria for synthetic STS securitisation within the current proposals. This is likely to cause some meaningful delay in the finalisation of the “true sale” STS 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.

Nevertheless, we urge that the current project should leave open the possibility of allowing synthetic STS securitisations at a later stage, when appropriate criteria have been drawn up.

PCS has recently begun to work on devising a set of synthetic STS criteria. We hope that these could form the basis of a fruitful discussion with stakeholders in the European securitisation market, including the public authorities, and the start of the creation of a robust synthetic STS securitisation category.

## CONCLUSION

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Once more, PCS welcomes the constructive and positive approach of the Commission to the revitalisation of a strong and stable European securitisation market. We believe that the creation of a legally binding definition of simple, transparent and standardised securitisation used to anchor a bifurcated regulatory framework is the approach most likely to allow for European and global savings to be channeled to real economy borrowers who cannot – usually for reasons of size – have a direct access to the capital markets. As such, this approach also fits seamlessly within the greater capital markets union project.

We also welcome the focus the Commission has given to the issues of operationalisation of the new regulatory framework. Such focus is vital if Europe is to move swiftly to re-opening the securitisation channel of funding.

# ANNEX 1

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## RESPONSE TO QUESTION 4

### *Certification in the context of a regulatory framework for securitisation*

#### **Introduction**

Following a number of consultations and position papers in 2014 and 2015, it is clear that the current direction of travel within Europe, when it comes to securitisation, is towards introducing a definition of simple, transparent and standardised securitisations. These securitisations would reflect the characteristics of European securitisations in the traditional asset classes that performed so well during the financial and economic crisis.

Once a definition of simple, transparent and standardised securitisations (“STS securitisations”) is drafted, it seems equally clear that the intention is to use this definition to craft a bifurcated regulatory framework in which these safer products could be subject to prudential regulation more appropriate to their inherent characteristics. The regulatory treatment of securitisations that did not meet the STS criteria, in turn, would reflect what we learnt during 2007 and 2008.

This European project for the regulation of securitisation has now also gained an international dimension with the consultation jointly published by the Basel Committee on Banking Supervision and IOSCO.

Having argued since our inception for such a bifurcated regulatory scheme, PCS warmly welcomes the work that is being done in this direction both in Europe and globally.

We also welcome the attention being paid to the practical aspects of how such a regulatory scheme would be “operationalised”. The Bank of England and the European Central Bank as well as the European Commission raised this issue in their respective consultative documents. This is a key issue if we wish to avoid the new regulatory scheme, explicitly designed to create a strong, deep but safe European securitisation market, from becoming a Pyrrhic victory: well designed in theory, but not capable of being operated in practice in a manner that would bring new investors into this funding instrument as well keeping the existing investors involved.

In this paper we will set up how we believe the new regulatory scheme could be “operationalised” effectively, cost efficiently and with the necessary prudential safeguards. We will look at the various alternatives, seek to identify the best and resolve the legitimate issues that could be raised around that choice.



This paper reprises a number of arguments that PCS has made in previous publications, particularly in our response to the Bank of England/ECB consultation and our paper on the issues surrounding self-attestation.

## **Characteristics and challenges of the new regulatory scheme**

When looking at the current STS securitisation proposals a number of characteristics and challenges emerge.

[A] Complex criteria and stark differences in outcome.

The current thinking regarding STS criteria create a regulatory dilemma. Assuming that a concept of STS securitisation enters the regulatory framework, it will be pulled in two different directions. On the one hand, the lessons of the crisis indicate that securitisations are, like many financial products, quite a complex instrument and that what went wrong with some of these instruments is not uni-dimensional. PCS' own analysis draws attention to four separate potential criticalities revealed by the crisis and probably a number of additional *sine qua non* conditions for robust securitisations. This drives the definition of STS securitisation towards a fairly complex set of criteria.

And indeed, the various current proposals and existing rules for STS securitisations are fairly complex. Solvency II's existing definition contains 12 separate conditions that require to be met. When one bears in mind that some of these are multi-part criteria, the real number of conditions to be met is above twenty. The EBA's own suggested criteria are set out in their consultation. PCS considers them to be an excellent and solid basis for a strong definition. But they do run to over fifty criteria.

This complexity is not, in our view, the product of over-zealous regulators but a genuine reflection of the lessons that can be learned from the crisis of 2007/2008 and of the requirements of a prudentially robust approach.

This complexity will also be made all the more difficult by the fact that the current proposed criteria are not all straightforward. It is a reality of all regulation that, notwithstanding the best intentions of the legislative and regulatory draftspeople, rules when they meet the real world require interpretation. The more complex the rule, the more likely is the need for interpretations. The more numerous the rules, the more interpretations are needed. PCS' own label criteria were designed to be as simple, straightforward and binary as they could be made. Yet, our own experience with our label over three years revealed surprising needs for interpretations.

However, the more complex a regulatory scheme the harder it is not only for regulators but for the market to manage. The additional compliance burden can lead investors (and/or originators, depending on where, and in what proportion, the burden falls) to turn away from the product – especially if alternative investments can be found which are free of such burden.

In addition to complexity, another characteristic of the likely new regulatory framework is that the difference in outcome between the treatment of STS securitisations and others is likely to be very stark. The differences in capital requirements under Solvency II are very substantial. In other cases, such as the Liquidity Cover Ratios and the likely Money Market Funds rules, the difference is absolute: it is the difference between being allowed to hold the securitisation within the rules or not.

Considering the stark difference in behaviour during the crisis between securitisations that met the STS criteria and those that did not, this does not seem unfair. But the

starkness of the difference in outcome indicates that a lot will turn, for investors, on the answers to fairly complex questions.

How can the complexities of the proposed STS criteria be streamlined so as to reduce the likelihood of confusion, regulatory risk and unnecessary costs?

#### [B] Need for new investors and due diligence

Any revival of the European securitisation market will require a substantial number of new investors. (The old, pre-2008 market was defined by the major involvement as investors of banks and creatures known as “structured investment vehicles” (SIVs). The point of the CMU project is to diminish the role of the former. The latter were liquidated in 2008 and will never – one hopes – be revived).

Such investors are unlikely to be attracted to a market where they run substantial regulatory risk but where such risk can only be mitigated through complex and very costly due diligence.

Indeed, PCS’ own conversations with those investors still purchasing securitisations indicates little, if any, appetite to continue investing should the due diligence burden and regulatory risk increase in the manner envisaged in current STS proposals without some mitigatory mechanism being put in place.

How does the new regulatory scheme not impose such costs and such risks as to deter investors from investing in the European economy through the securitisation market? How can the costs be reduced, for example by avoiding endless duplication?

#### [C] Multiple regulators

For the definition of STS securitisation to play its role in reviving a safe European market, it is generally acknowledged that it must be capable of being used by all types of regulated investors. Without a single definition one would end up with securitisation instruments that would be favourably treated by bank regulators but could not be purchased by money market funds or insurers; others that would be attractive to insurance companies but could not be invested in by funds or banks; etc... Such fragmented markets would each be too shallow to thrive (or even survive) and seem to run contrary to the foundational principles of the CMU project.

However, as we have seen, complex definitions such as those proposed for STS securitisations require interpretations. The current thinking envisages this definition to be used in regulations that are overseen by a very diverse set of regulators. At the very least EIOPA (for Solvency II), the EBA (and its various component central banks, for CRR) and ESMA (for AIFMD). If the definition is also used, as would make sense, for central bank collateral rules, then every European central bank becomes an additional quasi-regulator.

We understand that it is not allowable, as a matter of law, for a regulator simply to relinquish its regulatory obligation to another regulator.

So, how does the STS definition maintain its universal applicability over time for all types of European investors under the strain of multiple regulatory interpretations and practices? How is the STS approach to be deployed effectively, from a cost and efficiency point of view, without multiple redundancies resulting from multiple regulators performing the exact same tasks?

#### [D] Appropriate allocation of responsibilities

One of the lessons of the crisis was that through the absence of sufficient information on securitisations and misplaced over-reliance on credit rating agencies, investors failed to understand the nature of the risks that they had taken on.

Part of the STS criteria focus on transparency and are designed to ensure that appropriate information is always available to investors in STS securitisations. One of the key elements of any new regulatory scheme should be that investors are still required to understand what they have purchased and do the appropriate due diligence.

Another key element of the new scheme should be that issuers accept the legal and moral responsibility that comes with issuance of STS securitisations. As originators of the securitised assets and the party that structures the transaction, it is proper that they take ownership of the key aspects of what they are selling to investors.

At the same time, in all parts of the capital markets, investors when doing their due diligence are allowed to rely on trustworthy third parties and tools. Equally, the well known conflicts of interest that exists for issuers and credit rating agencies should lead us to be wary of over-reliance on their views.

So how does the STS regulatory framework provide for the relevant parties to take on the responsibilities that are properly theirs without disallowing them the use of legitimate tools and minimizing issues arising from conflicts of interest?

### **Requirements for an effective operational reality**

#### [A] Need for a functioning market

If one looks at the issues of the applicability of the STS securitisation criteria simply from the point of view of an investor's regulatory position – “can I purchase this?”/“what capital do I need to set aside for this purchase” – the complexity of the proposed definition is “only” a cost issue. The investor must be able to take an independent view of his or her investment and allocate risk and capital correctly based on this view. Once this is done, the regulations have fulfilled their purpose.

However, this approach fails to take into account that capital market investors invest in “markets”. They rely on being able to sell their positions if they so wish. To do this, though, they cannot just rely on their own due diligence and regulatory conclusions. They must also have some confidence that other participants in the market, having done their own due diligence, will come to the same conclusions. Since, as we have seen, the proposed securitisation rules are complex, there is a great risk that other investors will come to different conclusions.

This is why, in addition to the risk that it will suffer loss from making a mistake in interpretation – resulting in a regulatory re-categorisation of its investment – the investor in STS securitisations runs the additional risk of loss - notwithstanding having done what it considers to be an absolutely correct analysis - if other investors have done the analysis differently and reached different conclusions.

The risk of such differing approaches amongst investors is substantially increased in the case of the proposed securitisation regulatory framework since, as we have seen, the framework is intended to apply across different industries each regulated by different supervisory authorities.

## Primary market

In the primary market, the absence amongst investors (and possibly regulators) of a common interpretation of the STS criteria as they apply to any given issuance would make it extremely difficult to price such bond. Different investors will 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 the benefit of creating a regulatory space for STS securitisations.

## Secondary market

The impact of a lack of a shared view amongst investors would also likely affect substantially negatively secondary market 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 deep the liquidity for such a 'STS securitisation' really is since he or she will not know how many of other potential purchasers of this securitisation share his or her interpretation of the regulatory definition.

The issue of timing is even more difficult as it would occur even if the analysis of whether any particular securitisation meets the STS standards were fairly straightforward. If an investor wishes to sell a securitisation, he or she will approach trading counterparties and ask them for a quote. Normally, a price is given and – if it is acceptable - the trade takes place. However, the price differences between STS securitisations and others, for reasons already explained, is likely to be stark. In order to quote a price, the trading firm will need to know that it can unload the position to another investor at roughly the same price (minus the bid/offer spread). For this, the trader needs to know that likely purchasers will also consider the securitisation as an STS.

Few trading firms, if any, will be willing to take that substantial price risk on their own books. They will therefore only be willing to broker a sale – find another investor and put the seller and buyer in touch. The buyer, of course, will have to do his or her own due diligence as to whether the securitisation meets the criteria for STS status. This will take time.

So the problem, even for straightforward STS securitisations, is that every sale will be like that of a complex private placement, matching individual sellers with individual buyers and taking time. This is the anti-thesis of the deep, liquid market European policy makers are hoping for.

## Common currencies

In market situations such as these, where the value of an investment is not just determined by the analysis of the investor but by that of the investor community as a whole, reliance is placed on a "common currency" which is both public and shared. The most obvious example is the stock exchanges whose public prices for equities provide investors with a common understanding of the market's view. And this is why the European Union has sought to introduce a similar "common currency" in the bond

markets with post-trade transparency rules administered by third party institutions (the CTPs).

Such “common currency”, to be effective needs to meet a number of conditions:

1. Open: to be common, it must be available to all market participants.
2. Timely: as we have seen, to allow a workable primary market, it must be available at or before pricing of the STS securitisation.
3. Certain: because of the cost to investors of mistake in determination of STS status, it must be – in the absence of fraud or gross mistake – dispositive.
4. Trustworthy: because of the problems caused by misaligned interests (eg. US sub-prime or credit rating agencies), it must to as much as possible free of conflicts of interest.
5. Cost efficient: it must not impose a cost structure so burdensome as to prevent the market from fulfilling its role in funding the economy.

### **Possible “common currencies”**

#### [A] Self-attestation

Under a “self-attestation” scheme, the originators would certify that the securitisations issued by them met 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 episodes.

Also, there is strong anecdotal evidence, gathered from investors and investor representative bodies, indicating that the European investor community does not see a self-attestation approach as meeting their minimum requirements for safety and certainty.

We have set out in greater detail why we do not believe self-attestation would lead to any return of a strong but safe securitisation market in our paper “The illusory promise of self-attestation” (April 2015) and invite readers to refer to that paper for a full analysis<sup>27</sup>.

#### [B] Third party certification

Under a third party certification regime, a third party would examine each securitisation issuance and determine whether it met the STS criteria for regulatory purposes. Those securitisation transactions that met the requirements would be entered on to a publicly available master list which would be dispositive of the securitisation’s status.

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<sup>27</sup> This paper is reproduced in full as Annex 2 and may be downloaded from [http://pcsmarket.org/wp-content/uploads/publications/31873/An\\_illusory\\_promise.pdf](http://pcsmarket.org/wp-content/uploads/publications/31873/An_illusory_promise.pdf)

Such regime would need to meet the requirements of openness, timeliness, certainty, trustworthiness and cost efficiency set out above. If it did, it would provide the common currency needed for the growth of a strong, deep and liquid European securitisation market.

### **Certification agents: private or public?**

There are two types of institutions that could provide this type of certification: regulators or private sector bodies.

On balance, PCS believes that private sector bodies – provided they can meet essential conditions – are best placed to perform this task. There are a number of reasons for this.

#### **[A] A traditional European approach**

First, this type of certification on behalf of industry is an activity that is traditionally left to the private sector. Regulators issue rules and interpretations and supervise private sector bodies. They do not process large amounts of data, accept application forms, perform due diligence and maintain public data bases and liaise with issuers and investors as necessary.

In fact, across the European regulatory landscape the use of private sector bodies to verify conformity of products with prudential regulations, far from an oddity, is very much the norm. In more than thirty industries, including finance, you will find this model. This approach is usually enacted under the ‘notified body’ regime and is discussed in greater detail later in this paper in the “Questions that should be frequently asked” section. A fairly complete guide to ‘notified bodies’ and their uses can also be found in a document published by the European Union under the title: “The Blue Guide on the implementation of EU product rules”.<sup>28</sup>

#### **[B] Scalability**

Secondly, as we have seen, for this master list to be effective, the STS status of transactions needs to be publicly available at or before pricing<sup>29</sup>. This is true irrespective of how many transactions are issued any month, any week, any day. This means that any certification agent must be able to demonstrate a scalable business model capable of dealing with any kind of volume (high or low). Without such capacity, the market could grind to a halt during times of high volume. It is our experience that public sector bodies, hemmed in justifiably by fiscal and budgetary disciplines, are not always best placed to achieve this type of scalability.

#### **[C] Costs**

Thirdly, this activity should be paid for by the securitisation industry. If performed by private sector (and, as we will see, “not for profit”) bodies, the costs will be kept transparent, accountable and low.

Indeed, should the costs rise to points where they threaten the viability of the market, market participants would quickly set up new and cheaper alternative providers. In fact, as the scheme would not be set up as a monopoly but would be open to any body that

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<sup>28</sup> [http://ec.europa.eu/enterprise/newsroom/cf/itemdetail.cfm?item\\_id=7326](http://ec.europa.eu/enterprise/newsroom/cf/itemdetail.cfm?item_id=7326)

<sup>29</sup> Publicly available information need not be required, of course, for private transactions. How these could be dealt with within a STS certification scheme is set out in greater detail on page 40.

met the regulatory requirements, one should anticipate a healthy competition on price amongst certification agents. This will drive costs to the industry down.

This cannot be the case with a regulatory body.

#### [D] Preventing fragmentation

Fourthly, as we have seen, the STS regime will need to be overseen by a number of regulators that are not allowed to delegate their responsibilities to each other. By having third party private sector certification agents habilitated by all the relevant regulatory authorities, the problem of overlapping jurisdictions is overcome.

Fifthly, private sector certification agents accountable to a variety of regulators will need to have a mechanism to centralise interpretations of the rules. This resolves the issue examined earlier of how to maintain a single STS securitisation definition in the face of multiple regulatory regimes. Common interpretations of rules made by regulators would then be made public and become binding on all certification agents.

### **Possible issues with private sector certification agents**

In the post credit agency/LIBOR/Forex world, PCS is not unaware that the idea of private sector bodies performing quasi regulatory roles in the financial sector is not without issues. We would like to deal with some of them by setting out what we would consider minimum requirements before any entity be considered for the role of STS criteria certification agent.

#### [A] Alignment of interest

We have seen a number of serious problems occur with private sector bodies whose tasks contained an element of regulatory or quasi-regulatory function: the credit rating agencies, the banks in their role in setting LIBOR or forex rates or originators of US sub-prime mortgages.

In all those cases, the problems were traced to the effect of conflicts of interest: the bodies concerned had a financial interest in the way in which they performed these functions.

#### *Not for profit*

Although rules were, in some cases such as the rating agencies, introduced to provide for the proper management of these conflicts, we believe that the safest route is always to eliminate the conflict altogether.

This is why we believe that certification bodies should be not for profit bodies. We also believe that the definition of “not for profit” should be very strict and should not allow for what are effectively equity type returns to be extracted from the relevant certification agent through the means of bonuses or excessive loan repayment. In other words, any certification agent must be a genuine not for profit.

In addition, and to reinforce the absence of conflict, additional provisions should be introduced as requirements for potential certification agents.

### *Codes of conduct*

There should be codes of conduct for staff, similar to those that apply to registered Credit Rating Agencies in Europe. These should ensure that there is no linkage between compensation and certification volumes. They should also prohibit the ownership of shares or securities by staff in any entity whose securitisations are certified.

### *Governance*

The governance of potential certification agents should ensure the independence of management.

The composition of the board should be such that there is no majority representing entities whose securitisations are being certified. There should be a minimum of two independent board members whose role is to ensure the integrity of operations of the certification agent. Also, there should be representatives of investors or investor bodies on the board.

### [B] Costs

The certification agent would meet its costs by charging issuers who seek to confirm the STS status of their securitisations. However, the certification agent being a not for profit body should not only eliminate a major source of conflict of interest, but should also ensure that costs are kept to the minimum necessary to run the framework efficiently.

In order to ensure that industry provides an economic oversight of the certification agent's activities, it would be a requirement that the accounts of the agent be published at quarterly intervals and be the subject of an independent audit each year. This should ensure that costs only rise when justified.

### [C] No private rule making

The purpose of the certification agent is not to define STS securitisations but to certify existing norms defined by the legislator and the regulators. Once more taking the EU notified bodies regimes as a model, the agent's task is to designate securitisations as being in conformity with the EU mandated rules.

One of the most problematic aspects of the reliance by regulators on rating agencies is that this is a form of "private legislation". When the agencies change their criteria, in effect, they change the regulatory treatment of certain companies, nations or securities. Yet these changes are made internally by private, for profit companies: they are a form of private sector rule making.

The proposal for private sector certification agents within the STS securitisation framework would not provide for any such type of rule making.

This means that the framework would need to provide for a feedback mechanism should a certification agent encounter an ambiguity in the rules or a new set of circumstances where the application of the rules was uncertain. Any interpretation of the STS criteria would need to be provided by the regulatory authorities, not the certification agent.



#### [D] Regulatory supervision

As a certification agent performs a role within a regulatory function, it is right that it should do so pursuant under regulatory supervision.

First, the certification agent's status within the STS framework would be provided by the regulators. They should also have the right to remove that status should they determine for whatever reason that the agent cannot perform its tasks correctly.

To be able to oversee the certification agent's work, the relevant regulators must have full access, at any time, to all the operations of the agent. It must be able to speak to any member of the agent's staff or management. It must be able to peruse any file and check any financial transaction made by the certification agent.

To the extent that the certification agent acts through third parties, the regulators would have sight of all the relevant contracts with any such third parties.

We are agnostic and leave it to the regulators whether they would feel that they need to have members on the board of certification agents.

There are two ways in which the regulatory scheme could work. The certification bodies could be, by legislation, subject to regulation ie be "regulated entities" subject to oversight and penalties by regulatory bodies. Alternatively, the certification agent would not be "regulated entities" but would be defined in the legislation as bodies that had received the status of "STS securitisation certification agent". Such status would, in turn, depend on the agent meeting all the regulatory requirements and voluntarily submitting itself to oversight. If the regulator, at any point, determined the agent was not meeting the requirements, the status could be removed.

The creation of a full "regulated entity" status and the implementation of such formal oversight being more time consuming from a legislative and regulatory point of view, PCS strongly recommends the latter approach. The legislation could provide a 24 months review clause. Should the regulatory authorities determine that they needed the certification agent to be a fully regulated entity, the necessary changes to the legislation could be made at the review date.

#### [E] Confidentiality, non-public securitisations and ABCP conduits

A debate continues to take place on whether and how a STS securitisation regulatory framework should cater for securitisations with different disclosure standards (including ABCP conduits), particularly private placements. Whereas some voices argue that the public disclosure requirements of the proposed STS criteria should be absolute and therefore exclude *ipso facto* private placements and other securitisations with differing disclosure standards, others have argued that the STS securitisation designation should be open to such transactions on a different basis.

This paper is not the place to debate these varying approaches. However, we would like to address how a third party certification agency approach would still perfectly fit a regulatory model where private placements and ABCP conduits would be given STS securitisation status.

Should a transaction wish, under such a scheme, to be STS compliant, provisions could be made for the certification agents to review all the relevant items required by the STS criteria on a private basis. Thereafter, the private placement could be listed as an STS securitisation on a private site – rather than on the public master list

envisaged by the general approach. Rules would allow investors and potential investors in that transaction to confirm the STS securitisation nature of the relevant transaction. This would provide all the benefits of third party certification – including investor certainty – without endangering the confidentiality of such private placements. This approach would also assist regulatory authorities: since the regulators should have unfettered access to the private sites maintained by certification agents, they would have immediate access to information about private placement securitisations. This would assist their macro-prudential oversight.

For ABCP conduits, once appropriate STS criteria are in place, the certification agent could equally certify the conduit as a whole as meeting the STS criteria (rather than each individual commercial paper issuance). Depending on the exact nature of the STS criteria mandated for ABCP conduits, a certification agent would have to perform appropriate checks at regular intervals to determine that the conduit continued to meet the regulatory rules.

### **How would it work in practice?**

PCS has quite extensive experience, through its label, with certifying the structural integrity of securitisation transactions. This section is therefore based on our work and the issues we have encountered.

#### **[A] The certification agent**

A certification agent would be set up within the European Union as a not for profit body under relevant legislation.

The body would then apply to the relevant regulatory body or bodies for status of “STS certification agent”. Such status would need to be created within the STS securitisation legislation. Would each regulator with STS securitisation regulation oversight be required to license the certification agent? PCS would recommend that such task be delegated by the legislation to a single regulator.

The single regulator (if this is the chosen option) would check compliance by the putative certification agent with all the rules and, if these were met, would grant certification agency status. This would be published on a publicly available list.

#### **[B] Certification**

A week or more before a securitisation issue is priced, the originator would file a certification request with a recognised certification agent.

That request would be accompanied by all the supporting documentation necessary for the transactions’ STS status to be verified and a “verification checklist”.

What supporting documentation would be required would ultimately depend on the actual STS securitisation criteria set out in the legislation. The verification checklist would contain each criteria and a reference to a document evidencing this criteria, including where in that document the evidence may be found. This is the approach currently used by PCS in its labeling and has been found to be very useful by investors in their own due diligence.

Amongst the documents we would anticipate might be provided, where relevant and depending very much on the actual final criteria, one could find, for example:

- the prospectus;
- a legally binding statement by the originator as to the accuracy of information provided;
- a legal opinion;
- a third party audit of the pool;
- a statement by a data firm and a modeling firm that the originator had entered into the relevant disclosure contracts;
- supporting documentation evidencing compliance with the retention rules.

The certification agent would verify that, based on the provided information, the criteria had been met.

Depending on the final criteria, certification agents may be required also to verify some “downstream” criteria related to the originator’s underwriting and/or systems. These types of verifications would not be related to individual securitisation issuances but to the originator itself and its capacity to manage both its underwriting and the servicing of the securitisation. They could be performed on an originator first seeking certification and then at regular intervals.

If the agent determined that a securitisation met the STS criteria, it would issue a certificate to the issuer and would enter the information on a master list of all STS securitisations. It would also, to the extent it was legally possible, file all the documents and the verification list so that any investor or potential investor can do its own checking.

The issuer would pay a fixed fee for each issue for which it sought certification and an ongoing small annual fee thereafter. The quantum of that fee would be set so as to meet the operating costs of the not for profit certification agent.

#### [C] Interpretations

Should the certification agent come across a point that was ambiguous and it determined that an STS criteria required to be interpreted, it would communicate this immediately to a regulatory committee.

This committee would be composed of regulatory staff and would need to issue a determination. PCS would strongly urge that the legislation (or delegated acts) setting up the STS securitisation framework clearly set a time frame for such interpretations.

Once the interpretation had been made, it would be published and binding on all certification agents.

#### [D] Ongoing certification

If some of the STS securitisation criteria were such that they needed to be met on an ongoing basis, rather than merely at the issue of the bonds, the certification agent would need to be provided with such ongoing verification. Also, if the rules relating to retention allow the originator to change the manner in which it holds the retained interest, such changes should be disclosed to investors and can be verified by the certification agent.

[E] Document warehouse

The role of the certification agent within the STS securitisation framework is not to replace investor due diligence but to be a tool to assist investor due diligence. This role can be enhanced if the certification agents maintain a site through which investors can access the prospectuses, the documents used by the certification to determine compliance with the STS criteria, the compliance checklist, the investor reports and all other publicly available deal documents.

This could be a series of sites maintained individually by each certification agent or a collective site.

In its own labelling activity, PCS posts the prospectus and the PCS criteria checklist on its site, enabling investors to rapidly access information on any of the criteria that compose the PCS label. A number of investors have expressed the view that the existence of such a centralised resource has meaningfully improved their diligence capacity.

### **Questions that should be frequently asked**

Earlier we had mentioned certain characteristics that a proper certification scheme would need to have and certain challenges that it would encounter. There are also a number of questions relating to such a scheme that we anticipate will be asked. We therefore anticipate some of these here.

#### **[A] Is this not just an invitation for investors to over-rely on certification agents as they did on rating agencies before the crisis?**

No. There is a fundamental difference between relying on a rating and relying on the certification of a regulatory rule: judgment. A rating is a subjective assessment of the credit quality of a debt. Assessing the credit quality of what you are investing in is the key requirement of an investor. If an investor relies on a rating, it is substituting the judgment of a third party for its own.

The STS criteria are not subjective. There are objective criteria set out by the legislator that describe the structure of a given securitisation. When the agent certifies a securitisation as meeting the STS criteria, it is verifying the fact. It is not making a subjective call.

Therefore, relying on third party verification of objective fact is not an abdication by the investor of its obligations but the use of a verification tool. It is more like using a calculator. It is no different from all the other tools investors are entitled to use when seeking to understand a potential investment: the investor can look at the price of a security quoted by a stock exchange or a CTP, without being required to verify it independently; the investor can rely on the audited accounts of a company without being required to verify the P&L number independently; the investor can buy a computer model of a securitisation waterfall to understand how cash flows work in certain scenarios without verifying them independently; an investor can use publicly available data on inflation or national GDP without verifying them independently.

In other words, a certification of the STS criteria by an agent is an objective tool. It would be costly and wasteful to require each investor to do independently this verification when it can be centralised. In fact, it is likely to be so costly as to lead to very few, if any, investors willing to invest.

**[B] Is the licensing of a private third party certification agent not an incredibly novel and therefore risky new departure? Should we be willing to experiment in this way with something that could cause great damage if it goes wrong?**

Actually, the licencing of a private third party certification agent whose job is to verify that a product is in conformity with European regulation far from being novel is the norm.

European Union law uses such agents in over thirty different industries. Such bodies are called “notified bodies” and a list of them can be found on the EU web site. They are used in precisely the circumstances which are contemplated in the STS securitisation framework: manufacturers (here securitisation originators) who are required to conform to specific quality criteria; consumers (here investors) who rely on these criteria but where individual checks by each purchaser would be incredibly expensive but the manufacturers have a conflict of interest which makes self-attestation unwelcome. In fact, notified bodies are most usually used in industries where the risk of something going wrong can lead to genuinely dire consequences: e.g. food safety, medical equipment, medicines, safety equipment and nuclear power stations.<sup>30</sup>

As with the approach proposed here by PCS, “notified body” status is set out in the primary legislation that creates the norms that producers must meet. There is a regulatory body charged with licensing the notified bodies and supervising their quality.

**[C] Should investors not be required to understand what they are purchasing and perform necessary due diligence?**

Yes. But as we have stated above, in performing their due diligence, investors are entitled to rely on objective tools. Whether a securitisation meets the STS criteria is an objective fact that investors need to ascertain in the way they need to ascertain the nature of the securitised assets. But they are also entitled to ascertain these things based on information provided by trustworthy sources.

The certification agent being a not-for-profit entity under regulatory supervision is such a source of objective data.

Also, STS criteria do not provide any information on the absolute credit quality of a securitisation. These criteria very explicitly only speak to the structural integrity of the securitisation. Therefore, it would be impossible for any investor to look only at the STS status of a securitisation in deciding its purchase. This would be like buying an equity based solely on the fact that it was listed without doing any enquiry on the company whose share it was!

Therefore, the risk that the verification by a certification agent of the STS nature of a securitisation would lead an investor to suspend its due diligence is, to say the least, remote.

In addition, it is proposed that – as is currently done with the checklists for the PCS label – all the information that allows the certification to reach a conclusion on STS

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<sup>30</sup> Currently, the accreditation of notified bodies within the EU takes place pursuant to Regulation (EC) No 765/2008. As a technical matter, we are not suggesting that the STS securitisation certification agency rules be enacted under this Regulation (as it requires, for example, a separate body for each member state – reflecting the differing nature of the product regulations covered) but that the same general approach be followed.

status should be available publicly. This would allow any investor to double check the work of the agent.

**[D] Shouldn't issuers be liable for the quality of what they sell? Would a third party certifying the STS criteria not let them off the hook?**

Yes, to the first and no, to the second.

Most, if not all, of the information provided to the third party certification agent is provided by the issuer<sup>31</sup>. That information should be certified. In fact, such certification should be part of the legislative requirements. Therefore, if a certification agent erroneously certifies a transaction as meeting the STS criteria because of incorrect information, the liability should and would remain with the issuer. This is similar to audited accounts which remain the responsibility of the company being, as they are, based on company provided numbers.

Of course, there is always the remote possibility that an error is made by the certification agent. The possibility should be remote since the criteria are designed to be objective. In such case, the agent would have to accept liability. However, the possibility of such error would exist in **any** STS securitisation framework (as it exists in any regulatory or human endeavour) irrespective of the existence of a certification agent.

**[E] Doesn't the fact that the STS securitisation framework rely on these certification agencies create dangerous dependencies for the market? What would happen if an agent were to disappear?**

Such dependencies of course exist throughout all of finance: Clearstream, Euroclear, stock exchanges, commodity exchanges, auditors, the European Data Warehouse etc...

Here, however, the dependencies generate very limited risks.

First, the status of certification agent is open to any entity that meets the regulatory requirement and is licensed by the relevant authorities. Therefore, we would anticipate a number of bodies to apply, thus dispersing the risk of reliance on a single participant. In fact, there are already two well established bodies in Europe that perform quality checks on securitisations: PCS and True Sale International ("TSI")<sup>32</sup>.

Secondly, the creation of one or more small not for profit institutions to replace a failing certification agent as a market utility requires very little time and not a lot of money. One would anticipate that market participants would therefore be able swiftly to jump into the breach should there be any sense that there are too few agents or that one or more key agents was not performing as well as required.

Thirdly, the fact that certification agents are single purpose not for profit bodies limits considerably the risk that they would encounter the kind of financial stresses that could occur in fully commercial enterprises. They cannot go insolvent as a result of other mismanaged commercial activities or incautious acquisitions or diversifications.

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<sup>31</sup> We are using the word "issuer" here slightly inaccurately since, in most securitisations, the "issuer" of the bonds is a special purpose vehicle. Technically, the entity we are speaking about should be called the "originator". However, this is a term of securitisation art and so we prefer to use the word "issuer" (as does much of the market) to mean the "originator".

<sup>32</sup> <http://www.true-sale-international.de>

Finally, the fact that such agents will be under regulatory oversight further limits the risks as the regulators would ensure that no such body was licensed unless it could demonstrate the technical and financial wherewithal to perform the task.

**[F] If the definitions of what constitutes STS securitisations vary for each regulation (the “modular approach”) will this not require multiple certifications or multiple certification agents and lead to total confusion?**

Under the current discussions, it is universally expected that there should be a core set of criteria that define STS securitisation but that, taking into account the specific purposes of the varying regulatory schemes, additional requirements should be imposed. For example, the core STS securitisation definition may not contain any requirements regarding the probable liquidity of a securitisation since liquidity is an irrelevant concept to a capital requirement rule based on credit quality. But, when looking at a regulation such as that covering the liquidity cover ratios under the Capital Requirements Regulation (CRR) where liquidity is crucial, one would anticipate one or more additional requirements focusing on liquidity. For example, one could envisage a minimum issue size.

This combination of a core STS securitisation definition and additional regulation specific rules has been called the “modular approach”.

Would this, therefore, require multiple certifications of the same securitisation?

We believe not. The reason is that, for the STS securitisation regulatory framework to succeed in underpinning a deep, liquid and safe European securitisation market, the modular approach cannot be such as to require many complex additional criteria. If it did, then no liquid market could really emerge as there would be no actual STS securitisation definition at all but a multiplicity of very different types of securitisations that would each only be purchased by different types of investors.

So, although PCS is strongly supportive of the modular approach, we believe that policy makers understand that it may only work if the additional requirements are few for each regulation and fairly easy to due diligence. A minimum issue size, the fact that the bond is the senior tranche, the rating of the bond by two credit rating agency, the maturity of the bond are all examples of the type of easily verifiable additional criteria that should be incorporated under the modular approach.

Should this be the approach selected, then the additional costs to investors of checking the simple and few additional points should be minimal. Therefore, there would be no re-creation of the costs and certainty issues that lead one to opt for a third party certification regime for the core STS securitisation definition.

It is possible, notwithstanding this, that investors do express a desire to see, above and beyond the STS securitisation master list, additional lists of securitisations complying with specific regulations – the Solvency II compliant list, the LCR compliant list, etc... Although PCS would not welcome a system whose complexity led investors to request such additional lists, they can certainly be produced and maintained by the certification agents in the same way as they would maintain the single STS master list.

## **Conclusion**

The best way to ensure that a STS securitisation framework can play its role in bringing back a strong and safe European securitisation market is to ensure that a publicly available master list of STS securitisations is available to all investors.

The best and most cost effective way to achieve this is to provide for third party private sector not for profit certification agents under appropriate regulatory supervision.

This can be done without undermining the obligations of issuers or investors and should ensure a robust regulatory framework as it already does in countless European industrial sectors.



# ANNEX 2

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## ***The illusory promise of self- attestation***

This document was published by PCS on 20<sup>th</sup> April 2015, and may be downloaded from:

[http://pcsmarket.org/wpcontent/uploads/publications/31873/An\\_illusory\\_promise.pdf](http://pcsmarket.org/wpcontent/uploads/publications/31873/An_illusory_promise.pdf)

### **Introduction**

As the proposal for a new regulatory framework of European securitisation makes its progress, thoughts are quite rightly turning to the operational aspects of such regulation. To reinvigorate the securitisation market on a safe basis and allow for adequate capital markets funds to flow to the real economy, it is necessary, but it is not sufficient, to create a sound prudential market architecture. It is also necessary, in addition, to work out how such architecture can operate in practice.

From a conceptual point of view, the direction of travel is fairly well established. The working assumption is a regulatory approach built around a definition of “simple, transparent and standardised” (“STS”) securitisations. This definition will then be used in various prudential rules to create a bifurcated treatment for individual securitisations dependent on whether or not they meet the requirements of the definition.

Although we have long advocated this approach, its success in creating the conditions for a strong market also remains dependent on the operational infrastructure created around it. In particular, it relies on the belief by market participants that the risk and rewards as well as the costs of participating in this regulated market are worthwhile, both on an absolute and a relative basis.

In this paper we wish to address one proposal about how such operational infrastructure could be fashioned and why we think that, despite its undoubted superficial attraction, it would be very unlikely to revive any kind of securitisation market in Europe. Furthermore, there is a high risk it could result in a market deeply flawed in its fundamental prudential aspects.

### **Self-attestation and investor due diligence**

One proposal<sup>33</sup> as to how the new regulatory scheme could work is to impose an obligation of self-attestation on securitisation issuers: in other words, issuers would have to certify that their transactions met the regulatory standards. This would be combined with a de facto obligation on investors to make their own determination as to whether the securitisations they were buying met the requirements.

At first blush, this seems a very attractive idea. It removes the need for any meaningful ongoing regulatory oversight. (Regulators would only be required to intervene after a problem had occurred).

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<sup>33</sup> This proposal was put forward, for example, by the Bank of England and the European Central Bank in their response to the Commission consultation ([https://www.ecb.europa.eu/pub/pdf/other/ecb-boe\\_response\\_ec\\_consultation\\_on\\_securitisation20150327.en.pdf](https://www.ecb.europa.eu/pub/pdf/other/ecb-boe_response_ec_consultation_on_securitisation20150327.en.pdf)).

This proposal also seems to leave the risks and responsibilities where one would expect to see them. The issuers have structured the issuance and have the necessary knowledge to determine whether it meets the requirements of the rules. At the same time, the investors should know what they are buying and so should be expected to perform the necessary due diligence to determine whether the securitisation they are considering to purchase really meets the prudential requirements.

Unfortunately, although superficially attractive, this approach is unlikely to reverse the continued decline of the European securitisation market on its road to oblivion.

### **Costs, risks and rewards**

Any revival of the European securitisation market will require a substantial number of new investors. (The old, pre-2008 market was defined by the major involvement as investors of banks and creatures known as “structured investment vehicles” (SIVs). The point of the CMU project is to diminish the role of the former. The latter were liquidated in 2008 and will never - one hopes – be revived).

The current proposals for a new regulatory approach to securitisation have two important characteristics. First, the various proposals for a definition of STS securitisations are fairly complex. Solvency II’s existing definition contains 12 separate conditions<sup>34</sup> that require to be met. The EBA’s proposal runs to over 50. In addition, these conditions are not always straightforward. In other words, the due diligence of the STS criteria is not trivial.

The second characteristic is that the difference in outcome between the regulatory treatment of an STS securitisation and one that does not meet the standard is likely to be very stark. The differences in capital requirements under Solvency II are very substantial. In other cases, such as the Liquidity Cover Ratios and the likely Money Market Funds rules, the difference is absolute: it is the difference between being allowed to hold the securitisation or not.

Therefore, determining whether a securitisation meets the STS standard is detailed and complex, and therefore likely to be expensive for investors, the consequences of getting it wrong are very costly and the only help investors can expect is from the self-attestation of an issuer who has to adjudicate on a complex issue and has a strong incentive to reach a predetermined conclusion.

The last part is especially important when trying to revive the securitisation market. One of the incontrovertible lessons of the crisis is that misaligned interests, even with the threat of litigation or regulatory sanctions, are a very dangerous element to inject into structured finance. This is why the self-attestation proposal at the end really amounts to an investor due diligence requirement. Since, if the issuer fails in its duty, the losses fall on the investor it is difficult, after the 2008 crisis, to imagine new investors being willing to come to this market based on issuers’ assurances of quality. It is not even clear that investors still in the market would be willing to stay on this basis.

As a result, a requirement that investors invest in a product that still retains some stigma, on the basis of fairly complex and expensive due diligence, with severe penalties for getting it wrong and no independent assistance, will almost certainly close the door for all but the biggest and most sophisticated investors. In fact, based on conversations with existing sophisticated investors, the current proposals would lead

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<sup>34</sup> In fact, as some of those conditions are themselves composed on separate “sub-conditions”, the actual number of criteria that need to be met are in excess of twenty.

a number of them to leave the market for other bond markets where such risks are simply not there.

### **A “market” is not the same as an “investment”: the need for a common currency**

Another problem with the proposal is that it focuses, as one would expect if one takes a purely prudential and regulatory approach, on the individual investor accounting properly for his or her investment. An investor must be able to take an independent view of his or her investment and allocate risk and capital correctly based on this view. Once this is done, the regulations have fulfilled their purpose.

However, this approach fails to take into account that capital market investors invest in “markets”. They rely on being able to sell their positions if they so wish. To do this, though, they cannot just rely on their own due diligence and regulatory conclusions. They must also have some confidence that other participants in the market, having done their own due diligence, will come to the same conclusions. Since, as we have seen, the proposed securitisation rules are complex, there is a great risk that other investors will come to different conclusions.

This is why, in addition to the risk that an investor will suffer loss from making a mistake in interpretation – resulting in a regulatory re-categorisation of its investment – the self-attestation/due diligence proposal runs the risk that an investor suffers loss - notwithstanding having done what it considers to be an absolutely correct analysis - if other investors have done the analysis differently and reached different conclusions.

The risk of such differing approaches amongst investors is substantially increased in the case of the proposed securitisation regulatory framework since the framework is rightly intended to apply across different industries (insurance companies, banks, money market funds, alternative asset managers,...) each with different historical and institutional approaches and each regulated by different supervisory authorities.

Having to rely on one’s own due diligence without assistance is a disincentive to new investors entering into this market. But to have to trust other institutions’ due diligence is probably an insuperable barrier.

This is why, in market situations such as these, where the value of an investment is not just determined by the analysis of the investor but by that of the investor community as a whole, reliance is placed on a “common currency” which is both public and shared. The most obvious example is the stock exchanges whose public prices for equities provide investors with a common understanding of the market’s view. And this is why the European Union has sought to introduce a similar “common currency” in the bond markets with post-trade transparency rules administered by third party institutions (the CTPs).

In securitisation, the need for such “common currency” is made all the greater by the fact that the market will not be regulated by a single regulator but by many. This leads to the further likelihood that, as each regulator interprets the STS criteria differently, the hope of a single, harmonised and unified European market will swiftly crumble. The existence of a single determinative “list” of STS transactions together with the appropriate level of regulatory supervision and centralisation that such list will require is the best guarantor of a consistent approach across all types of investors.

### **The practical issues of timing**

Even if the analysis of whether a securitisation meets the STS standards were fairly straightforward, the absence of a publicly available list of STS securitisation will pose

substantial – and possibly fatal – obstacles to the operation of a proper secondary market.

If an investor wishes to sell a securitisation, he or she will approach trading counterparties and ask them for a quote. Normally, a price is given and – if it is acceptable - the trade takes place. However, the differences between STS securitisations and others is stark. And so the price differential is going to be equally stark. In order to quote a price, the trading firm will need to know that it can unload the position to another investor at roughly the same price (minus the bid/offer spread). For this, the trader needs to know that likely purchasers will also consider the securitisation as an STS.

Few trading firms, if any, will be willing, in the absence of a public list of STS securitisations, to take that substantial price risk on their own books. They will therefore only be willing to broker a sale – find another investor and put the seller and buyer in touch. The buyer, of course, will have to do his or her own due diligence as to whether the securitisation meets the criteria for STS status. This will take time.

So the outcome of a self-attestation/due diligence regulatory approach, even for straightforward STS securitisations, is that every sale will be like that of a complex private placement, matching individual sellers with individual buyers and taking time. This is the anti-thesis of the deep, liquid market the authorities are hoping for.<sup>35</sup>

## **Consequences**

Because of these limitations, the most likely outcome of a regulatory system without a public and recognised list – a “common currency” - is that the hoped for new investors needed to restart a securitisation market will simply stay away. It will shrink any possible European securitisation market to a minuscule, bespoke, specialist market far distant from what it could be and far from what the European economy needs.

The only other approach, i.e. that investors are somehow willing to treat the self-attestation by the issuers as determinative, is even worse. The absence of a third party independently derived “common currency” leads to self-attestations becoming that “common currency”. This would re-found the European securitisation market on the very same misalignment of interest that triggered the crisis in the first place. And, with its history, a single failure by a single issuer on a self-attestation is probably all it would take to destroy forever this financing channel in Europe.

## **Role of independent third parties**

Most, if not all, of the above issues of complex due diligence, informational asymmetry and conflicts of interest are not unique to securitisation. We have already mentioned equity pricing, for example.

In many cases where the cost to the buyer, in time and money, of bridging the informational gap is too substantial to allow for a market – financial or otherwise – to arise, the regulatory answer is to provide for independent, and usually regulated, third parties to help fill that gap.

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<sup>35</sup> Arguably, the self-attestation/due diligence approach could even result in excluding STS securitisations from those regulatory categories where the focus is on liquidity (eg LCR rules and Solvency II), resulting in exactly the reverse result from that which was anticipated.

This is ubiquitous, for example, in consumer regulation. Whether a bicycle helmet works is, quite literally, a matter of life and death for its wearer. The obligation on manufacturers of helmets to certify the safety of their product is absolute. But they have a conflict of interest. The wisdom of cyclists doing due diligence is very strong in view of the stark difference in outcomes. But becoming an engineer and buying the tools to test your helmet is clearly too high a cost. So third party bodies are approved by regulators to help consumers by providing quality certifications. The analogy with the secondary market also, to some extent, holds: a retailer would not want to purchase helmets on the basis that they meet the safety requirements to find that customers, having done their due diligence differently, disagree and refuse to buy them. The sticker of conformity provided by a regulated body (called “notified bodies” in EU law) is the comfort a retailer needs.<sup>36</sup>

Of course, it could be argued that the case of securitisation is different since the example provided is about consumer protection; that individual consumers require special protection and simply cannot be compared to sophisticated capital market investors; that such sophisticated actors should be required to “become engineers and buy the necessary tools”.

Yet, notwithstanding this, one cannot help notice that it is a legal requirement of companies accessing the capital markets that they publish accounts audited by independent third party regulated accountancy firms. Despite the view that investors should do all their due diligence and fully understand the investments they make, it is also recognised that complexity, informational asymmetries, conflicts of interests on the part of issuers and the need for a “common currency” that allows meaningful comparisons make auditing a practical necessity for any serious equity or debt market to exist.

As with the likely securitisation proposals, it is interesting to note that auditors are private sector independent actors that do not make the “regulatory” rules (the accounting standards) but apply them.

### **Maintaining responsibilities where they should lie**

The attraction of the self-attestation/due diligence proposal is that it leaves the responsibilities where one instinctively feels they should lie: with the issuer for information and respect of the rules, with the investors for due diligence of the products they purchase. The problem is that it is most likely to destroy the market.

An independent regulated third-party providing a “common currency” though does not have to lead to the responsibilities being removed from their natural bearers.

First, the investor is not exempted from the obligation to perform the necessary due diligence to understand what he or she is purchasing. What changes are the tools used to perform that due diligence<sup>37</sup>. In the same way as independent audited accounts are a tool that assists investors, a third party certification which provides the details of how each regulatory criterion is met, assists the investor in performing that due diligence.

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<sup>36</sup> In European law there already exist literally hundreds of such bodies in various areas of safety from medical equipment to food to vehicles and many others fields details of which may be found in the EU Blue Guide ([http://ec.europa.eu/enterprise/newsroom/cf/itemdetail.cfm?item\\_id=7326](http://ec.europa.eu/enterprise/newsroom/cf/itemdetail.cfm?item_id=7326)).

<sup>37</sup> An important aspect of any third party certification, for this very reason, would be that such certification lay out the details that have lead the certification agent to grant the requisite certification, thus allowing each investor to satisfy himself or herself of the key elements of the STS designation.

Secondly, as with an independent audit, a third party certification does not remove the obligation of the issuer to meet the STS standards. As with an audit, responsibility for the information provided to determine STS conformity and ultimate responsibility for the conclusions remain with the issuer. However, as with audits, a third party independent certification meets the best practice “four eyes” regulatory requirement and overcomes conflict of interest that otherwise rests at the heart of the self-attestation/due diligence model.

