

JOINT NOTE ON THE EU COMMISSION'S PROPOSALS ON SIMPLE, TRANSPARENT AND STANDARDISED SECURITISATION

This document seeks to identify key elements of the Commission's proposed regulation on simple, transparent and standardised ('STS') securitisation (the 'Text') over which the signatories have agreed that changes would be beneficial and necessary to create a safe European securitisation market able to support the economy.

This note seeks to address those major points on which there appears to be a broad consensus as to issues and solutions. It is not a compendium of every possible improvement to the proposals.

Individual signatories may well have additional issues which they believe would benefit from some modifications. If they do not appear here it may be because they are not agreed as a matter of consensus. But it may also be because we have tried to keep this report focused on key overarching issues. Therefore, the absence of any specific point in this document does not mean that it is not valid or of significant importance.

Especially, there are many "sectoral" issues that will need attention. These do not appear in this document as this document seeks to deal with those issues of overarching importance on which the signatories agree. Nevertheless, there are parts of the Text as drafted that would prevent certain types of funding qualifying as STS securitisation notwithstanding that they have performed impeccably during and since the crisis and are of great importance to the European economy. These important sectoral issues will have been and will continue to be raised by stakeholders.

General Comments

The potential of the STS proposals to help the economy

Securitisation has the potential to contribute greatly to the European economy by providing finance to European businesses and households. Specifically, by allowing banks to transfer assets to other capital market participants in a robust, regulated and transparent manner, securitisation allows banks to lend more without the need to raise new capital thus unblocking lending channels for the European economy.

The financial crisis has taught us many lessons, particularly in securitisation. We therefore fully support the new regulations already implemented in Europe in the last several years designed to address the weaknesses which the crisis identified:

- new regulations on "skin in the game" to ensure proper alignment of interests,
- new regulations on transparency and disclosure to assist investors to perform due diligence, and
- new rules on due diligence itself to prevent over-reliance on credit rating agencies.

The Commission proposals

Most European securitisations – even those structured before these existing regulations - have performed extremely well through and since the crisis¹. The Commission's STS and CRR proposals, therefore, identify the right lessons from the crisis and are a welcome starting point for re-invigorating a key funding channel for Europe's economy. They create a clear new regulatory category of simple, transparent and standardised securitisations that can be treated throughout the regulatory framework in a manner consistent with their structural strengths.

From our reading, the key elements of the Commission's proposals are:

- They establish a robust single definition for STS securitisation which can be used consistently across Europe without creating new risks of arbitrage and fragmentation of regulatory outcomes.
- The definition focuses on elements of structural integrity and transparency of the securitisation rather than on the credit quality of the underlying assets.
- The definition is designed to be used horizontally across the regulatory framework so that all types of investors and issuers in Europe benefit from operating under a single standard.
- The comprehensive 55-part STS criteria is broadly resilient and workable.

Why do certain aspects of the proposal need addressing?

- Markets are complex environments and may be likened to machines – all the cogs must be in the right places for the machine to function. Although the proposals put many key elements in place some essential components remain to be added. Without those components, a new robust securitisation market will not be able to function. As a major European auto-manufacturer remarked in this context: "Just because you have 90% of the essential parts of a motor in place does not mean that the car will travel at 90% of the expected speed. You need all the key components there for the car to move at all."

We have shown in a diagram (see Annex) the components that we believe still require work.

- Markets are holistic, not silo-ed. When investors decide where to channel their money, they look at all the available forms of financial instruments choosing the one that best balances risk, reward and cost of investment². This means that, if regulations unfairly penalise one type of investment compared to others whose credit and systemic risks are similar, investors will go to the less regulated or cheaper equivalent instruments. This results in moral hazard, regulatory arbitrage and an absence of interest in the penalised financial instrument. When looking at the current STS and CRR proposals, a holistic approach therefore needs to be applied – not just focusing on the proposed rules but on how those rules compare with the settled prudential rules for other investments of similar credit and systemic risk. The aim should be to ensure as far as possible that funding tools of equivalent risk receive an equivalent prudential treatment³. Otherwise investors will have little incentive to fund the European economy through STS securitisations.

¹ See the EBA report on Qualifying Securitisation, July 2015, Section 1.1.1 and in particular Figure 6, quoting Fitch data.

² A large component of the cost is determined by the costs imposed by regulations – such as capital requirements.

³ One example illustrates the deep inconsistencies amongst investments that exist in prudential treatment: a 30 year pool of European residential mortgages with 80% LTV will attract approximately 3% capital under Solvency 2 while the AAA tranche of a simple, transparent and standardised securitisation *of the same pool* benefiting from credit support will attract 10.5% capital. This is notwithstanding that these AAA European senior tranches suffered no losses whatsoever during the crisis.

- It is important to coordinate the work on the STS regulation with that on the CRR regulation, so that proposals on both regulations are developed consistently. This is why some of the recommendations included here concern the CRR proposals.

In details - What aspects need addressing?

This section seeks to identify the main issues and proposes solutions to address them.

1. Many criteria remain vague or unnecessarily prescriptive

The problem:

A number of the current 55 STS criteria remain very vague making it extremely difficult for issuers, investors and regulators to operate the STS designation and creating a heightened risk of unwelcome and unintended consequences that could unnecessarily damage the market. Some criteria also have been drafted in a manner that would exclude, on their face, very safe, traditional types of assets and securitisation to the detriment of core real economy financing.

By way of example only, the drafting of the criterion excluding defaulted receivables will capture many securitisations of household financing – such as credit cards – where a small portion of assets fall within the technical (but not practical) definition of default. Similarly, the criterion to exclude credit impaired borrowers, as drafted, will catch many extremely well performing assets classes such as car finance and SME equipment finance and leasing. These types of technical drafting issues should and can be resolved by safe amendments such as placing a reasonable low limit on the percentage of securitised assets that fall out of the rule.

A similar issue arises with the criteria required in the CRR proposals in addition to the STS criteria for a transaction to benefit from the better capital requirements, including drafting that limits the capacity of securitisation to help fund key parts of the real economy⁴.

The solution:

A careful examination of the individual STS criteria and the additional CRR criteria will need to be conducted to remove problematic areas of uncertainty and insure that traditional, proven and safe real economy assets and geographies are not accidentally excluded as the result of the technical drafting. Furthermore, clarification of many criteria will need to be made.

2. The lack of grandfathering provisions for STS and retention will cause unwarranted market dislocation and possible losses for existing investors

The problem:

With 55 highly technical criteria defining STS, almost no existing securitisations will qualify as STS, even if they very substantially conform to the actual requirements of an STS designation. The same risk exists with securitisations that conform, in all material respects, with the existing retention (“skin in the game”) and due diligence provisions but may be caught out by highly

⁴ Such as, for example, restrictions on high quality Dutch mortgages or the benefits granted (in the proposed art. 270 CRR) to SME finance

technical changes to those rules. This could cause an arbitrary division amongst fundamentally similar instruments. It may also result in very substantial divestments of otherwise sound securities as investors can no longer hold these securities (or hold them at an acceptable cost). This, in turn, would destabilise markets and cause losses to conservative investors for no discernible prudential benefit and at a time when the European financial markets and economy remain in a fragile state.

The solution:

Simple, short-form rules should be introduced to allow existing securitisations that are fundamentally STS to be treated as such, notwithstanding minor technical issues. Also changes should not be imposed in the treatment of securitisations that comply with the existing retention (“skin in the game”) rules.

3. Lack of a holistic approach for investor due diligence creates high barriers to entry for investors seeking to invest in a simple, transparent and standardised securitisation designed to fund the real economy

The problem:

As a legitimate reaction to the crisis, additional and very substantial, due diligence rules were imposed on investors. With the creation by the EU authorities of a simple, transparent and standardised securitisation category reflecting the outstanding actual performance of this product through and since the crisis, rules for investor due diligence require to be meaningfully recalibrated for STS securitisations. Also, when investors, such as insurance companies and pension funds, place money with professional investment funds they delegate purchasing decisions to these regulated professional bodies under a specific mandate. A quirk of the current STS drafting prevents such end investors from delegating the due diligence on securitisations purchased by these regulated market participants on their behalf. This results in a major, unnecessarily duplicative and costly process as, effectively, the same due diligence is carried out multiple times over the same investment risk, creating a strong disincentive to invest.

The solution:

In line with the holistic approach, the rules for STS securitisations should align with those of other simple and transparent products. In addition regulated asset-managers should be entitled to perform the due diligence on the assets they are delegated to select and purchase on behalf of end investors.

4. Originator/sponsor STS compliance attestation must focus on clear and controllable requirements

The problem:

The principle that originators and sponsors should attest to compliance and that negligent or fraudulent failures in attestation should be sanctioned is accepted. Originators and sponsors should however be held to account only for what they know and control i.e. the nature of the securitised assets and the structure of the transaction.

The current proposals require them to attest to the conformity of their issuance with the STS definition itself - in effect the individual 55 sub-components of the STS definition to be deployed

across asset types and jurisdictions whereas e.g. a SME loan has different operational modalities than a mortgage. This complex definition will be subject to regulatory interpretation. Many originators and sponsors will have serious and legitimate concerns about attesting in this fashion, given the potential for ultimately very heavy sanctions.

The solution:

- (a) component attestation – originators and sponsors should be required to attest to the individual components of the STS definition instead of to interpretations of the STS designation.***
- (b) if originators or sponsors get an independent, regulated third party certification agent to validate their interpretation of the rules but, ex post facto, a regulator disagrees with this interpretation, there should be in the rules at least a presumption of innocence from wrongdoing assuming a “negligence or omission” standard of liability.***

5. STS compliance must be clear to investors and consistently applied across the European Union and transactions

The problem:

There needs to be a sound basis to give most investors the confidence to participate in the resurrection of the European securitisation market. Many investors have indicated their support for regulated independent third parties to support the new STS regime.

As currently proposed the new STS proposals leave investors with duplicative, costly and inefficient new mechanical compliance burdens – reducing small institutional investor participation and creating disincentives across all investor groups. We believe strongly that the best way to avoid this is for the authorities to appoint and regulate independent, credible bodies to issue certifications of STS compliance under appropriate supervision.

STS compliance certification must be strictly distinguished from investor credit due diligence. Credit due diligence is a core investor fiduciary responsibility whereas compliance certification is not. Auditors certify financial statements, investors analyse those statements and take investment decisions on the basis of their contents.

The solution:

Establish a regulatory framework to oversee independent third party certification mechanism of STS compliance similar to other mechanisms approved by the Parliament such as APAs and CTPs in MiFiD. The use of such third parties though should not be mandatory and there should be multiple players authorised to provide such certification services so as to avoid any issues relating to a lack of competition.

6. The choice to leave the STS scheme with a multiplicity of national regulators is problematic

The problem:

National competent authorities have a key role in supervising STS implementation for the regulated entities under their supervision. However, if each regulator is responsible for interpreting the 55 sub-criteria, this risks fragmenting the single market for STS securitisation, even before its inception. The unintended consequence will be that a project designed to

strengthen the European single market will leave it more fragmented along national lines than it currently is.

The solution:

Establish from competent regulatory authorities a permanent, effective and swift European single point of interpretation to harmonise interpretation of STS criteria. This single point could be an existing regulatory body or a college of such regulatory bodies.

7. Maturity caps on underlying exposures and disproportionate public disclosure requirements for asset backed commercial paper conduits (“ABCP conduits”) do not match investor and prudential needs and will materially reduce this important market

The problem:

ABCP conduits are a meaningful source of funding for SMEs, trade, car and equipment leases and loans and have a strong connection to the real economy. It is estimated that European ABCP programmes provide roughly €125bn of working capital to companies throughout Europe – many of which are SMEs, unlisted, and unrated firms.

Only “fully supported” ABCP conduits can fulfil the STS criteria – meaning STS ABCP is a very short-term investment effectively guaranteed by a sponsor bank. The sponsor bank takes all the credit risks of the underlying securitisations and the investors only take the risk of the sponsor bank.

The current proposal includes a restriction on the maturity of assets that can be financed by conduits, which will artificially close this type of financing to certain types of assets currently funded in this way, such as, for example certain car loans, equipment leases or longer dated SME loans. These types of assets currently represent more than 50% of the assets currently financed by such conduits. This, as a means of addressing embedded maturity transformation, is unnecessary since the maturity risk for the investor lies entirely with the continued solvency of the sponsor bank and not the duration of the assets. As for the sponsor bank, all maturity mismatch risks, including those of sponsored ABCP conduits, are already covered by other prudential rules – namely the CRR liquidity cover ratios and net stable funding ratios.

In addition, because most ABCP conduit transactions are private transactions, the current proposal would require investors to receive significant and detailed public data disclosures of sensitive information which will be disproportionate and not relevant to investors when performing due diligence. This is also a concern for other forms of private transactions. This issue is sufficiently sensitive that some originators have stated that they will cease financing in this way should such public disclosure be required.

Finally, the combination of a too-narrowly drawn definition of STS for ABCP conduits and the likelihood that under the proposed MMF regulation money market funds will only be allowed to invest in ABCP conduits which qualify as STS, risks driving this large category of investors from this market entirely.

The solution:

The maturity cap on assets for STS ABCP programmes and equivalent forms of funding should be omitted or substantially extended and the disclosure requirements should reflect the different characteristics of this financial instrument and needs of the investors. Sponsor banks need to perform the due diligence expected of an investor in

an STS securitisation but, while attention should be paid to the broad composition of the underlying assets in the conduit, investors' due diligence should primarily focus on the risk they actually take, namely the sponsor bank.

8. Proposed revisions to the CRR capital framework remain a major disincentive for banks holding STS securitisations and for banks originating STS securitisations

The problem:

The proposed revisions of the SEC-ERBA calibrations included in the CRR revisions assume that an STS securitisation would be between 2 and 5.5 times more risky than the sum of the risk of each underlying asset taken separately. This assumption is made despite the compliance with the 55 sub-criteria of the STS definition, which have been selected to remove structural risks in the securitisation⁵. It also comes on top of the regulations already introduced since the crisis (namely the ban on re-securitisations, retention requirements and transparency).

Banks are not incentivised to originate securitisation as they cannot reach economic efficiency to reduce their capital in a commensurate way even if they transfer a significant part of the risk of the portfolio, as the mechanical increase of the capital due to the securitisation calibration makes this virtually impossible. The proposed STS calibration would not make a significant change from the current level (albeit it would be a reduction from the proposed Basel calibration which increases capital requirements from the current level and are to be used for non-STS securitisation.)

The hierarchy of approaches proposed by Commission implies that most institutions would be obliged to use the external rating based approach (SEC-ERBA) without any flexibility. This approach is not recalibrated when external rating agencies change their rating methodologies, and in many cases provides capital requirements not commensurate with the risk of the underlying portfolio, particularly for SMEs.

The solution:

The capital calibration should accurately take into account the benefit of application of the STS criteria. This might be done through some corrections in the current formulae such as:

- ***the removal of the double counting of maturity risk in SEC-ERBA;***
- ***changing some of the arbitrary numbers that generate requirements that are multiples of the observed risk for STS securitisations;***
- ***allowing European banks to use proxy data to estimate credit risk in a more effective way (as already proposed by Basel);***
- ***creating flexibility amongst the mandated methodologies so European banks can use the SEC-SA approach instead of the SEC-ERBA approach when the SEC-ERBA results are not commensurate with the actual risk of the securitised assets.***

⁵ For a more complete discussion of the issue of non-neutrality, one can consult the "EBA report on qualifying securitisations" pages 90 et seq.
(<http://www.eba.europa.eu/documents/10180/950548/EBA+report+on+qualifying+securitisation.pdf>)

This would bring the capital requirements closer in line with the actual risks of STS securitisations. The approach should reflect the holistic principle that investments with similar risk profiles attract similar levels of prudential capital.

9. The very severe consequences of securitisations losing their STS status as a result of ex post facto changes risks creating a very unstable system with substantial cliff-effects

The problem:

Competent regulatory authorities must be the final arbiters of what is STS. However, because of the multiplicity of rules and the complexities of markets, as well as the traditional regulatory approach of not providing ex ante clearance, there is a material risk that securitisations legitimately and in good faith believed to be STS could lose this status through ex post facto re-characterisation on very narrow technical grounds. The severe consequences for investors of such potential lack of stability and resultant cliff-effects will make it difficult for them to invest.

The solution:

Reasonable and safe regulatory mitigants should be introduced to reduce these cliff-effects. Also, minor non-compliance with STS criteria with no material impact on the securitisation should lead to proportionate capital penalties and not to the de-classification of securitisation.

10. There is an urgent need for a completion of the STS project by the addition of the remaining parts of the construction

The problem:

Securitisation must be able to encourage banks to generate additional lending. For the STS project to assist in revitalising the European economy, the benefits of this form of simple, transparent and standardised financing must be available to a wide array of potential investors. Currently, only the CRR capital requirements for bank investors are the subject of proposals. The Commission, quite rightly, sees the need to additionally amend other parts of the regulatory framework. Considering the urgent need to restore the flow of finance to the European economy and to unblock bank lending, we urge that no time be wasted in drafting the necessary additional changes to the existing texts to make them fit for purpose and the work on this start immediately.

The changes that will be required include capital calibrations for insurance companies under Solvency 2 that need to better reflect the actual risks that insurance companies are exposed to when investing in STS securitisations and which is often default risk and not spread risk; modifications to the rules on Liquidity Coverage Ratio eligible assets under CRR; modifications to ensure that assets securitised in transactions meeting appropriate criteria are excluded from the calculations of bank assets for leverage ratio purposes.

The solution:

The work should begin immediately and be swiftly completed to ensure that a safe securitisation market can be put in place as soon as possible to assist in unblocking the lending channels to the European economy.

Conclusions

The European economy is in a clear need of additional funding provided in a systemically safe and stable form. Europe also will need to diversify its funding mechanisms as part of the efforts to create a safer and better shared financial system. Securitisation, established on a simple, transparent and standardised basis and appropriately regulated has the potential very substantially to assist with these goals. The outstanding performance of these types of European securitisations throughout the crisis attest to that fact.

The Commission proposals go a long way towards achieving such a safe and robust securitisation model able to provide funding to the economy.

As set out earlier in this letter, markets are holistic environments where all the essential parts have to be present and in the right place for any movement to take place. Currently, a few such essential parts remain absent from the proposed structure. Meanwhile, there are too many risks due to regulatory and legislative uncertainty and too few incentives in terms of appropriate capital rules, LCR rules, leverage ratio rules for banks to use this funding channel and for investors to invest through this funding channel into the European economy.

Signatories⁶



⁶ The associations listed above have signed on behalf of all their members as they support this submission. Some of those members also wished to be listed as signatories in an individual capacity.

Annex

A Simple , Transparent and Standardised European ABS market requires four pillars

